ADDRESS OF
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OF THE
SECURITIES AND EXCHANGE COMMISSION

BEFORE THE
16TH ANNUAL CONVENTION OF
THE FINANCIAL ANALYSTS FEDERATION

AT CHICAGO, ILLINOIS
MAY 15, 1963

In light of my understanding that this is either the first or one of a very few times that an SEC Commissioner has had the pleasure of addressing this distinguished group, I thought it would be appropriate to direct my remarks to the nature of the relationship between the SEC and financial analysts as a professional group. It is obviously a timely topic when you relate it to the project in which the Commission has been so heavily engaged for the past 18 months.

We are now in the homestretch of the Special Study of Securities Markets which began on September 5, 1961. Since then my fellow Chicagoan, Milton Cohen, and an accordionlike staff of about 60, have been working days, nights and most weekends, almost without break. This remarkable group of dedicated pros under the direction of Milton, Richard Paul, Ralph Saul, Herbert Schick and Sidney Robbins have analyzed, with the help of a battalion of computers, hands and brains, literally thousands of detailed questionnaires; have conducted innumerable interviews; have drafted, reviewed and redrafted, and in general done a thorough and workmanlike job of fact gathering and writing. Last but especially, they have thought out and through a range of problems which, as gathered into a single package, has no precedent in the Commission's history if indeed it has any precedent at all. Even if their recommendations are not to be universally applauded or accepted they are, in the Commission's view, immune to the criticism that they are the ramblings of a bunch of ivory-tower professors down in Washington. They have the data and they've certainly done their homework. In a panel discussion before The Practising Law Institute last week, Milton Cohen said and I quote, "I believe that we have provided a springboard for action by the Congress, the Commission, the members of the self-regulatory bodies and by members of the industry." This is not just his personal judgment or that of the Special Study. It is one heartily endorsed by the Commission.

Chapters I, II, III, IV and IX have been delivered to the Congress already. The remainder is expected to be delivered on or before June 1. We are painfully aware that nearly everyone interested in the work product of the Study is still laboring in the dark, dependent on the coverage provided by the financial press and on word-of-mouth reports from the comparative handful of people to whom we have been able to make the text of those first five chapters available. As to when the lid of secrecy will be lifted by the distribution of printed copies, only the Government Printing Office really knows. I don't mean to be critical; it's just one of those unfortunate things which was not within our control.

Although I commend the entire Report to you, an unusually readable document, Chapters II, III and IX are those which should be of the most immediate and personal concern to this audience. Chapter II examines standards and controls relating to the entry of individuals into the securities business. Chapter III deals with the activities and practices of those already in the business with a special section on investment advice. Chapter IX deals with the extension of the reporting, proxy solicitation and insider-trading requirements of the Securities Exchange Act of 1934 to those companies having securities traded in the over-the-counter market and having a sufficient number of security holders to establish a public interest. It also considers problems arising from certain practices in the field of corporate public relations.

A luncheon talk is not the occasion to present all of the details but I will try to highlight some of the more thought-provoking aspects of the content of these Chapters. The highlights to be mentioned today can be most usefully viewed in the context of the respective roles and activities of the Commission and of analysts generally. What are we doing--what should we do next?

The development of the financial analyst as a personality and as an adviser to the general public closely parallels the popular acceptance of common stocks as an investment medium. That public acceptance didn't really develop until the public corporation began to cast off the mantle of secrecy and corporate financial information began to become generally available. In the 19th century, most corporations simply refused to reveal the basic facts about their operations. When the newly formed U. S. Steel Corporation published large excerpts from its annual report in 1903, it was considered a unique and daring experiment. The enactment of the Securities Acts followed a period of development of voluntary disclosure standards and prospectuses. Periodic reporting under these acts has ever since supplied the starting point for most sound evaluation. This is a chapter in the business history of our country for which it is hard to find a counterpart elsewhere, with the exception of the British Commonwealth nations. The English Companies Act is something of a grandfather for us all.

The famous Barron's contests of 1925 and 1927 probably did as much as anything to take the equity security from the category "speculative" and move it to the category "investment." The hypothesis that a sound investment program should take common stocks into consideration was developed by such writers as Edgar S. Smith, Kenneth S. VanStrum, Ralph E. Badger and others. Their work combined with the bull market of the late 1920's to awaken the interests of the general investing public. Graham and Dodd's--Security Analysis, one of the cornerstone texts of financial analytical theory, really made the point once and for all in 1934. The growing acceptance of common stocks as an investment medium for the investor of modest means as well as the financier with a few hundred thousand dollars to manage has swollen the ranks of owners of equity securities to the point where the most recent New York Stock Exchange census tells us that 17-1/2 million Americans own common stocks. Most of these people have neither the time, the inclination nor the specialized intelligence to arrive at investment decisions unaided and the Financial Analyst supplies in almost every case the missing ingredients. In this setting the population of the financial analyst community has demonstrated the same propensity for growth as evidenced by more than 7800 professional members of your Federation in 31 local societies. It is hard to imagine that this membership could have so grown in size and stature except in the context of the disclosure philosophy embodied in our statutes by Congress and fostered by the Commission, the principal stock exchanges and the NASD.

There are two categories of consumers of investment advice--the general investing public and the institutions which are entrusted with the savings of that public. Although large institutional buyers usually have their own analytical staffs, they frequently employ outside advisers in at least an auxiliary capacity. I think that any distinction between the "inside" and "outside" analyst, i.e., "buying" v. "selling" analyst is at most a technical one. In either case, analytical advice is the basis for the investment of someone else's money. Hopefully, a top flight analyst in either category would employ the same methods, use the same materials and render his advice in substantially the same form as his opposite number. So, for the sake of simplicity and because the average individual investor has more concern with the "selling" analyst, my remarks will center around him.

The average investor gets his investment advice either from his broker, an investment advisory service, a bank or other non-affiliated investment adviser. In many cases the advice that he receives is independently developed at its source but in many more cases it's borrowed from another analyst who, in turn, may or may not be an original author. But speaking of the effect of the advice, regardless of its source, I note that one writer estimates that certain analysts command influence sufficient to shuttle as much as $30 million in or out of a single stock as a consequence of his recommendations to his firm's individual or institutional clients. You are obviously persons of consequence and responsibility.

There are some problem areas which seem inherent in the structure where the analyst works for a broker-dealer. Our Study reports that "buy" recommendations far outnumber "sells." Recognition that the very function of the "selling analyst" is to produce such recommendations does not dispel concern prompted by a tendency to "accentuate the positive and eliminate the negative." Even if the analyst responsible for a market letter feels generally <u>bearish</u> he may be encouraged to suggest "stocks to buy for the decline"--"good defensive stocks," etc. You can gather a more human reaction to this problem from the following quotation from Chapter III: "The analyst in charge of research at one broker-dealer firm commented to the Study on the adverse reaction after he had recommended the sale of a stock which previously his firm had favored. The president of the issuer, he said, 'was quite upset about the sell recommendation in our December letter. Now, this in itself indicated some sort of, let's say, weakness on his part, to my mind, at least, in the sense that it showed some preoccupation with [the] common stock. . . . At least I should have the freedom of choice as to what we recommend and don't recommend.'"

This analyst may have been restricted by any one of a number of factors influencing his broker-dealer employer. For example, the firm might have had a position in the stock or an historical underwriting relationship with the particular issuer. The catch-all phrase in this area is, of course, "conflict of interest." In the case of a firm having a position in a stock, the Report quotes testimony to the effect that: "'Ownership tends to make errors on the bullish side.' Broker-dealers questioned by the Special Study showed no consistent views on the propriety of recommending securities in which the firm is disposing of its position, or on the necessity of disclosing that it was doing so. Some firms take the strictest view, saying that they will not even solicit purchases by their public customers of any such security. Others say they will not prepare a market letter or research report on a security in which they are liquidating an investment position."

It is not always clear what such a firm, so scrupulous with regard to its investment account, will consider ethical or proper with respect to trading accounts. Reliance on the typical "hedge" clause at the bottom of a market letter, such as: "In the general course of business, partners of and/or the firm of, and/or the employees of XYZ & Co., may or may not have a position, long or short, in the securities mentioned, and from time to time may be executing buy and/or sell orders for themselves and/or their customers" does not seem a very satisfying solution.

A market letter is presented to the public as a product of the hard work and ability of a trained analyst. The Study demonstrates that in many cases this portrait is unrealistic. A survey of research practices and the quality of research staffs of all types of advisers revealed wide variations. As I have already observed, attitudes toward "conflicts of interest" show a similar variability and are typically undisclosed. To permit the circulation of someone else's research without disclosing the source "represents an abdication of responsibility,"to quote the Study. It is clear to the Study and the Commission that in these areas existing controls are inadequate and the self-regulatory bodies have either avoided or have just begun to recognize the problems which have largely been left to them for solution. Market letters of member firms are presently reviewed by the New York Stock Exchange pursuant to certain "guide posts" which it has established. The effectiveness of this program is limited both by the generality of the guide posts and by the small staff assigned to the job. In 1955, the Commission suggested that a Statement of Policy be issued relating to general advertising and sales literature and that it be administered by the business community but this approach was rejected. The activities of the NASD, in collaboration with the Commission, in policing mutual fund sales literature demonstrates what can be done in this field. The Commission's Statement of Policy regarding investment company sales literature, which was adopted in August of 1950 and significantly amended in 1957, has resulted in considerable upgrading in the quality of that material. Since the inception of the joint inspection program pursuant to that Statement of Policy, the NASD has reviewed more than 80,000 pieces of literature and in 1961 commented on about half of the 10,500 pieces submitted by 165 firms. While the number of filings has increased each year, the percentage of corrective comments has consistently diminished. If the record of the self-regulatory organizations is spotty in this area, it must also be admitted that the Commission has hardly begun to take up the slack by exercising to any meaningful extent its powers under the Investment Advisers Act of 1940 and the other statutes it administers. Although the use of misleading literature has been one of the charges in broker-dealer revocation cases where there were other allegations of fraud, I know of no instance where we have moved against a misleading piece of sales literature standing alone. In the case of Heft, Kahn & Infante, we came close in that we named the author of a piece of misleading sales literature a cause of the revocation of a broker-dealer and thus focussed on his role.

Problems such as these that I have just mentioned, relating to the qualification of persons who would engage in the practice of financial analysis, to the mitigation of the consequences of conflicts of interest and to surveillance of the dissemination of the work product of analysis, are not dissimilar from those which have been dealt with to a greater or lesser degree in other areas of the securities business. In the solution of such problems in these other areas Government policy has placed explicit reliance on the concept of self-regulation. There seems to be no obvious reason why this same principle should not be applied in the area of analysis. For this reason, the Commission proposes to encourage both the development of a self-regulatory body for registered investment advisers as a class and the extension of NASD jurisdiction to the employees of NASD members who are engaged in analytical work. The Commission will also encourage the development of a statement of policy of more general application governing the content of market letters and similar materials distributed to the public investor.

The Commission has endorsed wholly or substantially the following pertinent recommendations of the Special Study: that the existing self-regulatory bodies develop standards and intensify their enforcement regarding broker-dealer representations as to the quality of their research staffs and advisory services; that standards of disclosure be developed through statements of policy covering conflicts of interest (including the position if any of the adviser), sources of research materials, research techniques employed and conservatism in predictions (including abolition of specific price predictions); that civil liability be a consequence of reckless advice; and that a self-regulatory body be developed to adopt and enforce substantive rules relating to advisory activities.

To further these recommendations, the Commission is developing a legislative program which in large part consists of Frear-Fulbright legislation designed to provide more of a public reservoir of information for more companies; a statute providing the basis for fixing minimum standards for entry into the securities business; an attempt to deal with the problems raised by the dissemination of false and misleading corporate publicity.

In addition, we are arranging for and conducting joint meetings with various segments of the industry including investment advisers. If there is one thing that the Study has told us, it is that there is very little about the securities industry that can be called average or normal. This is especially true when we are talking about qualifications and ethical standards and practices. The scale runs from the analyst who is a statistician, C.P.A., has a Masters in Economics and 20 years in the business to the adviser cited by the Special Study Report as having no financial experience and whose immediately preceding job had been as a writer for "Our Pet World." Therefore, in our discussions with industry, qualifications standards are a prime topic.

From the standpoint of rule-making, we are giving consideration to modification of the confirmation rule so as to provide more information to the investor at least at the time that he receives his confirmation, and rules designed to make a market letter a more uniform and informative document in that it will answer some of the questions raised by its reader, be he a member of the Special Study, a Commissioner, an analyst or an ordinary investor.

For your part, we think you should reassess and reevaluate your status as professionals and especially the function of this Federation and yourselves as members of this Federation. One of your most distinguished members has observed that "[Financial Analysis] is not an exact science, we all use the same tools. What really counts is imagination and how it is applied. Figures are not going to tell you everything." I might observe that his assertion as to the "use of the same tools" cannot be accepted without question. I certainly wouldn't deny that in most endeavors there is a knack or inborn skill which can't be taught. This is what enables some men to go to the very top of the heap and I have no desire nor do I think anyone could prevent this from continuing to happen. What I would like to see is such a standardization of basic requirements for entrance into the profession that the distinctions between the top and the bottom of the heap would be those of imagination and ingenuity rather than basic principles. In this regard I heartily applaud your activities in connection with the Institute of Chartered Financial Analysts. Some expertise is purely and simply the result of experience and I commend your recognition of this fact in the experience requirements for the three parts of the C.F.A. examination. I encourage you to support the Institute of Chartered Financial Analysts and to adopt a national statement of policy. This statement of policy should as a minimum include the disclosure of long or short positions in recommended securities and should stress independence. It should encourage a self-critical attitude and recognition of the limitations inherent in your profession. As one highly respected analyst has pointed out, "Admitting errors is an important part of this business. There never has been a market theory in all history that was 100% right all of the time." As another distinguished member of your ranks has said, "If you're right 60% of the time, you'll have a big following." It seems to me that while it may be somewhat less than an ego builder, it is important to the investor that the analyst promptly and candidly admit when he's wrong. Both the analyst and the public should be educated and encouraged to deemphasize the purely predictive aspects of financial analysis. A third important area to be covered by the statement of policy is the distinguishing of the analyst's obligations to the general public, vis-a-vis his clients, vis-a-vis his employer, and others. If you haven't read it, I recommend to you an article written by Dr. Douglas A. Hayes in the September-October, 1962, issue of the Financial Analysts Journal, "Ethical Considerations in Professional Stature of Analysts."

There is a risk that making membership in the Institute and the attainment of the degree of C.F.A. will become tantamount to certification of the analyst's product. I don't think this is a desired objective either for the public or for the analyst. It is nevertheless important to encourage analysts to take the examinations. This will serve to focus everyone's attention on the educational background and technical complexity of the profession and should weed out those individuals who are financial analysts by their own definition only. I have seen the study guide for part 3 of the examination and examined it thoroughly and I find the materials very provocative and searching. I would think that it would be in order for the Financial Analysts Federation to kick off a concerted membership drive closely tied to an individual's scheduling himself for these examinations and to encourage every analyst to complete the series and qualify for the degree C.F.A. Such a program should serve as a foundation stone for the future self-control and self-improvement of the financial analyst. A continuing emphasis upon the incorporation of attitudes of professionalism, conservatism and responsibility will best serve the public interest--the interests of both the purveyor and the consumer of financial analysis.