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INVESTOR RELATIONS AND CORPORATE CREDIBILITY

by

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I am happy to be here today to exchange ideas with you. When I was here last year, I said that the SEC and the NIRI have "parallel objectives." And what I have seen during the past year at the SEC convinces me of that. What you of the NIRI call "shareholder relations" and what we at the SEC call "investor protection" should come down to pretty much the same thing. So we're in business together.

Government can do and has done a good deal to attain the objectives that the Congress sought to achieve by the series of investor protection statutes enacted between 1933 and 1940. But in the last analysis the attainment of those objectives--which I might put in capsule form as a free, fair, and open market in securities, a market in which all of the participants have access to the information that they need in order to formulate rational investment decisions--depends on business, not on Government. It is the companies and not the Commission that have the information that investors need. So it is up to the companies to get that information out to the public. We at the Commission can guide and assist. But our role is secondary. Yours is primary.

I will in the main be talking about financial reporting disclosure to investors. That is the area of our common concern, the one in which the functions of the SEC and the NIRI intersect.

Significant though the Commission's disclosure accomplishments have been, its work in this field has reflected heavy emphasis on new financing and relative neglect of continuous disclosure for the statistically far more significant trading markets. There are many reasons for that.

Historically, the first task which the Congress delegated to the Commission was that of protecting buyers of securities to whom companies and underwriters offered new issues of securities. That task has always been and remains one which is pressing in the sense that a serious time deadline is always attached to it and one which commands the largest group of the Commission's Washington staff. This has over the years produced a bias toward calling for the utmost conservatism, towards demanding understatement, towards excluding judgments and expressions of opinion in describing a company and its prospects. This approach has been effective in curbing the more exuberant and less responsible promoter, albeit with side effects which have developed a negativism in new issue prospectuses which has impaired their usefulness, a condition we are trying to correct by rejecting boilerplate and calling for specific descriptions and expressions of judgments and opinion if they are well based.

But where this historical bias has really given way and where it is of great significance to investor relations people is when it has had the effect of underinforming existing shareholders by withholding from them management's opinions and judgments about the future. These shareholders are not necessarily buyers as are those to whom new issue prospectuses are addressed. They need information which will help them to decide whether to hold what they have or sell. If they are not given a full picture they may sell themselves out too cheaply. Thus, when we put restrictions on management passing along to stockholders information about appreciation in the value of assets, the prospects of new discoveries, the development of new technologies and methods and products,we may be putting existing shareholders at a disadvantage in their investment decisions and dealings with those who are able to acquire realistic information in the market place and elsewhere. Opinion, judgment and all future oriented information calls for prudence and care in developing the factual basis and drawing a conclusion but that is no reason for prohibiting it.

I'm aware that that places a heavy responsibility on corporate managements. But it's one which you can't avoid. As Joe Louis said about one opponent, "he can run but he can't hide." What do you really have to convey to investors about your company? There was a time when investors wanted to know the value of the company's assets and the reliability of its dividend. Then they wanted to know about earnings and growth in earnings. Today, we have seen enough situations where reported earnings and growth turned out to be illusory that I believe investors are looking for something more. True, they want an earnings figure and they want one which they can rely on as a consistent measure of corporate performance and progress and one which is not subject to manipulation. The development of accounting standards which will achieve that is perhaps the most important task before the accounting profession and the Commission. I believe the Commission has a continuing obligation in its disclosure work to bring out the facts on shifting accounting methods or utilizing tax elections or changing assumptions to produce an increase in earnings or obscure a decline in operating performance. But I believe you have an earlier and a more fundamental interest. Investors, actual and potential, in your company will increasingly expect information beyond what earnings are being reported. They want to know how good the company is, how solid the earnings are and how real the growth is. Now, much of this can be indicated by the financial statement. Much of it can be brought out in the reports required to be filed with the Commission. But only management and the professional securities analyst is likely to put it all together.

Which brings me to what, in my opinion, investor relations really is at bottom. It is the conveyance of the credibility of management.

When the figures are elusive, investors have to base their judgment on their confidence in management. To maintain credibility with investors, management has to tell it like it is. If the true course of operating progress or growth is exaggerated or obscured by accounting methods or tax factors or new assumptions or perceptions about the future, credibility can only be maintained by spelling it out whether the accountants require it or not.

The market itself has rather a good record in measuring credibility. You can fool some of the people some of the time but you can't fool the market for too long. The market has a measure of credibility which it calls the price-earnings ratio. When the work of analysts, the work of the financial press and the great reaction of investors big and small simmers into a feeling that earning figures may be contrived or gimmicked up and apparent growth is not real, the market speaks, the price-earnings ratio erodes and values evaporate. In recent years, we saw the price-earnings ratio erode in life insurance companies, leasing companies, land companies and others from two to five years before the accounting and financial reporting problems were publicly recognized and when that happens it's a long road back. If I were president of a public company, my job would be to maintain the credibility of our reports so that that would not happen to us.

I said a while ago that only management and the professional analyst department is likely to put together all the elements necessary to a judgment as to how good a company is and how real and durable its earnings and its growth are. Your securities are being traded today in a market in which institutions account for most of the trading while individuals own most of the stock. At the same time, institutions either employ or have access, frequently on a preferred basis, to most of the analytical talent while the liquidity of your shares and much of their long term value depends primarily on the confidence of your shareholders and your credibility with the investing public. It seems to me that if I were president of a public company I would instruct those charged with investor relations to do everything they could to see that the information available to my stockholders and potential investors was as good and stayed as good as that being put out by professional analysts. After all company information about its performance, its market, its technology should be at least as good as that put together by outside analysts. Now, I put this to you as a matter of self interest, whether or not it is a matter of legal requirement. And in doing so, I don't want to in any way be understood to be casting reflections on the role of the professional analyst which I believe to be very important. The work of good analysts is and always will be critical in spotting the management which does put a current flip in earnings ahead of long term credibility in assessing relative values and opportunities as between industries and companies in an industry, in relating equity values to new forces in technology and society and to the ebb and flow of national and international economic forces. But if they are able to provide some investor with better information about the true performance and clearly forseeable prospects of your company I think your stockholders have reason to be unhappy.

Compare two company presidents. One hears that analysts are predicting that his company's earnings will be up 20 and 30 and 40 percent increases in the current year. His own estimates and internal reports do not indicate anything like this. But he remains silent on the view that he has no responsibility for what someone else is saying. Then, all of a sudden brokerage firms who have been recommending the stock at prices reflecting analyst's projections wake up and try to get their customers out or the analysts revise their projections and tell their favorite institutions. Another president hears that analysts are predicting earnings for next year which he doesn't see. So he walks into a securities analyst meeting and says, I think we'll do good next year, maybe 7 percent over this year but not 15 percent higher as some of you have been predicting. Which company will have greater credibility, happier stockholders and the higher price-earnings ratio, all other things being equal?

Today, I'm going to outline our thinking on getting dissemination of the critical information which is disclosed and what we may be able to do to help.

Now I have said that management has the primary responsibility for disclosure and maintaining investor credibility. Whatever the SEC does about formal disclosure in documents filed with it, and we hope to do a lot to improve it, other types of disclosure of the type to which you devote so much of your time--press releases, reports to security holders, meetings with analysts--will continue to be of crucial importance. After all, in a nation with over 30 million stockholders, there are only about 1000 subscribers who regularly receive some or all of the disclosure documents filed with the SEC. The big dissemination of financial information is in annual reports and the financial press.

The Commission has a duty to bring to light facts which serve as checkpoints on the reliability of financial reporting and the adequacy of the dissemination of information as well as its disclosure and the trading of insiders--all elements bearing on the root question of credibility. Let me review some of the steps we have taken recently or have under consideration.

The trading activity of insiders may speak more tellingly than any message to the investing public. That's why Congress placed a statutory requirement on directors, officers and 10 percent shareholders to report to the Commission within 10 days after the end of each month all their purchase and sale transactions during that month in the shares of a company in which they had this position. A year ago, this data was filed manually and printed up by the Government Printing Office four months later. We have computerized this data. It will be available in printed form two months earlier. And I might also point out that the printed material will be more useful than it has heretofore been because it will for the first time give the price at which the insider sold. We hope for significant further progress in this direction. The Commission's new (at any rate, still relatively new) Rule 144 requires that a report be filed with us on the day the order to sell is given. Hence we are now getting contemporaneous information about insider sales. We no longer have to wait as much as 40 days until we get a report of the transaction. In the not too distant future we should be able to have computerized printouts of this 144 data available on a weekly (perhaps even on a daily) basis. And right now, today, someone interested in what the insiders of a particular company are doing can telephone or come down to our Division of

Corporation Finance and find out what 144 reports were filed with respect to dispositions of that company's equity securities last week, yesterday, and thus far today.

By placing this emphasis on insider sales I don't want to imply that any sale by an insider is a vote of no confidence in the future of the company. Indeed, it is my view that the public protection is enhanced when we make it easier for insiders to sell. When exuberance by analysts or institutions or the public takes the price beyond its reasonable value, insiders are in a position to recognize that fact. If they are restricted from selling, the supply demand factor is likely to take the price still further into the stratosphere. If they are able to sell, this will moderate the peaks and valleys and protect the public from paying excessive prices. That's why I believe Rule 144 and the short registration forms making it easier for insiders to sell a disclosed basis protects the public and promotes price stability and true values in the market.

Let me tell you about some of the things that we have done and are thinking of doing to highlight critical information--that which goes to the viability, the solidity of earnings reports and the credibility of an issue.

(1) Some time ago, we amended our Form 8-K to require that any change of auditors be reported promptly on that form. But we require much more than a mere bare statement that Messrs. A, B and C have been replaced by Messrs. X, Y and Z. If the change resulted from a conflict of views between the client and the first firm of auditors, we require that this difference of opinion be disclosed and a confirming letter from the auditors involved furnished. This requirement has been in effect for ten months. During that time we have received 15 reports indicating that switches from one auditor to another were attributable to differences of opinion about accounting treatment. Our staff is studying these reports closely. In due course we shall report on the results of these studies. That report will, I think, make for some real steps forward in financial disclosure and investor protection. It should certainly curtail the practice of shopping around among auditors for the purpose of finding the firm with the most flexible conception of "generally accepted accounting principles" and the one least inclined to insist that the phrase "applied on a consistent basis" means that there has been some real consistency.

(2) We recently issued an accounting release recommending that companies establish audit committees composed of outside directors so as to establish direct channels of communication between the non-management directors and the auditors. This will, we think, give investors greater assurance as to the quality of financial statements.

(3) Just this past Friday we published a proposal for amending all of our disclosure forms so as to require far more comprehensive and much more prompt disclosure on writedowns, writeoffs, and extraordinary charges. This proposal seeks to give the investing public a good deal more information than it now has about the underlying reasons for such charges, especially the reasons for timing them as they are timed. Why was a plant that had obviously become economically hopeless in 1969 not written off until 1972? By raising such questions the fuller disclosures that we have in mind should do much to discourage this kind of income management.

(4) We are thinking of amending our Form 10-K on which companies make their annual reports to us to require that anything in that report left undiscussed in the annual report to stockholders, which investors actually get, be specifically noted. This should expose the practice of

concealing from the stockholders material reported to the SEC because the law requires that it be reported to us. At one time a requirement that discrepancies between the 10-K and the report to stockholders be disclosed would have been doomed to futility. At that time not that many people bothered to look at our 10-K reports. Actually getting hold of the reports was difficult, time-consuming, and expensive. And when an unusually industrious analyst did go to the trouble of getting one, he often found it rather unilluminating. But in recent years the 10-K report has been greatly beefed up. And those reports are now available on microfiche to the financial community at reasonable cost. If an analyst can look at a 10-K report (as a great many of them now do) and see at a glance that there is something there that is not in the report to the stockholders, he'll know that he has to dig into things more deeply than he might otherwise think necessary.

(5) Auditors sometimes find themselves so dubious about a company's viability as a going concern that they find themselves unable to give an opinion as to the overall fairness of the financial statements, which rest after all on the implicit assumption that there is a going business here which can reasonably be expected to continue operating for an

indefinite period in the future. We think it imperative that such prime candidates for bankruptcy or reorganization proceedings be spotted at the earliest possible moment so that investors may guide themselves accordingly. Therefore, we propose to maintain a list of companies whose auditors have deemed themselves constrained to express serious reservations about viability and to publish the list in our Daily News Digest, which has a wide readership in the securities business and which financial reporters follows carefully.

Enormous quantities of information flow into the SEC. I have often described our Headquarters building down on North Capitol Street as the biggest goldfish bowl in town. There we maintain a treasury of facts and figures on the almost 10,000 companies that report to us. As you know, those companies file annual reports with us on our Form 10-K, quarterly reports on Form 10-K, and reports on our Form 8-K whose filing requirements are triggered by various significant corporate events. We get 15,000 of those 8-K reports every year. And the total number of reports filed with us in a year exceeds 200,000.

The problem -- and for many years it seemed virtually insoluble -- is that of getting this information out to investors and to those on whose advice investors rely. Here technology has come to our rescue. It has helped us get this material out of our morgue to where the people are and where the decisions are made. We have computerized much of our data and will be computerizing more of it. And I hope that in the not too distant future our tapes will be available to people around the country who wish to put them into their computers. Of course, we have the microfiche reproduction service to which I referred earlier.

But the job of putting the plethora of information that the SEC's requirements elicit into compact, usable, readily intelligible form so as to achieve maximum coverage is one for communications specialists like yourselves. I suggest, for example, that any event significant enough to be reported to the Commission on Form 8-K may be significant enough to warrant an immediate press release and perhaps a letter to shareholders. Certainly a review of 8-K's filed during the period would be appropriate in quarterly and annual reports to stockholders. We have already gone a long way toward achieving the ideal of a well-informed investing public. But much ground remains to be covered.

As you see, we at the Commission have given and are giving much thought to the dissemination problem. We welcome, indeed we solicit, ideas and suggestions from you that will help us move toward that ideal -- a really well-informed community of investors.