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THE RELATIONSHIP BETWEEN CORPORATE DISCLOSURE AND CORPORATE RESPONSIBILITY

THOMAS J. SCHOENBAUM*

I. INTRODUCTION

UNTIL recently, the field of corporation law was viewed by many as a relatively settled, albeit complex, body of rules designed to provide a framework for the conduct of business activity. As such it was primarily of interest to the corporate bar whose business it was to advise corporate leaders how to attain their desired goals without breaking any of the rules of the system. The framework itself was of ancient vintage and largely devoid of any significant policy content.

Such a characterization is no longer appropriate. A series of policy-oriented laws and judicial decisions have wrought fundamental changes in the relative rights and duties of officers, directors and shareholders, and in the relationship of the corporation to the external world. In 1964, Congress extended the federal securities registration requirements in the Securities Exchange Act of 1934¹ to over-the-counter securities, imposing regulation analogous in substance to federal incorporation.² The continuing development of case law under rule 10b-5³ promulgated pursuant to section 10(b) of the Securities Exchange Act⁴ has added to the fiduciary duties of corporate officers and directors.⁵ State court decisions have also redefined the fiduciary duties of corporate insiders⁶ and the responsibility of majority shareholders to the minority.⁷ Expanded powers have been granted to shareholders of corporations as a result of several

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1. 15 U.S.C. §§ 78a to 78hh-1 (1970).

2. Loss, *The American Law Institute's Federal Securities Code Project*, 25 *Bus. Law.* 27, 29-30 (1969).

3. 17 C.F.R. § 240.10b-5 (1971).

4. 15 U.S.C. § 78j (1970).

5. The leading case is, of course, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Subsequent developments and cases are summarized in A. Bromberg, *Securities Law: Fraud—S.E.C. Rule 10b-5* (1969).

6. See, e.g., *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

7. See, e.g., *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

decisions based upon the proxy rules of the Securities and Exchange Commission.⁸

These and other developments in the law, as well as the continuing crisis in American society—an unpopular war, unemployment, racial conflict and environmental degradation—have produced a movement to examine the fundamental principles underlying the body of corporate law with a view to their policy basis. The new focus centers on how corporations are actually constituted, the real process of corporate decision-making and the role of the corporation in society. Thus, Professor Eisenberg, in a brilliant series of articles,⁹ has carried out a fundamental reassessment of what he calls the “received legal model” for corporate decisionmaking. Several other authorities have made searching inquiries into the problem of corporate responsibility and the relationship of the corporation to the external world.¹⁰

This article will attempt to carry forward the movement inquiring into the fundamental principles of corporate law. It will focus on the pervasive concept of corporate disclosure in the federal securities laws and examine the relationship between disclosure, corporate responsibility and the “received legal model” for corporate decisionmaking. The article will summarize the present state of corporate disclosure requirements under the federal securities laws, consider the theoretical bases of disclosure, and offer suggestions for the implementation of greater disclosure requirements for corporations.

II. CORPORATE DISCLOSURE REQUIREMENTS UNDER THE FEDERAL SECURITIES LAWS¹¹

A. *Disclosure Under the Securities Act of 1933*¹²

A corporation first comes under federal disclosure requirements when it

8. The leading cases are: *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated and remanded for dismissal as moot, 92 S. Ct. 577 (1972).

9. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 *Calif. L. Rev.* 1 (1969); Eisenberg, *Access to the Corporate Proxy Machinery*, 83 *Harv. L. Rev.* 1489 (1970); Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 *Harv. L. Rev.* 1577 (1971).

10. There is more research and writing on this subject at the present than at any time since the 1930s. E.g., Blumberg, *Corporate Responsibility and the Social Crisis*, 50 *Boston U.L. Rev.* 157 (1970); Blumberg, *The Politicalization of the Corporation*, 26 *Bus. Law.* 1551 (1971); Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Responsibility*, 21 *Stan. L. Rev.* 248 (1969); Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 *Mich. L. Rev.* 421 (1971).

11. Since these requirements are generally well known, they will be dealt with in summary form with the emphasis placed on certain developing and problem areas.

12. 15 U.S.C. §§ 77a to 77aa (1970).

issues securities.¹³ Unless exempted,¹⁴ no sale of a security may be made unless a registration statement is in effect with respect to the security.¹⁵ Since securities generally cannot be registered "for the shelf,"¹⁶ a new registration statement must be prepared and filed by the corporation each time securities are issued. Although the security, not the company, is required to be registered, most of the information required in a registration statement concerns the company. This includes information about the management and controlling shareholders of the issuer, the character of its business, its earnings history and capital structure, pending or threatened legal proceedings, the planned use of the proceeds of the offering, and financial statements certified by independent accountants.¹⁷

The registration requirement is enforced through the supervisory power of the Securities and Exchange Commission, which gives careful attention to each statement filed¹⁸ and has the power to delay or suspend the effectiveness of a registration statement.¹⁹ A material misstatement or omission of material fact in the statement can result in civil and criminal proceedings²⁰ as well as civil liability to innocent purchasers.²¹ In order to assure the dissemination of the information to the public and to potential investors, the Securities Act requires the delivery of a prospectus containing information essentially identical to that in the registration statement.²²

B. *Disclosure Under the Securities Exchange Act of 1934*

The Securities Exchange Act imposes disclosure requirements on corporations in addition to those imposed by the Securities Act. Unlike the Securities Act, the Securities Exchange Act requires registration of securities of companies of a certain size. Any company having total as-

13. Securities Act § 5, 15 U.S.C. § 77e (1970).

14. Sections 3 and 4 of the Securities Act provide limited exemptions. *Id.* §§ 3 & 4, 15 U.S.C. §§ 77c & 77d (1970).

15. *Id.* § 5, 15 U.S.C. § 77e (1970).

16. Section 6(a) of the Act states that a registration statement "shall be deemed effective only as to the securities specified therein as proposed to be offered." *Id.* § 6(a), 15 U.S.C. § 77f(a) (1970).

17. See Form S-1 Registration Statement under the Securities Act of 1933, in *Securities Regulation Sourcebook 3-1* (Knauss ed. 1970-71).

18. See 1 L. Loss, *Securities Regulation* 265-316 (2d ed. 1961).

19. Securities Act §§ 8(b) & (d), 15 U.S.C. §§ 77h(b) & (d) (1970).

20. *Id.* § 17, 15 U.S.C. § 77q (1970).

21. *Id.* §§ 11 & 12, 15 U.S.C. §§ 77k & 77l (1970).

22. *Id.* § 5, 15 U.S.C. § 77e (1970). The prospectus delivery requirement has never functioned as envisioned in the Securities Act. The Securities and Exchange Commission has recently acted to improve the dissemination and delivery of Securities Act prospectuses. See *Disclosure to Investors—A Reappraisal of Administrative Policies under the '33 and '34 Acts 106-26* (1969) (popularly known as the Wheat Report) [hereinafter cited as *The Wheat Report*]; Posner, *Developments in Federal Securities Regulation*, 26 *Bus. Law.* 1677, 1689-91 (1971).

sets exceeding one million dollars and a class of equity securities held of record by 500 or more persons must register its securities under section 12(g) of the Securities Exchange Act.²³ Securities listed on a national securities exchange are exempt from this requirement, but the issuers thereof are required to register the securities with the exchange, with duplicate originals of the registration statement going to the Securities and Exchange Commission.²⁴ The information required of both classes of issuers is similar and approaches that required in a Securities Act registration statement.²⁵

The information disclosed through initial registration with the Commission is required to be kept up to date. Section 13 of the Securities Exchange Act²⁶ provides that all companies subject to registration under section 12 of that Act, as well as certain other companies having registered securities under the Securities Act, must file periodic reports. Included are an annual report (Form 10-K) which is due 90 days after the close of each fiscal year,²⁷ a quarterly report (Form 10-Q) which must be filed within 45 days of the end of each of the first three quarters of each fiscal year,²⁸ and a current report (Form 8-K) which must be filed within 10 days of the close of any month in which any one of several specified events occurs.²⁹

The Securities Exchange Act also requires all companies whose securities are subject to section 12 to distribute proxy materials to shareholders.³⁰ These materials must disclose information regarding the business, management and financial history of the issuer substantially similar to that contained in the original registration and periodic reports under the Securities Exchange Act. Unlike the disclosures made in the latter documents, the information contained in the proxy materials reaches the shareholders since the materials are actually sent to them. If a proxy solicitation is made on behalf of management regarding an annual meeting at which directors are to be elected, the proxy materials must be accompanied or preceded by an annual report which can be in any form

23. 15 U.S.C. § 78l(g) (1970).

24. Securities Exchange Act § 12(b), 15 U.S.C. § 78l(b) (1970).

25. 17 C.F.R. § 249.210 (1971).

26. 15 U.S.C. § 78m (1970).

27. SEC Securities Exchange Act Release No. 9000 (Oct. 21, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,919, at 80,048.

28. Id. No. 9004 (Oct. 28, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,920, at 80,050.

29. 17 C.F.R. § 249.308 (1971).

30. Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1970). Even if the company does not solicit proxies, substantially equivalent information must be sent to shareholders. Id. § 14(c), 15 U.S.C. § 78n(c) (1970).

deemed suitable by management, but which must contain, with minor exceptions, certified financial statements.³¹

Significant penalties are provided for failure to comply with any of the Securities Exchange Act registration and reporting requirements, including civil proceedings by the Securities and Exchange Commission, criminal prosecution by the Department of Justice and civil actions by private persons.³²

C. *Developing Areas of Disclosure*

1. Coordination of Securities Act and Securities Exchange Act Requirements

In a well known article in 1966,³³ Mr. Milton Cohen proposed a better coordinated system of disclosure by increasing the quality and quantity of disclosure required under the Securities Exchange Act and eliminating unnecessary duplication of disclosure under the Securities Act. This became one of the central themes of the "Wheat Report,"³⁴ a study commissioned by the Securities and Exchange Commission to examine the operation of disclosure under the securities laws. The Wheat Report made specific recommendations for changing the emphasis of disclosure from initial registration to continuous disclosure.

The Commission has either proposed or adopted many of the reforms urged by the Wheat Report. The registration and reporting requirements under sections 12 and 13 of the Securities Exchange Act were revised to provide information similar to that required in a Securities Act registration statement.³⁵ Form 10, the general registration form under the Securities Exchange Act, must disclose a summary of operations for the past five years, the dollar amount of backlog of orders and a greater amount of information relating to management.³⁶ Form 10-K, the principal form used for filing annual reports, must contain a breakdown of sales and contributions to profits attributable to each line of business of the company, as well as more information about properties, management, business history and transactions with insiders.³⁷

The Commission has also changed the interim reporting requirements

31. 17 C.F.R. § 240.14a-3 (1971).

32. Securities Exchange Act §§ 10, 18 & 21(e), 15 U.S.C §§ 78j, 78r & 78u(e) (1970).

33. Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340 (1966).

34. See note 22 supra.

35. 15 U.S.C. §§ 78l & 78m (1970).

36. SEC Securities Exchange Act Release No. 8996 (Oct. 14, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,914, at 80,034.

37. Id. No. 9000 (Oct. 21, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,919, at 80,048-49.

under the Securities Exchange Act. Form 9-K, used for the filing of semi-annual reports, was rescinded and a new Form 10-Q has been adopted for use in filing the required quarterly reports.³⁸ Uncertified financial information must be disclosed in this form as well as information regarding the capitalization of the company.³⁹ The Commission is also studying Form 8-K, which is used in the prompt reporting of certain specified events, and will probably revise it or incorporate it into an expanded Form 10-Q.⁴⁰

Substantial progress was made toward making Securities Act registration requirements less burdensome in cases in which information normally required in a registration statement was already available through the Securities Exchange Act system of disclosure. Amendments to Form S-7, a short form adopted in 1967 for registration of securities of well established companies under the Securities Act, make it available to a larger class of issuers.⁴¹ The period during which the registrant must have been subject to and complied with the Securities Exchange Act reporting and proxy requirements has been shortened from five years to three years.⁴² The requirement that the registrant must have engaged in business of substantially the same general character since the beginning of its last five fiscal years was eliminated.⁴³ The minimum gross sales or gross revenues requirement was deleted and the minimum net income test was lowered.⁴⁴ A new Form S-16 was also adopted for securities of any issuer meeting the Form S-7 requirements; it may be used for offerings by selling security holders on a national securities exchange, offerings by an issuer to holders of convertible securities of an affiliate which are convertible into securities of the issuer, and offerings regarding publicly held warrants.⁴⁵

These changes were accompanied by Securities and Exchange Commission steps to increase the dissemination of information available under the Securities Exchange Act. In 1968 a microfiche system was instituted under which a subscriber to the service is able to receive copies of filed documents reproduced on a relatively inexpensive sheet of film containing photographic images of up to 60 pages of material.⁴⁶ As a result, sub-

38. Id. No. 9004 (Oct. 28, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,920, at 80,050.

39. Id.

40. Id.

41. SEC Securities Act Release No. 5100 (Nov. 12, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,927, at 80,059.

42. Id.

43. Id.

44. Id.

45. Id. No. 5117 (Dec. 23, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,941, at 80,094-95.

46. See The Wheat Report 313-18.

scribers are able to obtain copies of Securities Exchange Act reports shortly after they are filed with the Commission.

There is every indication that these changes are only the beginning of what will be one of the major efforts of the Commission in the years ahead. The ultimate goal is to drastically increase the amount of information a company must disclose on a continuing basis, the dissemination of this information, and the number of companies required to make such disclosure. These ends will probably not be fully realized, however, until the completion of the project to recodify the federal securities laws.⁴⁷

2. Securities and Exchange Commission Encouragement of Disclosure Going Beyond Statutory Requirements

The Securities Exchange Act provisions for continuous reporting are applicable only to companies having securities listed on a national exchange,⁴⁸ companies with total assets exceeding one million dollars and having a class of equity securities held of record by 500 or more persons,⁴⁹ and certain additional companies which have filed a registration statement under the Securities Act.⁵⁰ In recent months, however, the Securities and Exchange Commission has exercised its rulemaking power to encourage companies which do not fall into one of the above categories to "voluntarily" subject themselves to the Securities Exchange Act requirements. This has been primarily accomplished through two recent Commission releases.⁵¹

In adopting rule 15c2-11⁵² under section 15(c) of the Securities Exchange Act,⁵³ the Commission intended to curb the abuses of certain companies "going public" without registration by utilizing a shell corporation or certain spin-off devices. The scope of the rule is quite broad, however, prohibiting a broker-dealer from submitting any quotation for any security to any quotation medium without assuring that meaningful financial information is publicly available either through the registration and reporting requirements of the Securities Act and the Securities Exchange Act, or by the broker-dealer himself providing specified informa-

47. See Loss, *The Current Status of SEC Codification*, 26 *Bus. Law.* 555 (1970).

48. Securities Exchange Act § 12(b), 15 U.S.C. § 78l(b) (1970).

49. *Id.* § 12(g), 15 U.S.C. § 78l(g) (1970).

50. *Id.* § 15(d), 15 U.S.C. § 78o(d) (1970).

51. SEC Securities Act Release No. 5223 (Jan. 11, 1972), CCH Fed. Sec. L. Rep. ¶ 78,487, at 81,049; SEC Securities Exchange Act Release No. 9310 (Sept. 13, 1971), CCH Fed. Sec. L. Rep. No. 387, at 49 (extra ed., Sept. 15, 1971). See notes 52-56 *infra* and accompanying text.

52. SEC Securities Exchange Act Release No. 9310 (Sept. 13, 1971), CCH Fed. Sec. L. Rep. No. 387, at 49 (extra ed., Sept. 15, 1971).

53. 15 U.S.C. 78o(c)(2) (1970).

tion similar to that available in Securities Exchange Act reports.⁵⁴ The obvious practical effect of this rule is to provide a great incentive for all companies whose stock is publicly traded to subject themselves to the Securities Exchange Act reporting requirements even though they are not required to do so by statute.

Rule 144,⁵⁵ the newly adopted letter stock rule of the Commission, attempts to provide more objective and policy oriented tests for permissible sales by control persons and resales by private purchasers. The rule distinguishes between securities of companies for which public information is available under the Securities Exchange Act requirements or new rule 15c2-11, and securities of all other companies. The use of rule 144 in large measure is limited to holders of securities of companies in the former category.⁵⁶ This creates additional pressure on companies to voluntarily subject themselves to continuous public disclosure requirements.

3. Disclosure Relating to the Environment and Civil Rights

The Commission has responded to contemporary concern about industrial pollution and discrimination against minority groups in employment in a recently issued release.⁵⁷ Issuers subject to the Securities Act or the Securities Exchange Act must disclose, if material, when compliance with new environmental laws may necessitate significant outlays of capital affecting the earning power or nature of the business. Companies must also disclose material legal proceedings arising out of various anti-pollution laws. In the area of civil rights, disclosure is required as to material legal proceedings which may result in the cancellation of a government contract or a change in the nature of the business done.⁵⁸

Although the Commission announced this release as its response to changing national priorities, it is evident that little more is required under the new release than was already necessary under prior laws and regulations. Perhaps the only thing new is the requirement that any information relating to these two areas which is omitted from a filing must be disclosed to the Commission with the reasons for its omission.⁵⁹

54. The new rule specifies 16 categories of disclosure which the broker-dealer must furnish concerning the company.

55. SEC Securities Act Release No. 5223 (Jan. 11, 1972), CCH Fed. Sec. L. Rep. ¶ 78,487, at 81,049.

56. *Id.*

57. SEC Securities Act Release No. 5170, Securities Exchange Act Release No. 9252 (July 19, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,150, at 80,487.

58. *Id.* at 80,488.

59. *Id.* The Commission may thus use its supervisory power to compel disclosure.

4. The Obligation of Affirmative Timely Disclosure

In addition to disclosure obligations arising under the provisions of the Securities Act and the Securities Exchange Act, disclosure requirements are maintained by the major stock exchanges for issuers of listed securities⁶⁰ and by the National Association of Securities Dealers for issuers of over-the-counter traded stock.⁶¹ These rules and policies express a general policy that companies are to make timely disclosure of material business developments.⁶² It is generally assumed that there is no legal obligation of corporate disclosure under these rules,⁶³ but enforcement by a stock exchange of its timely disclosure policies will be upheld.⁶⁴

Another source of a timely disclosure requirement may be rule 10b-5⁶⁵ under section 10(b) of the Securities Exchange Act.⁶⁶ Although it is well established that a corporation may be liable under rule 10b-5 for a disclosure that is materially misleading or omits to state a material fact, it is unsettled whether rule 10b-5 creates an affirmative obligation to make public disclosure of corporate developments going beyond the continuous reporting requirements of the Securities Exchange Act.⁶⁷ Two recent Securities and Exchange Commission releases seem to recognize a limited duty of affirmative disclosure under rule 10b-5.

In an October 1970 release,⁶⁸ the Commission spoke approvingly of the timely disclosure requirements of the major exchanges and implied that rule 10b-5 imposed a similar obligation. Despite some ambiguous language that would lead to a more conservative interpretation,⁶⁹ the Commission clearly stated that there is an affirmative obligation to make prompt dis-

60. American Stock Exchange Company Guide § 401, at 101 (1968); N.Y. Stock Exchange Company Manual § A 2, at A-18 (1968).

61. National Association of Securities Dealers Manual ¶ 2155, at 2073 (1971).

62. The New York Stock Exchange requires companies to "release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities." N.Y. Stock Exchange Company Manual § A 2, at A-18 (1968).

63. Alberg, SEC Disclosure Requirements for Corporations, 26 Bus. Law. 1223, 1224 (1971).

64. *In re Intercontinental Indus., Inc.*, SEC Securities Exchange Act Release No. 8858 (April 3, 1970), [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,827, at 83,911.

65. 17 C.F.R. § 240.10b-5 (1971).

66. 15 U.S.C. § 78j (1970).

67. Because nearly all public corporations now maintain a continuous flow of information, the distinction may be unimportant. See Alberg, *supra* note 63, at 1225.

68. SEC Securities Act Release No. 5092, Securities Exchange Act Release No. 8995, Investment Company Act Release No. 6209 (Oct. 15, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,915, at 80,035.

69. See Posner, *supra* note 22, at 1710.

closure of material facts regarding the company's financial condition.⁷⁰ It will be up to the courts to reconcile the view expressed by the Securities and Exchange Commission release with the existing view that affirmative disclosure is not required where there is a valuable corporate purpose not to disclose.⁷¹

In a subsequent release dated August 1971,⁷² the Commission issued guidelines for the disclosure of information by issuers whose securities are in the process of registration under the Securities Act. The release strongly reaffirms the Commission's mandate in prior releases and rules⁷³ that corporate information channels are to be kept open during the registration process. According to the release, factual information relating to business and financial developments must be continuously disclosed by the issuer both voluntarily and in response to unsolicited inquiries from stockholders and the press.⁷⁴ Only predictions, projections, estimates and opinions concerning value are not to be disclosed.⁷⁵

Unfortunately, the August release leaves open two serious questions of disclosure which may arise in the period during which an issuer's securities are in the process of being registered under the Securities Act. First, little guidance is provided with regard to when the release of corporate information during this period will be considered an "offer" in violation of section 5(c) of the Securities Act.⁷⁶ The release states that this will continue to be determined on a case-by-case basis considering the facts and circumstances surrounding each case;⁷⁷ presumably, however, an issuer which makes certain that its disclosures are within the guidelines set out by the release will be afforded some protection.

A second and related question, also left open by the August release, is

70. SEC Securities Act Release No. 5092, Securities Exchange Act Release No. 8995, Investment Company Act Release No. 6209 (Oct. 15, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,915, at 80,035.

71. Affirmative disclosure is required, however, if the corporation or insiders are purchasing or selling the corporation's securities or if nondisclosure would cause a prior release of information to be misleading. See Alberg, *supra* note 63, at 1224.

72. SEC Securities Act Release No. 5180 (Aug. 16, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,192, at 80,578.

73. See, e.g., SEC Securities Act Release No. 5101, Securities Exchange Act Release No. 9010 (Nov. 19, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,929, at 80,061, which clarifies the permissible scope of circulation of information by issuers and broker-dealers prior to and immediately subsequent to the filing of a Securities Act registration statement.

74. SEC Securities Act Release No. 5180 (Aug. 16, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,192, at 80,579.

75. *Id.*

76. 15 U.S.C. § 77e(c) (1970).

77. SEC Securities Act Release No. 5180 (Aug. 16, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,192, at 80,580.

the extent to which the newly developing obligations to make timely disclosure will conflict with the statutory obligation to refrain from publishing information amounting to a prohibited offer during the registration period. The Commission considers this possible difficulty "more apparent than real,"⁷⁸ but as *Chris-Craft Industries, Inc. v. Bangor Punta Corp.*⁷⁹ shows, it may be a difficult problem, and it will probably be necessary for the Commission to face this question directly at some future time.

III. THE THEORETICAL BASES OF CORPORATE DISCLOSURE REQUIREMENTS

Considering the pervasiveness of the concept of disclosure in the federal securities laws, it is surprising that there has been relatively little examination of the purpose of the doctrine either in the legislative history of the acts or in the writings of the commentators. The principal controversy at the time the Securities Act was passed was whether to adopt the disclosure approach to securities regulation or to grant governmental authorities the power to pass on the merits of an issue of securities.⁸⁰ Disclosure, of course, ultimately prevailed, chiefly because it was the theory of the English Companies Act⁸¹ and because governmental regulation was thereby minimized.⁸² One can, however, identify three fundamental reasons for disclosure requirements: investor protection, the creation of a free and open securities market, and the raising of standards of conduct of corporate fiduciaries.

A. *Investor Protection*

To those responsible for the drafting and passage of the securities acts, the principal objective of disclosure was to protect the investor. The effort was to assure the potential purchaser of a security that he could obtain adequate information regarding the security and furthermore that

78. *Id.* at 80,579.

79. 426 F.2d 569 (2d Cir. 1970). In this case *Chris-Craft* sought to enjoin an exchange offer because of a press release which allegedly violated section 5(c) of the Securities Act. The defendant's response was that the press release, which contained the value of the exchange offer, was required by rule 10b-5 and section 10(b) of the Securities Exchange Act. The court resolved the question by stating that disclosure was not required under 10b-5 because the value of the exchange was not material. Thus, a violation of section 5(c) and Rule 135 was found. *Id.* at 574. The dissent vigorously criticized the majority's finding that the value of the exchange offer was not material to a reasonable investor. *Id.* at 580.

80. *Heller*, *Disclosure Requirements Under Federal Securities Regulation*, 16 *Bus. Law.* 300, 301 & n.6 (1961); *Landis*, *The Legislative History of the Securities Act of 1933*, 28 *Geo. Wash. L. Rev.* 29, 30-34 (1959).

81. 11 & 12 *Geo.* 6, c. 38 (1948).

82. *Heller*, *supra* note 80, at 301; see *A. Schlesinger*, *The Age of Roosevelt: The Coming of the New Deal 441-42* (1958).

the information would not be fraudulent or misleading.⁸³ A need was recognized for the law to intervene in the free market on the side of the customer, the "consumer" of securities because, unlike most consumer goods, the value of a security can not be adequately determined by physical inspection or use. The customer therefore had to be provided with a detailed description of the product.⁸⁴

The basis for the necessity of governmental intervention to aid the purchaser of securities had been provided by many scholars of the period. Attention had been called to the degree of concentration of business activity in corporate "giants" managed by a small group of professionals.⁸⁵ This phenomenon, coupled with a trend toward greater dispersion of stock ownership among ever increasing numbers of people, led to the realization that there was a separation of ownership from control in the modern business corporation.⁸⁶ Small management groups were responsible for the handling of "other people's money."⁸⁷ There was a widespread feeling in 1933 that the system as a whole had failed and that the investor had to be protected.⁸⁸

It is interesting to note then, that the primary objective of the reformers was not corporate disclosure but securities disclosure. The required information regarding the management and business of the issuer was only incidentally required as a necessary adjunct to disclosure regarding the security. The fact that at the point of departure in the American law of securities regulation the primacy of the idea of full corporate disclosure was overlooked has contributed to the problems concerning disclosure in the ensuing years.

B. *The Creation of a Free and Open Securities Market*

Another basis for requiring disclosure relating to securities is to ensure that the securities markets will operate in a free and open fashion. This purpose is closely related to protection of the investor in that it makes possible an intelligent choice on his part. The availability of information

83. See Message of President Franklin D. Roosevelt to Congress on March 29, 1933, in H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933); Heller, "Integration" of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934, 29 *Law and Contemp. Prob.* 749, 768 (1964); James, *The Securities Act of 1933*, 32 *Mich. L. Rev.* 624, 632 (1934).

84. Hetherington, *supra* note 10, at 263.

85. See 1 L. Loss, *supra* note 18, at 8-10.

86. A. Berle & G. Means, *The Modern Corporation and Private Property* (1932). A revised edition of this work was published in 1968.

87. L. Brandeis, *Other People's Money and How the Bankers Use It* (1914).

88. See A. Schlesinger, *supra* note 82, at 434 for a discussion of the 1933 investigation into banking, stock exchange, and security practices by Ferdinand Pecora, Counsel to the Senate Banking and Currency Committee.

also helps assure that the price of a security will more nearly correspond with its actual value.⁸⁹

The concept of assuring a free and open securities market also has the aim of improving the allocative efficiency of the capital markets. The economic function of a capital market is to channel capital from economic units with a surplus of funds to economic units which can use such funds most productively.⁹⁰ Thus, a goal of disclosure policy is to avoid possible interruptions of securities markets by assuring that all investors have equal access to information.⁹¹ With full information, investors will tend to make wiser investment decisions, thereby allocating capital resources more efficiently. Furthermore, it is posited that the operational efficiency of the securities markets will be improved as well, allowing the securities industry to produce a given service at the lowest possible cost.⁹²

Whether full disclosure does in fact improve the efficiency of the securities markets is a question that will not be resolved without additional empirical research. The research performed to date appears to be inconclusive. While data developed by some economists indicates that public disclosure of information about corporations does not have a significant effect upon the market prices of securities,⁹³ and the cost of regulating insider trading exceeds the benefits of regulation,⁹⁴ other economists have put forth findings which suggest that the economic performance of the securities markets has improved since the advent of regulation.⁹⁵

Operational and allocational efficiency is bound to increase in importance as a purpose of disclosure and of securities regulation. Research is needed regarding the optimum pattern of disclosure for the attainment of maximum efficiency. How this goal is to be balanced with regard to other possibly conflicting aims of regulation must be determined.

C. *Assuring Higher Standards of Fiduciary Conduct by Corporate Managers*

At the time of the passage of the securities acts, the more perceptive writers noted that these acts would have an effect on the conduct of

89. See James, *supra* note 83, at 632; Knauss, *A Reappraisal of the Role of Disclosure*, 62 Mich. L. Rev. 607, 614 (1964); The Wheat Report 50.

90. Friend, *The SEC and the Economic Performance of Securities Markets*, in *Economic Policy and the Regulation of Corporate Securities* 185, 187 (H. Manne ed. 1969).

91. West, *Timely Disclosure—The View from 11 Wall Street*, 24 Sw. L.J. 241, 246 (1970).

92. Friend, *supra* note 90, at 192-94.

93. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in *Economic Policy and the Regulation of Corporate Securities* 23 (H. Manne ed. 1969).

94. Demsetz, *Perfect Competition, Regulation, and the Stock Market*, in *Economic Policy and the Regulation of Corporate Securities* 1, 11-17 (H. Manne ed. 1969).

95. E.g., Friend, *supra* note 90.

corporate insiders.⁹⁶ Since more of their actions would be subject to public view through disclosure, there would be a tendency for corporate managers to avoid conflicts of interest and questionable business practices.⁹⁷ This has now been generally accepted by the Securities and Exchange Commission as a major goal of disclosure.⁹⁸ By opening matters to public scrutiny, societal standards as to what is permissible conduct will actually be raised, thereby constituting a check on the manner in which a corporate manager may handle other people's money.

D. *Disclosure and Corporate Responsibility*

In recent years a new policy basis for corporate disclosure has emerged. Its scope is not yet clear and it has not yet received formal recognition in the law, but its significance cannot be underestimated. This is the idea, first expressed by Professors Cary⁹⁹ and Knauss,¹⁰⁰ that disclosure has a role in regulating corporations as major power centers of our society. Acceptance of this wider role of disclosure to any degree is to say that there is a direct relationship between corporate disclosure under the securities laws and corporate responsibility.¹⁰¹

The novelty of this view should be emphasized. It would mean that disclosure is not merely investor-oriented but society-oriented. The efficient allocation of capital resources is secondary to the ethical and moral aspects of disclosure—and ethics and morality encompass more than merely restraining overreaching by insiders. The heart of the problem is getting at the impact of corporate behavior on society, not only as to its financial affairs, but also in the areas of civil liberties, the environment, health, safety and consumer rights.

Two well entrenched concepts of present securities law prevent the further development of disclosure as an instrument of corporate responsibility. First, the securities acts require registration of securities, not companies; second, disclosure is conceived of as relating merely to investors and the investment community. The validity of these propositions is questionable.

1. Registration of Companies, Not Securities

In 1969, Professor Loss stated that it was time to think in terms of registering companies, not securities, under the federal securities laws.¹⁰²

96. E.g., Frankfurter, *Securities Act—Social Consequences*, *Fortune*, Aug. 1933, at 55

97. *Id.*

98. *The Wheat Report* 50-52; see Cary, *Corporate Standards and Legal Rules*, 50 *Calif. L. Rev.* 408, 410-11 (1962).

99. Cary, *supra* note 98, at 419.

100. Knauss, *supra* note 89, at 646-48.

101. See Schwartz, *supra* note 10, at 526.

102. 46 *ALI Proceedings* 259 (1969).

This was regarded as desirable in order to eliminate unnecessary duplication of disclosure under the Securities Act and the Securities Exchange Act and to emphasize and ensure the better dissemination of continuous corporate reporting. As indicated earlier,¹⁰³ this was also a major theme of the Wheat Report.¹⁰⁴ The Securities and Exchange Commission has begun to implement a disclosure system based more on company registration through the promulgation of new Securities Act forms and Securities Exchange Act requirements,¹⁰⁵ and through the installation in 1968 of a microfiche system which allows its subscribers to receive documents containing required information about the corporation shortly after they are filed.¹⁰⁶

There are, perhaps, more basic reasons for changing from securities disclosure to company disclosure. For this inquiry, the experience of other legal systems and in particular the German legal pattern of company disclosure is instructive.¹⁰⁷ In Germany there are disclosure requirements upon incorporation and the issuance of shares as well as continuing disclosure obligations.

a. *The German Pattern: Disclosure upon
Incorporation and Issuance of Shares*

In German law, incorporation of a stock company is not a mere formality; it is an important transaction which includes an obligation of substantial public disclosure. The corporation can exist as a legal person only upon the entry of required information into the trade register (*Handelsregister*).¹⁰⁸ Much of the information is published in the *Bundesanzeiger*, an official government publication, and the documents required in the application for entry into the trade register are available for inspection by members of the public and the court (the *Amtsgericht*, the lowest German court of original jurisdiction) to which application has been made.¹⁰⁹

103. See text accompanying note 34 supra.

104. The Wheat Report 55-64.

105. See text accompanying notes 35-45 supra.

106. See The Wheat Report 313-18; text accompanying note 46 supra.

107. Since at least 1959, the year of the "little revision" of German stock company law, there has been an important movement underway in Germany to require business entities to make increased information about their affairs available to the public. Similar currents have been at work in other European countries and on the supranational level in the European Communities, but the German movement is perhaps the most developed and therefore the most interesting. A. Hueck, *Gesellschaftsrecht* 111-15 (15th ed. 1970).

108. Aktiengesetz § 41(1) (C.H. Beck 1965) [hereinafter cited as AktG]. The Aktiengesetz has been published in a bilingual edition. See Aktiengesetz 1965: *The German Stock Corporation Law* (R. Mueller & E. Galbraith transl. 1966).

109. The application for registration must include copies of the articles of association (*Satzung*), documents relating to the appointment of the board of management and the

The incorporation procedure and its attendant disclosure obligation is the same whether or not the stock is to be distributed to the public. All shares must initially be subscribed by the founders.¹¹⁰ Public distribution is carried out through syndicates of banks which underwrite and sell the issue. Before agreeing to act as underwriter, the banks investigate all aspects of the company and their judgment acts as protection for investors.¹¹¹

Because of the lack of an American-type over-the-counter market in Germany, new issues of securities are commonly listed on one of the

supervisory board, the formation report (Gründungsbericht), the examination reports of the board of management, the supervisory board as well as the formation auditors, and a certificate that the report of the formation auditors has been submitted to the Chamber of Industry and Commerce. AktG § 37(2).

The availability of these documents assures that much information about the company will be available to the public. The articles of association must contain the name and domicile of the company, the purpose of the enterprise including the kinds of products or merchandise traded or manufactured, the amount of the legal capital (Grundkapital), the number of shares issued and their par value, and the number and qualifications of the managing board. Id. § 23(3). They must also specify the participation of each subscriber of shares and certify that all the shares of the company have been subscribed. Id. § 23(2). The articles must be executed before a court or a "Notarr." Id. § 23(1).

A more important document of disclosure, however, is the formation report. This is a written report which must be filed by the promoters regarding the steps they have taken to form the company. Id. § 32(1). It must state all material facts relating to the adequacy of contributions in kind in exchange for shares. Where shares have been issued in exchange for an existing business, the income from operations of the last two years must be disclosed. Id. § 32(2). Any profits from the formation of the company must also be disclosed. Id. § 32(3).

The formation report must be examined by the managing board and the supervisory board to determine whether the shares stated in the articles of association have been fully subscribed and whether the consideration has been adequate. Id. § 33(1). If the shares have been issued for a consideration other than cash or if the members of the managing board or supervisory board had a personal interest in the formation of the company, an additional examination of the report must be made by independent auditors. Id. §§ 33(2) & 34(1). Written reports are filed by the managing board, the supervisory board, and the independent auditors. Id. §§ 33 & 34.

The court also makes an examination of the application for entry into the commercial register and the documents submitted. The court may deny the application on the ground that any of the statements in the required reports are untrue or that property which the company is to receive for shares or cash is grossly overvalued. Id. § 38.

The promoters, members of the managing board or supervisory board, and other persons participating in the formation of the company are liable to the company for damages caused by incorrect or incomplete statements in the application for registration or in the accompanying documents. Liability is joint and several unless a promoter can prove that he used the care of a prudent businessman. Id. §§ 46-48.

110. Id. § 29.

111. See Note (-Br-), *Ausreichende Informations-Kontrolle durch Banken und Börsen*, 1969 *Bank-Betrieb* 112.

German stock exchanges. The Stock Exchange Law¹¹² requires additional disclosure; a listing prospectus (*Zulassungsprospekt*) must be published in order to obtain German stock exchange listing. The required prospectus is the most detailed prospectus used in any European national market.¹¹³ The application for listing and the listing prospectus are reviewed by the admission committee of the particular stock exchange to which application has been made, and if the information is incomplete or the issue would constitute a fraud on the public, the committee may refuse to grant permission for trading.¹¹⁴

A problem, however, is that review of the listing prospectus does not occur until after the sale of the securities because listing is not normally applied for until after sale. Prior to and during the selling of the securities, it has become customary to use a selling prospectus which is not subject to statutory requirements or review by an independent authority.¹¹⁵ For this and other reasons, there has been some discussion in Germany about revision of the Stock Exchange Law, but most commentators do not believe an independent governmental authority to review selling prospectuses is necessary, either on the national or supra-national level.¹¹⁶

b. *Continuing Disclosure in Germany*

The German system of continuous corporate disclosure functions through (1) the recognition of a shareholder's right to information and (2) periodic reporting requirements.

Every shareholder must, at his request, be given information at the shareholders' meeting by the board of management about any matter on the agenda of the meeting.¹¹⁷ The information must be truly and

112. Börsengesetz of June 22, 1896, as revised May 27, 1909, § 38 [hereinafter cited as BörsG].

113. Mott, *Foreign Bond Issues on European National Markets*, 24 *Bus. Law.* 1285, 1297 (1969).

114. BörsG § 36.

115. Mott, *supra* note 113, at 1298.

116. The "Segré Report" on European markets discussed favorably the idea of a European Securities Exchange Commission. *Le développement d'un marché européen des capitaux, Rapport d'un group d'experts constitué par la Commission de la C.E.E.* 246-47 (1966). For criticism of the idea of central administrative control see Note (-Br-), *supra* note 111, Koenigs, *Die Börse als Organ des Kapitalmarkts*, 1968 *Bank-Betrieb* 329, 331. For an argument in favor of more self-regulation by exchanges see Bremer, *Die neuen Schwerpunkte der Börsenreform*, 1970 *Der Betriebs-Berater* 1.

117. AktG § 131(1). Since most shares in German stock companies are bearer shares, many of which are deposited with banks, shareholders do not normally get direct notice of the meeting and the agenda from the company. Notice of the meeting must be published, however, and the managing board must send copies of the agenda for the meeting and its recommendations as to each decision to all banks and shareholder protective organizations

fairly given.¹¹⁸ There are, however, five statutory exceptions to the duty of the managing board to supply information, the most important of which is that disclosure need not be made if a reasonable business judgment on the part of the board determines that supplying the information would cause not inconsiderable damage to the company or a connected enterprise.¹¹⁹ Significantly, there is judicial review of the board's decision.¹²⁰ In addition to the shareholder's right to information, those present at the shareholders' meeting can vote to appoint special auditors to investigate a particular matter or transaction.¹²¹ Even a minority of shareholders can obtain the appointment of special auditors under certain circumstances.¹²² The effectiveness of the right to information is, of course, limited by the fact that the right exists only at the shareholders' meeting; nevertheless, it is considered to be a very important disclosure device.¹²³

With respect to periodic reporting, a balance sheet and a profit and loss statement as well as a business report (*Geschäftsbericht*) must be prepared by the managing board within three months after the end of the fiscal year of a stock company.¹²⁴ In the preparation of the financial statements standard accounting principles must be followed to give an accurate picture of the company's financial condition.¹²⁵ Consolidated statements are required of a group of related enterprises if a stock company belongs to the group.¹²⁶ Classifications and captions for the annual balance sheet and the profit and loss statement are set out in great detail by statute.¹²⁷ Strict rules are also set out for the valuation of assets and the proper showing of liabilities.¹²⁸ The formerly widespread

which exercised the right to vote for others at the last shareholders' meeting. Shareholders can also make proposals for the agenda and nominations for office. All proposals and nominations for office and statements in support of proposals must be transmitted by the banks to their clients. See Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 Harv. L. Rev. 23, 56 (1966).

118. AktG § 131(2).

119. Id. § 131(3).

120. Id. § 132.

121. Id. § 142(1).

122. See id. § 142(2).

123. See R. Godin & H. Wilhelmi, *Aktiengesetz, Kommentar* 705-13 Anm. 1 (3d ed. 1967). See also A. Hueck, *supra* note 107, at 161.

124. AktG § 148.

125. Id. § 149.

126. Id. §§ 329 & 330.

127. Id. §§ 151-52 & 157.

128. Id. §§ 153-56.

practice of providing undisclosed or excessive reserves has been curtailed by these rules.¹²⁹

The content of the business report which must be prepared by the managing board is set forth in great detail by statute.¹³⁰ The annual financial statements must be fully explained.¹³¹ The legal and business relationships with connected enterprises must be disclosed,¹³² and compensation paid to members of the managing and supervisory boards must be amplified.¹³³ Liability is imposed for any false statement or omission of material fact.¹³⁴

After having been audited, the financial statements and annual report of the managing board are examined and checked by the supervisory board, which has the power to make independent checks of the corporation's records. The reports are then submitted with the auditor's and supervisory board's comments to the annual shareholders' meeting.¹³⁵ The shareholders have the power to resolve any conflicts between the managing board and the supervisory board.¹³⁶ The financial reports are required to be published in the *Bundesanzeiger*, and all the reports, accompanied by a notice of publication, must be submitted to the local court which keeps the trade register.¹³⁷

c. *Meaning for American Law*

The federal securities acts embody requirements of much greater sophistication regarding both disclosure on issuance of shares and continuing disclosure than does the German law.¹³⁸ But it is the *pattern* of German law rather than its *substantive* requirements of disclosure which is of value for American law.

The observer of the pattern of German law is struck by the fact that

129. See Berger, Shareholder Rights Under the German Stock Corporation Law of 1965, 38 Fordham L. Rev. 687, 712-15 (1970). The elimination of the possibility of hidden reserves in the balance sheet is important because the disposition of retained earnings is up to the shareholders; however, they may dispose of retained earnings only to the extent they are shown in the annual financial statements. AktG § 174.

130. AktG § 160.

131. Id. § 160(2).

132. Id. § 160(3).

133. Id.

134. Id. § 400.

135. Id. §§ 170-71.

136. Id. § 173.

137. Id. § 177.

138. The American observer is impressed, however, by the efficiency with which disclosure by stock companies is disseminated and with the universality of the reporting requirements.

it is based on disclosure regarding corporations; there is almost no disclosure concerning securities. Furthermore, disclosure is an integral part of the corporate law of Germany. In contrast to the American pattern, which treats corporate disclosure as securities regulation, separate from and in addition to the state corporation laws, the German pattern recognizes that disclosure obligations should be interwoven with corporate law and are properly required of entities granted the right to do business in the corporate form.

The American law of disclosure could profit from consideration of these ideas. Although disclosure in the United States must continue to be a matter of federal law and, as such, separate from state corporation law, and although federal disclosure requirements should not be extended to close corporations,¹³⁹ it should be clearly recognized that corporate disclosure obligations under the securities acts are in fact and function "federal corporation laws." They have become necessary not only because of a need for uniform corporate reporting, but also because competition for tax revenues and other factors have caused the states to abdicate their responsibility to regulate corporations through disclosure requirements and other means. State corporation laws have been weakened to the point where they are now, as one commentator recently suggested, "largely a compendium of procedures for the formation of corporations and for the conduct of corporate affairs."¹⁴⁰

2. Disclosure as Society-Oriented, Not Investor-Oriented

The official position of the Securities and Exchange Commission is still that disclosure is aimed at the investment community and as such should be investor-oriented. Even the recent Commission releases relating to disclosure obligations concerning the environment and civil rights justify the disclosure duty in terms of the effect on the financial condition of the enterprise.¹⁴¹ As Professor Cary has stated, in practice corporations themselves recognize that disclosure properly should go beyond merely what is required to inform investors.¹⁴² It is commonplace for corporations to recognize that disclosure should relate to the social

139. The federal disclosure requirements should, however, be extended to more companies. As Professor Knauss has stated, the asset and shareholder tests contained in section 12(g) of the Securities Exchange Act are unrealistic and many corporations which should be required to disclose are excluded. Knauss, *supra* note 89, at 623-26.

140. Bahlman, Rule 10b-5: The Case for its Full Acceptance as Federal Corporation Law, 37 U. Cin. L. Rev. 727, 732 (1968).

141. See text accompanying notes 57-59 *supra*.

142. Cary, *supra* note 98, at 419.

influences of the business and its responsibility to society.¹⁴³ Again, the German experience is instructive.

Until 1969, disclosure in German law depended on the legal form of the enterprise and had nothing to do with the size of the entity. Only stock companies and associations limited by shares (*Kommanditgesellschaft auf Aktien*) were subject to annual reporting requirements. Other forms of doing business are, however, very important in Germany. In 1969, there were a total of only 2,328 stock companies as against 67,416 limited liability companies (*Gesellschaft mit beschränkter Haftung*).¹⁴⁴ It is true that most of the latter are what would be referred to in the United States as "close corporations" of small size, but some limited liability companies are among Germany's largest economic enterprises. In fact, one of the reasons for doing business in this form has been a desire to avoid the disclosure requirements of the stock company law.¹⁴⁵

However, this situation was altered by the Publicity Law (*Publizitätsgesetz*)¹⁴⁶ which became effective August 15, 1969. Under this law any business enterprise, regardless of form, is subject to annual reporting requirements if two of the following three criteria are met: (1) a balance sheet total (*Bilanzsumme*) of more than 125 million DM; (2) annual sales (*Jahresumsatz*) of more than 250 million DM; and (3) an average of more than 5000 employees.¹⁴⁷ Essentially, the law provides that during the first three months of their fiscal year these large enterprises must prepare a balance sheet, profit and loss statement and business report for the previous fiscal year, submit it to independent auditors and publish it in the *Bundesanzeiger*.¹⁴⁸ In the preparation of the financial statements and reports, the provisions of the stock company law are applicable.¹⁴⁹ Special rules apply to connected enterprises to assure the filing of con-

143. Id. See also Blumberg, *The Politicalization of the Corporation*, 26 *Bus. Law.* 1551, 1554-55 (1971).

144. Gessler, *Die Reform des GmbH-Rechts*, 1969 *Der Betriebs-Berater* 589.

145. See A. Hueck, *supra* note 107, at 118-19, 199-200.

146. Law of 1969, [1969] *BGBI. I S 1189* [hereinafter cited as *PublG*].

147. Id. § 3. There are certain limited exceptions and special provisions with regard to insurance companies, cooperatives and credit institutions.

148. Partnerships and single proprietorships are exempt from the requirements of preparing a business report, however. Id. § 9.

149. *AktG* §§ 149, 151-52 & 157-58. An exception is allowed, however, with regard to the valuation rules applicable to balance sheets of stock companies. The *Publizitätsgesetz* does not prevent the use of "hidden reserves." See Hellner, *Das Publizitätsgesetz*, 1969 *Zeitschrift für das Gesamte Kreditwesen* 718. See also A. Hueck, *supra* note 107, at 200-01.

solidated financial statements and to make certain that large enterprises are unable to avoid disclosure by dividing into parts.¹⁵⁰

Forty-seven limited liability companies were made subject to publicity requirements for the first time by the new law.¹⁵¹ Moreover, greater disclosure requirements have been proposed. The proposed reform of the limited liability company law (*GmbH Referenten-Entwurf*) would subject all limited liability companies having a balance sheet total of more than four million DM to disclosure requirements similar to those required of stock companies.¹⁵² Furthermore, all limited liability companies, regardless of size, would have to file their annual balance sheet with the trade register where it would be open for public inspection.¹⁵³ The latter proposal is very controversial, but it is stated to be necessary for the protection of the public and creditors.¹⁵⁴ Also proposed are new provisions requiring disclosure when a limited liability company is formed and the promoters contribute property in exchange for shares.¹⁵⁵ Such disclosure is required of business entities in Germany even though there may be no public trading in their shares.¹⁵⁶ This was justified to provide some measure of control over their activities, to protect creditors,¹⁵⁷ and also because of the important effect modern corporations have on society, especially regarding questions of social and economic policy.¹⁵⁸

The Securities and Exchange Commission should officially recognize the public policy bases of disclosure that have been accepted in Germany and have been admitted in practice by United States corporations: disclosure is society-oriented and is not just for investors. The continuing movement of the 1950s and 60s toward concentration of corporate economic power and the even greater dispersion of ownership of shares among individuals during this period, as well as the emergence of institutional investors which act for great numbers of people, have made many

150. PubLG § 11.

151. Gessler, *supra* note 144, at 589.

152. *GmbH Referenten-Entwurf* § 138. There are some essential differences from the stock company law pattern, however. For a comparison see Gessler, *supra* note 144, at 593-94.

153. *GmbH Referenten-Entwurf* § 152.

154. See Gessler, *supra* note 144.

155. *GmbH Referenten-Entwurf* § 14. See Battes, *Sacheinlage und Sachgründung im Referentenentwurf*, 1969 *Gmbh-Rdsch* 253.

156. The German limited liability company is prohibited from raising money through the public issue of stocks and bonds and its securities may not be traded on the securities markets. A. Hueck, *supra* note 107, at 232.

157. See Pruhs, *Die Konzernrechnungslegung nach dem Publizitätsgesetz*, 1969 *Der Betrieb* 1385; Deringer, *Organschaft, Umwandlung und Publizität*, 1968 *Die Aktiengesellschaft* 211, 214; Hellner, *Das Publizitätsgesetz*, 1969 *Bank-Betrieb* 338.

158. A. Hueck, *supra* note 107, at 199.

corporations quasi-governmental entities. The impact of corporate decisionmaking should be opened to public view.

3. The Role of Increased Disclosure

a. *What Should Be Disclosed?*

New categories and required items of disclosure should be developed by the Securities and Exchange Commission. The disclosure categories should remain flexible and the Commission should periodically review corporate information practices so that disclosures relate to societal needs. Some needed categories are: (1) the impact of the corporation's activities on the environment;¹⁵⁹ (2) hiring practices relating to women and minority groups; (3) political contributions and activities; (4) concern for the safety, health and welfare of employees; (5) concern for product safety and corporate practice relating to consumers; (6) corporate charitable contributions and philanthropic efforts; and (7) corporate activities relating to the community in which major business operations are located.

b. *Disclosure for Whom?*

An argument in favor of the institution of additional corporate disclosure requirements for the purpose of informing society, as distinct from the investor, will be met with the question of whether this constitutes a departure from the generally accepted idea that the function of a corporation is to maximize shareholder profits. It has been stated that substitution of the public interest for the profit motive as the guiding principle for corporate behavior entails extensive legal consequences.¹⁶⁰ Full acceptance of the idea that the business corporation owes a duty to employees, customers and the general public as well as to shareholders may require changes in the organic structure of the corporation.¹⁶¹ However, the addition of society-oriented disclosure rules to present Securities and Exchange Commission regulation need not involve a departure from the principle of profit maximization or require the acceptance of a totally new concept of corporate duty. It would merely be a recognition of the fact that the large corporation is not a private and autonomous institution, but is a community asset which is public in its conduct, its mores and its impacts.¹⁶² The basis of increased disclosure is simply that al-

159. Such disclosure is now required of federal agencies under the National Environmental Policy Act of 1969, 42 U.S.C. §§ 4321-95 (1970).

160. Ruder, *Public Obligations of Private Corporations*, 114 U. Pa. L. Rev. 209, 213 (1965).

161. Blumberg, *supra* note 143, at 1560.

162. Drucker, *Big Business and the National Purpose*, Harv. Bus. Rev. 48, 59 (1962).

though a corporation exists to maximize profits, society has a right to be informed of the undeniable public impact of its actions.

c. *Why Disclosure?*

Greater corporate disclosure requirements would have two important effects. First, corporate decisions which have a societal impact would be more open to public view. There would be increased debate among the public and among the corporation's shareholders concerning many decisions. Shareholder and public opinion would act as a check on management and stimulate executives to higher ethical standards regarding public interest matters.¹⁶³

It may be objected that under the present model for corporate action, managers may be liable to shareholders for breach of their fiduciary duty if they depart from the framework of profit maximization and act out of consideration for the public interest. Professor Schwartz has explored this argument in depth and has found it to be lacking.¹⁶⁴ Under the business judgment rule corporate managers can act in an enlightened way, sacrificing immediate profits for long-term gains both for the corporation and for society. Expenses may be undertaken which do not increase profits but which improve the welfare of the community in which the corporation operates.¹⁶⁵

A second result of increased disclosure would be to expose those areas of corporate behavior which cannot be reformed internally, but which must be dealt with through government action and legislation. The theory here is that disclosure is the least restrictive form of regulation in that it provides an incentive for self-reform. But there will be matters which can be corrected only through direct action by government. Disclosure would provide a basis for knowing when new laws are needed and, just as important, when they are not needed.

IV. THE IMPLEMENTATION OF SOCIETY-ORIENTED DISCLOSURE REQUIREMENTS

The most practical way to provide increased information concerning the impact of the corporation's activities in a way which would not be unduly burdensome is to utilize the annual report to shareholders. At the present time the annual report must accompany or precede each proxy statement which solicits proxies on behalf of management for the election of directors.¹⁶⁶ For the most part, management may determine

163. It is well accepted that disclosure has a beneficial effect on ethical standards. See Cary, *supra* note 98, at 417.

164. Schwartz, *supra* note 10, at 462-82.

165. *Id.*

166. 17 C.F.R. § 240.14a-3(b) (1971).

its content,¹⁶⁷ and the report is not deemed to be "soliciting material" or to be "filed" with the Securities and Exchange Commission so as to subject the corporation to the civil and criminal penalties which are the usual consequence of a violation concerning soliciting materials filed with the Commission.¹⁶⁸

Nevertheless, the annual report to shareholders is probably the single most important disclosure document required by the Commission. Together with the proxy statement, it is disseminated more widely than even the Securities Act prospectus in that it must be sent to all shareholders of record.¹⁶⁹ The annual report, in contrast to the proxy statement, is normally full of brightly colored photographs, thus attracting more attention; but studies have shown that it is an important tool for professional analysts as well, and that markets frequently react to its publication.¹⁷⁰

The Commission should revise its requirements relating to the shareholders' annual report in order that it may realize its full potential.¹⁷¹ The content of the annual report should be directly specified by Commission rule, and at least part of the report should be considered soliciting material filed with the Commission.¹⁷² The society-oriented disclosure categories discussed above¹⁷³ should be a requisite part of the filed content of the annual report. The latter document would thus be primarily society-oriented while other disclosure mechanisms could continue to serve the traditional functions of disclosure. Societal disclosure could in this way be required without a complete departure from present practice.¹⁷⁴ Moreover, in recent years annual reports have tended to serve as a vehicle for emphasizing the corporation's social responsibility; many reports are replete with information relating to efforts to abate environmental and community problems. This proposal would merely subject these disclosures to Securities and Exchange Commission rules. There would be two other major legal consequences: new possibilities would

167. *Id.*

168. *Id.* § 240.14a-3(c).

169. *Id.* § 240.14a-3(a).

170. Wheat, *The Disclosure Policy of the SEC*, 24 *Bus. Law.* 33, 39 (1968).

171. One of the major faults of the Wheat Report was its failure to recommend any substantial change regarding annual reports. See *The Wheat Report* 371-73.

172. This has been proposed by Professor Loss. See 46 *ALI Proceedings* 260 (1969).

173. See text accompanying and following note 159 *supra*.

174. It is questionable whether societal disclosure can be compelled by Securities and Exchange Commission rulemaking. It may be argued that the Commission may properly make rules in this regard since section 14(a) of the Securities Exchange Act authorizes the Commission to make such rules and regulations as are necessary "in the public interest or for the protection of investors." Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (1970).

be opened for the use of the shareholder proposal rule¹⁷⁵ of the Commission, and corporations would be subjected to potentially greater civil and criminal liability for violations of disclosure requirements.

A. *New Possibilities for Use of Shareholder Proxy Proposals*

There is a significant trend in the law to increase shareholder access to the proxy machinery administered by the Securities and Exchange Commission. Professor Eisenberg has argued that the Commission proxy rules are deficient in providing shareholder access since they are rooted in the original philosophy of the securities acts which was to provide information and control the use of false information.¹⁷⁶ He proposes that shareholders should be granted the right to designate candidates for the board of directors in the corporate proxy materials.¹⁷⁷ In addition, groups of shareholders have been formed which have attempted to use the proxy machinery to carry on "public interest proxy contests" to compel corporations to have greater regard for the public interest.¹⁷⁸ The culmination of this movement was the case of *Medical Committee for Human Rights v. SEC*,¹⁷⁹ which was the product of judicial frustration with the inconsistent and conservative manner which for decades has characterized Commission policy regarding shareholder access to the corporate proxy machinery.

Medical Committee involved the presentation of a proposed shareholder resolution to the management of Dow Chemical Company for inclusion in management's proxy materials prepared in connection with the annual meeting of shareholders.¹⁸⁰ The management of Dow announced its in-

175. 17 C.F.R. § 240.14a-8 (1971). This rule requires management to include in its proxy solicitation material any shareholder proposal other than those related to elections to office. There are three substantive exceptions to inclusion: (1) a proposal that is not a proper subject for shareholder action under state law, (2) a proposal submitted primarily to promote general economic, political, racial, religious, social or other similar causes, and (3) a proposal relating to the conduct of the ordinary business operations of the issuer. Id. § 240.14a-8(c).

176. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 Harv. L. Rev. 1489 (1970).

177. Id. at 1502-11. This right is recognized under state law but is artificially restricted by the proxy rules. Eisenberg's proposal is that it should at least be possible for shareholders owning some minimum percentage of the corporation's stock to designate candidates for office.

178. The most famous of these has been "Campaign GM" conducted by the "Project on Corporate Responsibility." For an account see Schwartz, *supra* note 10, at 527.

179. 432 F.2d 659 (D.C. Cir. 1970), vacated and remanded for dismissal as moot, 92 S. Ct. 577 (1972), noted in 39 Fordham L. Rev. 791 (1971).

180. The resolution read as follows: "RESOLVED, that the shareholders of the Dow Chemical Company request that the Board of Directors . . . consider the advisability of adopting a resolution setting forth an amendment to the composite certificate of incorporation of the Dow Chemical Company that the company shall not make napalm." Id. at 663.

tention to omit the proposal and the Securities and Exchange Commission refused to compel its inclusion. On direct judicial review, the United States Court of Appeals for the District of Columbia Circuit held that the Commission's acquiescence (by its "no action" letter) in Dow's decision was reviewable. The court further found that the Commission had misapplied proxy rule 14a-8¹⁸¹ and remanded the matter for further proceedings.¹⁸² In order to aid the Commission on remand, the court offered advice to the Commission with respect to interpreting its own rule. The court took a restrictive view of the general cause exception¹⁸³ to the shareholder proposal rule, favoring the interpretation that it has no application regarding proposals even of a general or social nature as long as they relate to a matter completely within the sphere of corporate activity.¹⁸⁴ The court also seemed to view the ordinary business operations exception¹⁸⁵ as inapplicable if the proposal is a proper subject for shareholder action under state law, thus greatly diminishing its scope and status as an independent ground for the omission of a shareholder proposal.¹⁸⁶

One of the results of *Medical Committee* has been to compel the Commission to reevaluate its policy relating to the shareholder proposal rule. Legal writers have discussed alternatives for consideration by the Commission.¹⁸⁷ Professor Chisum has argued¹⁸⁸ that the only sound exception to allowing shareholder proposals is the "proper subject" exception,¹⁸⁹ and that therefore the other exceptions should be eliminated. This makes eminent good sense in the light of the policy of the proxy rules and the shareholder proposal rule. There is no reason why the federal proxy rules should provide barriers to shareholder access to the proxy machinery in addition to those provided by state law.

If as a result of the decision in *Medical Committee* and the ensuing

181. 17 C.F.R. § 240.14a-8 (1971).

182. 432 F.2d at 681-82.

183. 17 C.F.R. § 240.14a-8(c)(2) (1971).

184. 432 F.2d at 681. The SEC has proposed an amendment to the general cause exception that seems to accept the court's view. The proposed amendment would permit management to omit a shareholder proposal if it relates to the enforcement of a personal claim or grievance or if it consists of a recommendation that action be taken with respect to any matter that is not significantly related to the business of the issuer or not within its control. CCH Fed. Sec. L. Rep. ¶ 78,465, at 81,009.

185. 17 C.F.R. § 240.14a-8(c)(5) (1971).

186. 432 F.2d at 681. For a complete analysis of *Medical Committee* see Chisum, Napalm, Proxy Proposals and the SEC, 12 Ariz. L. Rev. 463 (1970).

187. E.g., Allen, The Proxy System and the Promotion of Social Goals, 26 Bus. Law. 481 (1970); Schwartz, *supra* note 10.

188. Chisum, *supra* note 186, at 475.

189. 17 C.F.R. § 240.14a-8(c)(1) (1971).

discussion the shareholder proposal rule is revised along the lines suggested by Professor Chisum, and if the Securities and Exchange Commission were to consider the shareholders' annual report as soliciting material containing required categories of society-oriented disclosure, far-reaching possibilities would be opened for the use of shareholder proposals. The shareholders' annual report could be required to be sent 90 days before the proxy statement, thereby affording shareholders an opportunity to formulate proposals based on the information in the annual report. Under a liberalized rule 14a-8, public interest proposals on almost any matter germane to corporate affairs would be included in the proxy materials so that these matters would at least be opened for public discussion, and corporate managers would be under pressure to either change their policies or defend them on the merits.¹⁹⁰

B. *Potential Consequences with Respect to Civil and Criminal Liability*

The proxy rules of the Securities and Exchange Commission prohibit the use of false or misleading statements of material facts or omissions of material facts in the solicitation of proxies.¹⁹¹ The Commission is authorized to investigate possible violations¹⁹² and to seek injunctive relief in a federal district court.¹⁹³ Willful violators are subject to criminal penalties.¹⁹⁴ In addition, the United States Supreme Court has implied a private right of action for injunctive or monetary relief, which can be used by any person damaged or threatened with damage by any violation of the Commission's proxy rules.¹⁹⁵

This powerful array of private and administrative deterrents is not applicable, however, to false or misleading statements or omissions of material facts contained in the shareholders' annual report. In the recent case of *Dillon v. Berg*,¹⁹⁶ the court held that the language in rule 14a-3(c)¹⁹⁷ stating that the annual report is neither deemed to be "soliciting material" nor to be "filed" with the Securities and Exchange Commission has the effect not only of exempting the annual report from section

190. Chisum, *supra* note 186, at 476. One of the results of "Campaign GM" has been that the management of General Motors Corporation has undertaken many reforms and has had to justify its corporate policies to the public. See Schwartz, *supra* note 10.

191. 17 C.F.R. § 240.14a-9(a) (1971).

192. Securities Exchange Act § 21(a), 15 U.S.C. § 78u(a) (1970).

193. *Id.* § 21(e), 15 U.S.C. § 78u(e) (1970).

194. *Id.* § 32(a), 15 U.S.C. § 78ff(a) (1970).

195. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

196. 326 F. Supp. 1214 (D. Del. 1971).

197. 17 C.F.R. § 240.14a-3(c) (1971).

18 of the Securities Exchange Act,¹⁹⁸ but also of exempting it from all the other proxy rules (including the anti-fraud provision)¹⁹⁹ except rule 14a-3.²⁰⁰ The court stated that the annual report must be totally disregarded for purposes of determining whether the proxy materials violated section 14(a) of the Securities Exchange Act²⁰¹ since that report is regulated solely by rule 14a-3, which contains no prohibition against the use of misleading statements.²⁰²

It is submitted that this decision creates an intolerable gap in the Commission's proxy rules. Unless corrected, it will result in even greater use of the annual report by companies without regard for standards of disclosure that they must respect in other documents required by the Commission. It is true that statements made in annual reports have given rise to liability under section 10(b) of the Securities Exchange Act and rule 10b-5,²⁰³ but this is not as effective as rule 14a-9(a)²⁰⁴ liability since rule 10b-5 imposes liability in connection with the purchase or sale of a security, not in the solicitation of proxies.²⁰⁵ The exemption of the annual report from the anti-fraud requirements of rule 14a-9(a) conflicts with the basic policy of the Commission's proxy machinery which is to require disclosure of information which will result in informed shareholder voting. It is indisputable that the annual report has the potential to influence the shareholder voting decision. It should be subject to the same anti-fraud requirements as are the rest of the proxy materials.

Such would be the result if the Commission were to amend rule 14a-3 so that the annual report would be considered to be "filed" and "soliciting material" for purposes of the proxy rules. If in addition the Commission were to utilize the annual report to require new categories of society-oriented disclosure, rule 14a-9(a) would also operate to assure the truth

198. Section 18 of the Securities Exchange Act imposes civil liability for misleading statements and omissions of material fact contained in any document "filed" pursuant to any provision or rule of the Act in favor of a person who in reliance on the document purchased or sold a security to his damage. Largely because of the reliance requirement, this provision has never been used. See Securities Exchange Act § 18, 15 U.S.C. § 78r (1970).

199. 17 C.F.R. § 240.14a-9 (1971).

200. 326 F. Supp. at 1230-31. The court rejected the view of Professor Loss that Rule 14a-3(c) merely provides immunity from section 18 of the Act. 2 L. Loss, *Securities Regulation* 887-88 (2d ed. 1961), as supplemented, 5 id. 2850 (Supp. 1969).

201. 15 U.S.C. § 78n(a) (1970).

202. 326 F. Supp. at 1231.

203. See, e.g., *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969).

204. 17 C.F.R. § 240.14a-9 (1971).

205. See Fleischer, "Federal Corporation Law": An Assessment, 78 *Harv. L. Rev.* 1146, 1157 (1965).

and objectivity of society-oriented disclosure. Less than complete candor with respect to the impact of a corporation's activities on society would then be subject to private actions for injunctive or monetary relief and Commission enforcement.

V. CONCLUSION

New categories of society-oriented disclosure should be developed by the Securities and Exchange Commission and required of corporations. In order to increase corporate responsibility, a corporation should be required to disclose fully the impact of its activities on society. The annual report to shareholders should be the vehicle for the new disclosure requirements, and it should be considered soliciting material filed with the Commission. If accompanied by liberalization of the shareholder proposal rule, there would be an enormous impact on the role of shareholders in the modern corporation and on corporate responsibility.