

**ADDRESS OF
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OF THE
SECURITIES AND EXCHANGE COMMISSION**

**BEFORE THE
WASHINGTON SOCIETY OF INVESTMENT ANALYSTS**

**AT WASHINGTON, D. C.
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I would like to take advantage of this occasion, a little less than 2 months prior to the date on which the Commission is to report to the Congress the results of its Special Study of Securities Markets, to review with you some highlights of the history of progress made in the last 30 years by the securities community and to raise some questions which that history leaves unanswered. I have in mind that analysts will have a special interest in the content of our report. Their function and responsibility in the operations of the securities market place will be focussed upon. What is now the homework of the Commission will soon be yours. I am sure that after having done their homework your spokesmen will have views to express on your behalf.

In the 19th century most corporations simply refused to reveal the basic facts about their operations. There were no laws requiring that corporate reports and records be made public. In the latter part of the century the New York Stock Exchange and a few trail blazing financial editors and writers, including such names as Henry Varnum Poor, Charles H. Dow, Edward D. Jones, Clarence Barron and John Moody, succeeded in establishing rudimentary collections of basic, factual material about publicly held corporations. When in 1903 the newly formed United States Steel Corporation published large excerpts from its annual report, it was considered a unique and daring experiment and created considerable stir. The change in the economic circumstances and interests of our people during and just after World War I gave rise to a need for more extensive and complete analyses of investment situations. The need was met to some extent by the increasing

availability of business and economic statistics. As the bull market of the 20's progressed it was accompanied by a substantial rise in the amount of financial information--and misinformation--offered to an increasingly eager investing public. Unfortunately, sources of accurate information were limited and materials made available to the public were often inadequate. A Twentieth Century Fund study has pointed out that many of the prospectuses used by underwriters and brokers of the period contained extravagant and unfounded promises, material omissions and outright misstatements. In short, prior to the enactment of the Securities Acts, public investment was made upon the basis of corporate financial information which was inadequate and frequently misleading in content and entirely lacking in uniformity either as to quality or quantity.

After 30 years under the Securities Acts, where are we?

In the April, 1962, issue of The Atlantic Monthly, Thomas W. Phelps, an investment counselor and a partner in the investment advisory firm of Scudder, Stevens & Clark, said and I quote: "Information available to the investor is a great deal better than it was * * * * * undoubtedly the necessity of making so much information public in SEC registration statements helped to bring about this change. So did the steady pressure of the New York Stock Exchange for fuller disclosure. But, increasingly, corporate managements in America have come to realize the value of being well known to the investing public.* * * * *

The great increase in the number of competent securities analysts at the service of the investing public has contributed to making our financial markets safer than they otherwise would be." These few

sentences give credit where it is surely due: to the Congress and the Commission for the benefits flowing from the Securities Acts enacted in the early thirties and thereafter; to a leading self-regulatory securities institution; to the most responsible members of corporate management; and to the careful and conscientious analyst. (Unfortunately, none of the recipients of these bouquets is free to emulate Ferdinand the Bull and spend the rest of his days sitting on his haunches sniffing flowers. All have much more work to do.)

As a disclosure statute, the Securities Act of 1933 constituted a deliberate choice by the Congress of one of several available techniques for dealing with the abuses which necessarily had to be eliminated. The Congress could have used a licensing technique for the sale of securities which is an essential part of the securities laws of many of the states. It could also have resorted to the so-called fraud-type law which remains in use in a few of the states. Neither of these was found necessary or attractive. It was thought sufficient, as the President said at the time, "to insist that every issue of new securities to be sold in interstate commerce be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public." The basic assumption had to be that the buying public faced with all the material facts could arrive at its own judgment of the investment merits of the security offered. At the same time, there is no doubt in my mind that both the assumption

and the statute preserved the "inalienable right of the citizen to make a fool of himself." Paradoxical as it may seem to you, my personal view is that the assumption was and is unrealistic but I nevertheless agree that the statute took the right approach.

We are now told by the New York Stock Exchange that according to its most recent census, there are approximately 17 million individual owners of equity securities of publicly held companies. I doubt whether the great majority of those millions are in fact capable of making responsible investment decisions upon the reading of a prospectus meeting the requirements of the Securities Act. I take comfort from the fact that an older and wiser man said about the same thing in 1934. In a Yale Law Review article in that year Justice William O. Douglas said that: "Those needing guidance will receive small comfort from the balance sheets, contracts or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them or find them useful, or are so concerned with a speculative profit as to consider them irrelevant." I am not expressing any criticism of the lawyers, accountants and analysts who are the real authors of the document, or of the standards of disclosure which have developed in our thirty-year history of experience or of the efficacy of our review procedures at the Commission. I simply mean to suggest that a lay reader can read perfectly clear English and an orderly presentation of financial data and end up without a comprehension of the message sought to be conveyed. Having this view, how then do I justify a

continued personal support of the disclosure philosophy and technique? The short answer is that the public investor must continue to rely on investment advice. He has traditionally relied on others including his broker, investment counselor, securities salesman or even his bartender for that advice. It is the job of the Commission, with the assistance of the professionals in the securities business, to assure that these persons relied on, other than the bartender, have the information they need.

Some of you will recall more vividly than others the physical bulk and intellectual complexity of the early registration statements. Even as late as the early post World War II era a prospectus was a formidable document. A continuing drive toward simplification and clarification has revolutionized the document but it has not changed the essential fact that between the document and the investor there must be an intermediary whose function is to translate, summarize and recommend. For that intermediary to perform his function efficiently and responsibly at least the information called for by the statutes, our rules and forms is certainly necessary. We have, however, explicitly recognized that the typical investor would find much of this information burdensome rather than informative. The larger part of the material included in a registration statement is either omitted from, or briefly summarized in, the prospectus.

Let me highlight some of the principal contributions which the Securities Acts have made to the analyst and through him to the investor. First, the Securities Act of 1933 for the first time made

available with respect to a securities offering reliable information presented in accordance with consistent standards. Next, the Securities Exchange Act of 1934 extended standards of disclosure to listed securities. Periodic reports were required for both listed securities and for certain of those which had been registered under the Securities Act. (Since our other statutes have more specialized functions, I am passing them by.) The most significant part of the information called for by the '33 and '34 Acts relates specifically to financial data, including capital structure on both current and pro forma bases, audited balance sheets, and earnings and surplus statements.

(When I was in private practice, frequently as underwriter's counsel, I commonly took the position that the guts of the prospectus were to be found under the headings "Application of Proceeds," "Capitalization," and "Summary of Earnings."

In Section 19 of the Securities Act, the Commission was given authority, among other things, "to prescribe the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets or liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and non-recurring income, in the differentiation of investment and operating income, and in the preparation * * * * * of income accounts * * * * *." The Commission has exercised these sweeping powers with considerable restraint. The Commission's philosophy in this regard was set forth in its Accounting

Release No. 4, dated April 25, 1938, and it has not changed in 25 years.

A reliance upon "generally accepted accounting principles," as developed by the accounting profession, has left a great deal of room for variation in the accounting practices and principles observed by companies, whether or not they are subject to the requirements of the Commission. The unanswered question presented by this history, to which analysts might well help us find an answer, is whether the Commission's restraint has been and continues to be in the public interest and in the interest of investors. Do the disclosures of accounting principles followed, as contained in the prospectus, really make it possible for an analyst to make a side by side comparison of two competing companies' earnings statements? I doubt it. I do not suggest that unvarying application of uniform accounting principles is a desirable end in itself. I don't like strait jackets. However, we may not have gone as far in that direction as we should.

A related question which arises is whether the form and quality of the internal accounting controls and systems maintained by a particular issuer are of such a character as to permit reliance by the analyst on the interim, unaudited earnings statements which are now commonly released by the issuers to stockholders and the public, and which appear with regularity in prospectuses. Our accounting staff makes it a practice to inquire into this matter in cases where the circumstances suggest the need for such an inquiry. In all cases the issuer is required to represent that all

adjustments necessary to a fair presentation have been made and to identify in detail any adjustments other than normal recurring accruals. Are these safeguards sufficient? Should we require a certifying accountant to comment on the quality and character of the internal systems and controls, inasmuch as he is the only independent person who has, as a matter of course, an intimate familiarity with them? Should the underwriters be the select beneficiaries of the so-called "comfort letter"? Personally, I think not.

Consider, if you will, another aspect of disclosure. In the business of many issuers, emphasis is frequently placed on the amount, character and effectiveness of expenditures for research and development. You gentlemen are familiar with securities which have been sold on the basis of that and little more. I question whether it is sufficient that there be disclosure of the amount of such expenditures, or of the number of M.I.T. graduates who are on the payroll, etc. How does the analyst really get to the heart of the matter? Is there anything that can be done within the limits of our powers to provide more meaningful information? A similar question can be asked with respect to the brief biographical data furnished in respect of the management of an issuer which comes into the public eye for the first time through a public offering. No responsible underwriter and no responsible analyst would make a judgment as to the quality of management on the basis of the disclosure which we now require.

Finally, there is that ugly, dirty word, the forecast. A prediction of sales or earnings, the prospect of securing a contract or striking oil, each of these is an anathema to a Section 10 prospectus or a Regulation A offering circular. It is one thing to recognize that the use of prediction presents the most tempting, not to say irresistible, opportunity for fraud, old-style or new. It is quite another to refuse to face the fact that every expenditure is based upon anticipation. As long as saving and investment require, as they must, a deliberate choice in favor of the postponement of expenditure for desired ends, the investor must be "sold" on the choice. You and I know of no "stick" tolerable in our political and economic system which will produce investment of private capital. We are all aware of the "carrots" whose use is accepted because they are necessary, legitimate and effective. I prefer Dickens' "Great Expectations" to Proust's "Remembrance of Things Past," and I am not talking about literary taste.

The information to which I have referred is a part of the raw materials you insist on having--or at least you do if you're worth your salt. For a variety of reasons, you will not find any of it in the public files of the Commission. To that extent at least, it is "bootleg" data. There are several things wrong with this information so long as it retains its bootleg character. For one thing, as was the case with all pre-1933 data, there are no satisfactory standards of uniformity or quality or objectivity. The sales and earnings forecast of an electric power

and light company may be money in the bank; a similar forecast for a new R & D company, however well intended, may be the rankest speculation. For another, it is very difficult to pin ultimate responsibility for the use of this information on the right person. An investment counselor, registered under the Investment Advisers Act of 1940, has a statutory responsibility within certain limits, for the information which he furnishes to his client. I have no trouble with that result, but I am made uncomfortable by a circumstance which, as a practical matter, permits the original source of the misinformation to go scot-free. Our anti-fraud provisions, such as Sections 12 and 17 of the '33 Act and Section 10 of the '34 Act, are not perfect policing devices.

To sum up, our Special Study is going to produce a lot of food for thought and action. The fact that it may not focus on each and every aspect of disclosure standards should not be taken as an indication that such is no longer warranted. After 30 years, we have only just begun.