

SECURITIES AND EXCHANGE COMMISSION
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THE ANALYSTS AND THE SEC

An Address by

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

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New York Society of
Security Analysts

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Now that I am here - - and I am most pleased to be able to spend some time with this most prestigious body - - I have some things I would like to say before we open things up for a general question and discussion period.

We at the Commission are well aware of the fact that financial analysts are the principal immediate beneficiaries of our disclosure program. You will therefore be gratified about our steps toward an improved continuous disclosure process. To name a few of the more important ones, we have acted affirmatively with respect to:

(1) the filing of timely information regarding unusual charges and credits to income.¹ This information was designed to enable analysts and others to study with care the major charges and credits which were being made to the income account, often, previously, without full disclosure. Under the new rules, a Form 8-K must be timely filed, setting forth the details associated with the charge and including a letter from the registrant's independent public accountant indicating that the accounting principles followed are in conformity with generally accepted accounting principles.

(2) the disclosure not only of substantial additional details as to cash outflows in connection with leases, but also the present value of noncapitalized financing leases, in a single figure, to enable analysts and others to appraise debt equivalencies, and to compare, in a meaningful way, companies using lease financing with those using more conventional debt techniques.² In addition, this rule requires disclosure of any effect on earnings that would have resulted if nonfinancing leases had been capitalized.

¹ Accounting Series Release No. 138 (Jan. 12, 1973).

² Accounting Series Release No. 147 (Oct. 5, 1973).

(3) requirements for the disclosure of income tax expense,³ which we believe will be of substantial assistance to the analytical community. Corporations now must explain why their effective tax rate, as indicated by their financial statements, differs from the statutory federal income tax rate, and they must reconcile any differences between the two. By the use of these data, analysts will be able to understand variations in tax rates from one period to the next, and will be able to judge whether they constitute merely a one-time tax saving, or a tax saving which may be expected to recur and, investors and, at the same time, provide more detailed schedules and other data which will be meaningful to professionals who have the ability and time to make use of them.

Some persons have expressed concern that such a policy of differential disclosure exacerbates the inherent imbalance favoring the institutional investor over the individual. I appreciate the motivation behind this concern, but I think that upon examination, it implies an untenable policy. It suggests that we limit corporate disclosures in form and content to material which is comprehensible to the least sophisticated and most hasty reader. Obviously, this would not be satisfactory. In fact, the federal securities laws have always recognized, at least by implication, that the disclosures required have levels of usefulness. The only thing new is the explicit articulation of policy.

Even this is not really so new. Some of you may recall, in this regard, the Commission's study of disclosure policy popularly known as the Wheat Report. It had long been commonplace to observe that the typical statutory prospectus hence, to contribute, on a continuing basis, to a firm's earning power. In addition, this rule change requires disclosure of the source of timing differences between book and tax deductions,

³ Accounting Series Release No. 149 (Nov. 28, 1973).

which should further assist analysts in understanding the nature of the tax accrual and the current and prospective cash implications of taxes.

(4) increased disclosure of short-term financing costs and policies.⁴ Under these rules, corporations must disclose short-term borrowing rates, lines of credit outstanding, maximum amounts of short-term borrowings incurred during the year and compensating balances maintained to support short-term financing arrangements.

Perhaps of most significance for the future was our formal espousal, for the first time, of what we are calling “differential disclosure.” This refers to requirements, actual and proposed, for providing summary and, hopefully, more graphic information which will be meaningful to ordinary investors and, at the same time, provide more detailed schedules and other data which will be meaningful to professionals who have the ability and time to make use of them.

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⁴ Accounting Series Release No. 148 (Nov. 13, 1973).

formidable a document to be read and comprehended by most investors, to say nothing of the even less digestible information provided in Part II of the registration statement and the exhibits. The conventional response was that even if this is so, the investor's professional adviser can comprehend the material and the investor benefits from his advice.

The Wheat Report, in a sense, went a step further. In surveying uses of corporate disclosures produced by the federal securities laws, it made a most interesting discovery. It found that professional securities analysts regarded the full-blown merger proxy statement as the single most informative document produced by the whole system, while ordinary investors regarded this same document as an incomprehensible horror. This was a dramatic indication of the fact that disclosure documents mean different things to different people, and Mr. Wheat drew the reasonable conclusion that we should work toward providing useful communications in both directions - - summary information which can be grasped in a hurry plus detailed information for those with the time and inclination for study and analysis.

We are aware of the difficulties involved in such differential disclosures. Summaries make lawyers and accountants nervous. There is always the danger that some omitted detail will upon hindsight be judged material. And on the other side, there is the fear that, once the Commission departs from the discipline of limiting disclosures to material readily comprehensible by the ordinary investor, there may be no end to detail that may be required. We understand these worries, but we don't think them sufficient to abandon the frank recognition of a policy of differentiation that has always been inherent

in the process. The answer must lie in good judgment, as indeed it always has. Analysts, in particular, should welcome such a policy.

Now, having noted the central role played by securities analysts in the total disclosure process and the Commission's articulated policy of requiring disclosures expressly for utilization by analysts, let me turn to the burning question of the professionalization of securities analysts. We are in favor of it. Analysts are playing an increasing role in the making of decisions that determine the allocation of capital for American industry. We think it desirable that these decisions be made, in the main, by sound, fundamental analysis rather than by random walking or dart throwing.

This requires not only that the analyst have available as much meaningful data as possible but also that he have the competence to make use of it and that he make use of it in an ethical manner, consistent with a fair and equitable market for all investors.

As might be expected, in the absence of restraints, legal or otherwise, the practice of securities analysts has attracted the ugly along with the beautiful, the inept imposter along with the highly trained and conscientious professional. As we have learned in other areas of comparable endeavor, this is bad for the public, and it is also bad for those practitioners who want to behave in accordance with high performance and ethical standards, because unprincipled competition makes the maintenance of high standards more difficult by those so inclined and gives the whole activity a bad name.

I think there is widespread, if not universal, agreement on these broad propositions. There has been somewhat less agreement on what to do about it. Attitudes that I have encountered run the whole gamut. Some argue that whatever problem there is in the present situation will work itself out. Competent analysts will drive incompetent

competition out of business by the quality of their work, and unprincipled analysts will ultimately lose their clients or be put out of business by law suits or government action. Furthermore, analysts have too many methods of approach, none being able to claim superiority, and serve in too great a variety of ways to constitute an officially recognized and regulated profession.

Others, of course, including most notably the leaders of your own society here in New York, have come to quite the opposite conclusion and have sought to establish securities analysis as a legally recognized and fully regulated profession.

The leadership of the national Federation, as you know, has come down pretty much in the middle. The proposals adopted by the delegates at the FAF annual meeting last Sunday look toward voluntary establishment of professional standards and discipline without legal sanction or governmental intervention.

Where does the SEC stand on this issue? As far as official actions and pronouncements are concerned, we have stood only on the sidelines, much to the irritation of militant partisans in each camp. For a variety of reasons, including other priorities, we have not taken the initiative in the professionalization movement. Those of you who have been engaged in discussions with our staff on these matters have, nevertheless, discerned now certain attitudes, most of which are probably predictable for a federal agency.

There is no reason in the world why we should oppose the FAF's current program and every reason why we should wish it great success. As in other professions, standards set by the profession itself are most willingly adhered to by its members, and the formal disapproval by one's fellow practitioners is strong medicine for anyone who cares about

his reputation and standing. We applaud the FAF for taking this critical and progressive step, and we hope it is supported by the societies so that the great experiment can begin.

From the governmental point of view, the obvious question is whether this voluntary program is enough. Last winter, thinking that we might want to say something officially on the subject, our staff drafted a statement which reflected our position but which we never in fact issued since the abandonment of your society's legislative proposals made such statement unnecessary - -

One proposal announced by the Financial Analyst Federation calls for voluntary membership in the FAF for all security analysts. Members would meet certain qualifying standards, adhere to a code of practice and ethical standards and be bound by the disciplinary procedures of the Federation. We recognize that a voluntary program may not reach those very persons for whom standards of qualifications and practices are needed. We also recognize that a voluntary program may have only limited effect in disciplining members who go astray. Nevertheless, to the extent this program would elevate the level of information available by establishing national, uniform standards of qualifications and practice for all security analysts, it is worthy of encouragement.

The same statement then referred to the then still live proposal of your society for state legislation, saying - -

Although this is a laudable attempt to professionalize the security analysis community, it could lead to differing procedures and standards in each state which would certainly create confusion and hardship for all. Further, it would have a far reaching impact outside of New York. For these reasons, it would seem that if any regulatory system of this type is necessary, it should be implemented only on a national scale. We are also concerned that the NYSSA proposal would extend only to "publishing" analysts, with merely voluntary licensing for the large community of portfolio managers, investment counselors and their research associates.

I realize how frustrating it is for those of you eager for quick legislative action when we say that if any such thing is done, it should be at the federal level, and then nothing happens at the federal level. Nevertheless, the truth of it is that we do not find

the answers to the several questions involved in any federal program at all obvious. Nor do we view the situation as presenting such a critical emergency that we should rush to Congress with some hastily constructed crash program.

As some of you may know, we have asked our staff to work on possible regulatory and legislative approaches which we can consider. One of the threshold questions in this regard is whether the mere adoption of a federal legislative program or administrative rules on our part would be used as a reason not to support the present FAF proposal, a result that I think would be most unfortunate. I would hate to see this voluntary effort defeated before it could begin, and anyway, many moons can pass between the proposal of a legislative program by the SEC and the final effectiveness of legislation.

Once one considers what form any federal legislative proposal should take, a host of other questions arise. These include whether there should be direct government regulation or government sanctioned self-regulation, after the pattern of the Maloney Act and the national Association of Securities Dealers. And what should be the point of entry, so to speak, especially in relation to the Investment Advisers Act of 1940. Should it be publishing with attribution - - the public practice of securities analysis - - or anyone doing such work, even though not disclosed to the public? These are the same questions that your society struggled with in developing your proposed legislation, but we are not instantly prepared to adopt your solutions.

To sum up, we wish to encourage the movement toward more effective professionalization of securities analysis, and that means, first of all, that we hope the FAF's proposed program is approved and gets going. If there is to be a legislative or

regulatory approach in addition to the FAF's voluntary program, we think it should be federal rather than state. We are not yet fully convinced that federal regulatory or legislative action is necessary, but to enable us to consider the question more intelligently, our staff is working on possible solutions.

In closing, let me express our admiration for the vigor and public spirit that your society continues to display. Even while not favoring your legislative effort, we fully agreed with what you were trying to accomplish and respected you for trying. Your society and the SEC have so many common causes to pursue that I hope our relations will remain close and cooperative.