AN ADDRESS

BEFORE

The District of Columbia Institute of
Certified Public Accountants
The Association of Customers' Brokers
and
The Federation of Financial Analysts

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Delivered by Commissioner Ellis for Chairman

The three distinct groups present here this evening -- the accountants, the customers' brokers, and the financial analysts, putting you in alphabetical order -- represent three diverse disciplines. While there are differences among you, each group is striving for full professional status. And each has its own separate but important function in the securities industry. But there is one matter with which all of you are vitally concerned, the information furnished investors. I would like to discuss briefly some aspects of this common link, with particular reference to the Securities Acts Amendments of 1964, which became law last August.

The 1964 amendments have two major objectives. The first is to afford to investors in the securities of certain publicly-held companies traded in the over-the-counter market the same fundamental disclosure protections heretofore provided by the Securities Exchange Act of 1934 to investors in securities listed for trading on a national securities exchange. The second is to strengthen the standards for entrance into the securities business and to make more effective and flexible the disciplinary controls of the SEC and industry self-regulatory organizations over securities brokers and dealers and persons associated with them. These changes are interrelated and complementary: the provisions concerning issuers

are designed to provide the information necessary to informed decision by investors; the other provisions are intended to raise the standards of competence and conduct of those who use or should use the information in advising investors.

The extension of the disclosure requirements of the Exchange Act to the larger issuers of over-the-counter securities removes an anomaly unwarranted by public investor needs. Under new Section 12(g) of the Exchange Act, most over-the-counter issuers with total assets in excess of $1 million dollars and a class of equity security held of record by 750 or more persons will be subject to the comprehensive disclosures required by the Exchange Act. After July 1, 1966, the shareholder requirement will drop to 500. The three federal banking agencies, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, have the responsibility of administering disclosure requirements as to banks subject to their control and the states will administer similar requirements for insurance companies.

Prior to the amendments, these companies were subject to disclosure requirements only in connection with or as a result of public offerings of their securities. As you know, the Securities Act of 1933 requires that certain public offerings by issuers, persons in a control position with such issuers, and their underwriters be preceded

by the filing of a registration statement with the Commission disclosing financial and other material information concerning the issuer, the securities offered and the terms of the offering. If the offering exceeded a certain size, the issuer was required to keep current some of the information contained in the registration statement by filing periodic reports with the Commission.

The effect of the new amendments is to apply a more thorough pattern of disclosure which will not be dependent on the happenstance of a public offering. Over-the-counter issuers meeting the statutory criteria will be required to follow a registration procedure similar to that specified for the issuers of listed securities and designed to elicit financial and other information necessary for informed decision. Thereafter, by filing annual and other reports, they will keep the information contained in the registration statement reasonably current.

In addition, the newly-registered over-the-counter issuers will become subject to two other statutory provisions: Section 14 of the Exchange Act, governing the solicitation of proxies from the holders of the securities, and Section 16, concerning so-called "short-swing trading" and short sales by officers, directors and the holders of more than 10% of the stock of the issuers. The amended Act also requires that holders of listed securities as well as of unlisted

securities be provided with important information concerning matters to be considered at stockholder meetings even when their proxies are not solicited, and authorizes the Commission to require the disclosure of material contracts in documents filed under the Act.

The need for this expansion of disclosure requirements was demonstrated by the Special Study of Securities Markets concluded in 1963. The Report of the Study demonstrated that irresponsible selling tactics, reckless investment advice, extravagant financial public relations and erratic securities markets thrived when adequate information was not available. Thus, the overwhelming preponderance of fraud cases before the Commission in past years has involved securities of companies not subject to the Commission's reporting requirements.

I think it is important, however, not to over-emphasize unsavory sales techniques engaged in by some as the necessary justification for these changes. The most important reason for, and result of, the amendments is that reliable information as to many companies will now be available for the first time to the investing public. Security salesmen who conscientiously seek wider investment opportunities for their customers will now approach over-the-counter issues with greater confidence.

An estimated 2900 additional companies will be subject to these basic disclosure requirements under the SEC's administration. In addition, 600 banks will be subject to the requirements as administered by the Federal banking authorities and 400 insurance companies will be required to meet state requirements. The number of companies generally subject to the over-all disclosure requirements will have been almost tripled, although many were already filing periodic reports pursuant to Section 15(d) of the Exchange Act. As companies increase in size and their securities become more widely held, more will fall within the asset and stockholder tests under the statute, thus reaching the larger companies in which there is a substantial public interest.

The legislation poses a major challenge to the SEC. It adds considerably to the regulatory tasks before the Commission and its staff, and we are now busily preparing to assume the new responsibilities. As a preliminary step we have recently promulgated several new forms to simplify the registration process and new rules defining the statutory terms more specifically. We expect a deluge of filings on April 30, 1965. Although most issuers will have little difficulty preparing the registration statements required by Section 12(g), many will be filed by issuers which have not previously been required to comply with the Commission's disclosure requirements and will necessarily demand considerable effort and care. We at the Commission pledge our full cooperation and assistance. In the final analysis, however, the

primary responsibility for compliance is on the issuers, their lawyers, and their accountants.

Because of his special status and responsibility, the accountant has a unique role in insuring compliance with the statutory standards of investor protection. The "financials" provide the key information essential to our techniques for the distribution and trading of securities. The work of the accountant in their preparation and publication is vital. Independent accountants, by their opinions as experts, lend authority to management's representations, and they operate as a check on management in assuring that the financial data are fairly presented in accordance with generally accepted accounting principles.

In many cases, the accountant will be the primary bridge between the issuer and the Commission. He will be called on to explain the "hows" of the Commission's rules. He should also explain the "whys." The accountant should advise on the establishment of systems and controls which will promote the most effective and comprehensible form of compliance. A little foresight can avoid many unnecessary, and possibly embarrassing, problems. For example, when it is contemplated that a company will have to register in the future -- as when the shareholder limit under the amendments drops to 500 in 1966 -- the appropriate internal controls should be established now to avoid potential problems which might preclude the issuance of an unqualified

certificate. In short, good practices and procedures should be adopted and followed at the earliest possible time.

The increased availability of information will highlight the need to improve the quality of financial information and methods for its presentation. You are all aware of recent criticisms of present accounting practices as developed, used and required by the profession and the regulatory bodies, including the SEC. I agree that there is room for improvement; I believe, however, that these criticisms tend to obscure or distort real efforts currently under way to improve standards. Indeed, efforts along these lines have been going on for some time. As early as 1937 the SEC emphasized the importance of narrowing areas of difference in accounting. In its Accounting Release No. 1, the Commission announced a program of publishing releases giving "opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."

While all or most of the problems have not as yet been solved, a fair examination of the changes which have taken place in accounting since the early 1930's will indicate many significant advances. Pending a further narrowing of areas of difference, the recent statement of the Council of the American Institute of Certified Public

Accountants that departures from Opinions of the Accounting Principle Board and effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure should be disclosed, should be of real value to analysts and securities salesmen and their customers.

Two articles in the December issue of the Journal of Accountancy have placed the present controversy in terms of uniformity of principles, or comparability, on the one hand, versus disclosure and consistency on the other. With all the respect which a non-accountant owes to the able authors of those articles, I believe that all these concepts must be considered in the establishment of meaningful standards of accounting. I might state that the Editors of the Journal of Accountancy suggest the two articles indicate that "there are more areas of agreement than disagreement."

Concurrent with this discussion, if not controversy, among public accountants has been a recent agreement by seven Federal agencies to put on a more formal basis the existing informal practice of discussing accounting problems of mutual concern. An interagency committee of policy-level accountants representing the Civil Aeronautics Board, the Federal Communications Commission, the Maritime Administration, the Federal Power Commission, the Interstate Commerce Commission and the Securities and Exchange Commission has been organized and will meet periodically to discuss new accounting problems as they arise and any differences which may develop. This cooperative arrangement

among the agencies should lead to major improvements in regulatory accounting and assist the agencies in obtaining background information and data on which to base their accounting decisions.

Although the issue concerning accounting standards has received most of the attention, the challenge to improve standards in the furnishing of information to investors also faces analysts and customers' brokers. After all, the intended beneficiaries of the 1964 amendments are their clients and customers.

Meaningful analysis is a difficult task which involves much thought and effort. The importance of the analyst's function and the need for standards in the field has been increasingly recognized. There has been a rapid growth in the number of practicing analysts in recent years. This is indicated by the increase in the number of local groups which are members of the Federation, from 20 to 36 in the last ten years. This growth has been accompanied by steps toward self-regulation, a sine qua non to professional status and recognition. The development and expansion of the Chartered Financial Analysts program is but the latest manifestation of this trend.

The C.F.A. program is based on the belief that professional designation should be an indication of an individual's competence and his awareness of, and dedication to, a code of ethical behavior. It

is my understanding that the C.F.A. examinations include problems which present ethical questions. Hopefully you will go further and develop a code of conduct for practicing Chartered Financial Analysts, one that will provide sanctions for those persons who violate the code. There are many matters with which such a code could concern itself. Many of you are familiar with the Supreme Court decision in SEC v. Capital Gains Research Bureau, Inc., in which the Court held that non-disclosure of "scalping" by an investment adviser violated the anti-fraud provisions of the Investment Advisers Act. Practicing analysts can undoubtedly list many more important ethical questions with which they are often presented.

Recognition should be accorded to the stress the Federation is placing on the development of principles of analysis in conjunction with its drive for more complete corporate information -- a program which has already achieved considerable success. The work of the Corporate Information Committee of the Federation in developing criteria for and rating annual reports to shareholders should improve further the value of these documents. The Federation strongly supported the Accounting Principles Board in condemning the use of the terms "cash earnings" and "cash earnings per share." I especially commend the efforts of the Joint Committee of the Federation and the Institute, which worked on this problem with an ad hoc committee of the Federation,

and urge it to continue its efforts to develop improved standards of financial reporting. This type of effective cooperation can only redound to the benefit of the public investor and to both professions.

The Commission has emphasized the importance of annual reports to stockholders by the amendment to its rules requiring greater conformity between the financial statements in these reports and those filed with the Commission. Another proposed rule change would require over-the-counter issuers to include a description of their operations in reports to stockholders. Accountants can play a major role in the improvement of these annual reports, most of which contain certified financial statements. Many accountants now rightly require that the texts of such reports not conflict with the published financial statements. Public accountants can wield great influence toward the improvement of the textual discussions found in stockholder reports. Registered representatives, in their dealings with investors, can also play an important role. They are at the principal point of contact with the investing public, for whose benefit all this information has been gathered. It is the job of the salesman to see to it that the available information is used in a way which will ensure that his customer can make an intelligent investment decision.

The duties of securities salesmen with respect to the information which they furnish investors is an obvious one. Many of you are probably aware of the SEC's administrative decisions and statements of policy developing and enunciating standards of conduct required of broker-dealers and salesmen under the statutory obligation of fair dealing. I believe the most significant of these concerning corporate information furnished investors, is the prohibition against statements made without an adequate basis. No attempt has been made to define this rule in all circumstances, but the Commission has made clear that a salesman cannot ignore important adverse facts in his statements and recommendations to customers. In this way the principle of disclosure -- the heart of the regulatory scheme -- is brought to the benefit of the public investor.

The amendments established no significant new standards in this area; rather they attempted to make the Commission's enforcement machinery, and that of the NASD, more efficient against the minority of salesmen who engage in unethical practices. I stress that word minority. The securities industry could not have undergone its tremendous growth in recent years unless the majority of salesmen treated their customers fairly. Securities salesmen are affected by a loss of public confidence in the securities markets more quickly than others. They have a real interest in efforts to raise standards

throughout the securities industry. Although most salesmen are not full members of the self-regulatory organizations, they can aid the efforts of these organizations by their actions and moral support.

The concept of self-regulation is based on the assumption that the members of the securities industry agree with the principles set out in the Federal securities laws. This depends ultimately on self-regulation, on the most basic level, of the actions and attitudes of the individual members of the industry. Each of you has a role to play in proving that assumption to be correct. Each of you must in all your dealings follow "high standards of commercial honor," and contribute to the development of "just and equitable principles of trade."