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"AMERICA NEEDS THE SMALL INVESTOR"

An Address By

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Securities and Exchange Commission

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NATIONAL ASSOCIATION OF
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I am happy to be here this evening with you of the National Association of Investment Clubs. Speakers often begin with sentences like that. I freqently do it myself. But this time I really mean it. Let me tell you why.

As Chairman of the SEC, my audiences normally consist of persons in the securities industry or in the business community generally, or in the professions that serve business--such as law, accounting, public relations. Exchanging ideas with such groups is an important part of my job. My colleagues and I on the SEC cannot do our jobs properly, cannot regulate intelligently, unless we are intimately familiar with the problems of those whom we regulate and with their thinking about those problems. That requires continuous contact between the regulators and the regulated.

Moreover, the task of raising standards in the securities industry and of seeing to it that we have the fair and the efficient capital market that we need to maximize economic progress is much too big for the Commission to do by itself. The attainment of that objective depends in very large measure on the climate of opinion among professionals in the securities business and in industry generally.

Government's big stick is an important part of securities regulation, as it is of all law. But the big stick is only part of the story. Securities regulation is a cooperative endeavor.

Of course, the Commission must be vigorous and independent. It is often said these days that regulatory agencies tend over time to become much too friendly with whom they regulate, that relationships of almost incestuous intimacy develop between the regulators and the regulated, and that the public interest suffers. By and large this type of criticism is greatly overstated. Charges of this type often rest on superficial analysis and on what I consider the pernicious notion that the ideal relationship between business and government is a state of perpetual warfare and unremitting hostility. And whatever the regulatory situation may be generally, I can assure you that SEC is in nobody's pocket and that it certainly isn't Wall Street's captive.

Indeed, when I address industry groups I sense a certain healthy tension. The audience wonders about what the SEC is going to come up with next, what we're going to try to take away from it now, what new disclosures we're going to insist on.

So I come at last to what it is about this evening that is a special source of pleasure to me.

Tonight there is no such tension between me and my audience. I am addressing a group of investors. That means I am talking to my own constituency and am among friends. It is a very pleasant feeling and one I seldom get. I seldom get it because, unlike such other interest groups in our society as Business, Labor and Agriculture, investors are by and large unorganized. There are well over 30 million of them. But, because of this lack of organization, the voice of the ordinary investor is soft. Usually one can't even hear it. That is most regrettable. It needs to be heard. I hope that in time to come this organization will do something to remedy that deficiency by performing the role of spokesman for the individual investor.

After all, you are the community the SEC was created to serve. If there were no broad investing public, there would be no real need for an SEC. To the extent that this broad investing public regards itself as disadvantaged in a marketplace dominated by the very rich, the powerful, and those who manage huge pools of other people's money; to the extent that it lacks confidence in the elementary fairness of the capitol market's mechanisms; to the extent that it finds the securities industry unresponsive to its needs; to the extent that it finds it difficult to get good, hard, meaningful information about the enterprises to which it has committed its savings; to the extent that it looks on the stock market as a vast gambling casino in which the house is something less than fanatically honest--well, to that extent the SEC has fallen short of its goals. And I might add that to this same extent, the whole society suffers.

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Let me review with you what the SEC is seeking to do for the small investor. We have a market today where institutions do over 60 percent of the trading and individuals own over 60 percent of the stock. We must see that growing institutional activity does not create a situation where individual shareholders no longer continue to have the service, the information and the fair dealing which attracted them to the equity markets in the first place.

I can think of no more appropriate audience to discuss these matters with. You represent some 12,000 of the close to 50,000 investment clubs estimated to be operating in America. Your 12,000 clubs have some 200,000 members. Your president, Mr. Thomas O'Hara, from whom I have received both good ideas and good information since coming to the SEC, has sent me data from a survey of investment clubs. This data indicates that members of investment clubs make new investments of $13 million every month, over 150,000,000 a year.

That's important money. But perhaps more important, I visualize investment club members as typical of serious, thoughtful individual investors utilizing an opportunity, open to all, to participate in a broad way in our economy. A while ago, an investment journal ran an article entitled

"Who needs the small investor." My colleague, Commissioner Hugh Owens, responded with a speech entitled "America Needs the Small Investor" and I agree wholeheartedly. So what are we doing to attract and hold the small investor?

First- we have had enacted the SIPC legislation to guarantee up to $20,000 in cash and $50,000 in cash and securities left with brokerage houses.

Second - We will put into effect on January 1, 1973, new regulations which will require brokerage firms to maintain reserves for customer's free credit balances, to segregate customer's securities and keep customer's assets separated from their business operations. This represents a considerable reform in practices which had grown up in the brokerage business and I believe we've worked it out so that it will not seriously impede the flow of paper or increase the costs necessary to the handling of stock transactions.

Third - There is progress in automating the handling of stock transactions. Over-the-counter clearing facilities and depositories to immobilize the stock certificate are working. We hope that Congress will pass next week legislation already approved by Senate and House Committees and voted in the Senate, which would give the SEC authority over transfer agents, depositories and clearing agencies and direct the elimination of the stock certificate in broker-to-broker transactions at an early date.

Fourth - We have been conducting an inquiry into the hot issue phenomenon which has already produced steps leading to prospectuses and rules designed to give all investors something close to the information and the investigation which the professional venture capitalist demands. We are now studying the reform of trading practices in new issues with a view to making them more evenly and broadly distributed to the public from the beginning and less susceptible to the boom and bust phenomenon which emerged in 1962 and 1968.

Fifth - We have proposed a rule on institutional membership in stock exchanges designed to encourage institutions to contribute new capital and to perform brokerage services for the public but to eliminate the kind of institutional membership which merely gives institutions the ability to use the exchanges without paying commissions and enjoy other special privileges without undertaking to contribute to the purpose of the exchange, which is to serve customers who require brokerage services. We have requested legislation which would authorize us to require all exchange members to trade in a manner which would contribute to price stability and yield to public orders.

Sixth - We constantly wage war to require companies to make prompt public disclosure of all developments relevant to a decision to buy, sell or hold their stock. This requirement has been developed to the point where any possession of inside information is frozen from trading and muzzled from passing on inside information until it is made public. This utilization is, I believe, now quite effectively enforced by surveillance of trading and inquiry into notable changes in price and volume,and by the simple fact that any person is no longer safe in receiving or using inside information until a public disclosure has been made.

Seventh - The accounting profession has undertaken to set up a re-invigorated board to establish more uniform, more comparable and more meaningful accounting standards. The SEC will require additional disclosure to bring out to investors the significance of the numbers in financial statements. Our Penn Central investigation revealed that disclosure relating to the viability and liquidity of a company can be more significant that reported earnings. We have been seeing too many companies taking huge sudden losses. We have put out rules and are developing additional ones to bring out the imminence of, or the potential for, super-chargeoffs or liquidity crises.

Eighth - Professional research and investment judgment is widely available to institutional investors. We believe this kind of assistance should be available to individual investors. Indeed, we have taken the position that it is a violation of law for a broker to give new research information or recommendations to favored customers without also making it available to others he has put into a stock on the basis of his earlier research. We are stressing the obligation of brokers to make their research available to all customers. We are reviewing our rules to encourage the provision of quality brokerage service, including research, to facilitate brokers setting up investment management services for the small investor and to emphasize the obligation of brokers to know the goods they sell and know their customers.

Ninth - We are working toward the development of a central market system and are close to finalizing rules we have proposed to make prices, volume and quotes from all over the country available to any investor anywhere. This will make it possible for the first time for every investor to know where he can get the best price in buying or selling a security. It will give every investor the benefit of competition in price from all over the country which I consider more important than competition in commissions, which primarily benefits the big professional investor.

That's 9. I could take it to 10 or 20. This is a large territory, with a lot to be done. But let's make it a sampling of 9, not necessarily in the order of their importance, of the things we are doing and trying to do to keep our markets hospitable and attractive to smaller investors like those represented at this Convention.

But in the final analysis, either your judgment or that of a professional analyst has to be applied to the company information, the research and the market data which we require to be disclosed to you, information which corporations and the investment community provide for you. This judgment is what investment is all about. It is a difficult and exacting task, but a challenging and a stimulating one. Tonight, let me give you what has always seemed to me to be a major criterion of selection. It's the credibility of the company and the management whose shares you either buy, sell or ignore.

Let me say first of all that every investor has his own style. This is often reflected in periods that we pass through when emphasis at one time might be on assets, at another time on earnings growth, at another time on market action. But all the time we should have an eye principally on what kind of job the company is doing, how strong is the demand for its product, how solid are its earnings figures, and how real is the growth. Is it all based on quality and acceptance and performance and technology or does the company give us accounting gimmicks to make things look better? Does the company tell you enough to make this judgment? Does the company tell you so little about its innards, its inner workings, that a research analyst can tell big investors things the company knows about itself but doesn't tell its shareholders?

All of this boils down to a judgment you have to make about the credibility of the company. You have to rely on a company's willingness to take its shareholders into its confidence. This is very important in an investment evaluation because if a company loses credibility by exaggerating its earnings, or inflating its prospects, the market somehow will know. And the company's price-earnings ratio will begin to erode and its share values will start to evaporate. This is a process all too many people have become familiar with through painful experience. When that happens its a long way back. The credibility of a company's reports is a key factor you should consider in making up your mind about the value of its shares.

There is a second major factor you should consider in your guage of a company's credibility. That is the way it treats its individual shareowners in comparison to the way it treats large institutional investors. We are in a securities market today in which institutions account for most of the trading while individuals own most of the stock. At the same time, institutions have access to most of the analytical talent, frequently on a preferred basis. Too often there is a vast gap in the information available about a company to institutions and to individual investors. Too often inside information is passed on to analysts working with institutions. It seems to me that if I were an investor I would make it my business to compare the quality of information that the company is making publicly available with that of the information that may be finding its way into the marketplace and causing big movements in the price of the shares. As a stockholder, you as an individual investor have a right, it seems to me, to expect from the company the same quality and timeliness of information as that available to outside analysts. If the company is favoring analysts and playing games with the dissemination of its information, it has little credibility.

Now let me be clear in my comments about securities analysis. It is the job of the securities analyst to assess relative values and opportunities among companies, to relate stock values to forces in technology and society and to the movement of international economic forces. This is very important and valuable to investors. But if you have reason to believe that the company is providing analysts with harder and better information on which to make these judgments, the company doesn't deserve your confidence as an investor or shareholder.

There is another factor in evaluating credibility in a company and that is the candor and the sense of responsibility with which management talks about the company's prospects. Let me give you an example. One company president notes that analysts are predicting his company's earnings will be up 20 or 30 per cent in the current year. His own estimates and what he knows internally indicates nothing like this. But he remains silent, thinking he has no responsibility for what someone else is saying. Then, the awakening comes and all of a sudden brokerage firms who have been recommending the stock at prices based on analysts' projections try to get their customers out, or the analysts suddenly revise their projections and tell their favorite institutions. You know the rest.

But take another company president who hears that analysts are predicting earnings for next year which he can't agree with. So he makes it his business to tell the investment community: "I think we'll do well next year, perhaps 7 or 8 per cent above the present, but nothing like the 15 per cent increase you people have been predicting."

I think you would have little trouble determining which company has the greater credibility, which company deserves your confidence and investment interest.

Tonight I have tried to give you a progress report on what we are doing at the SEC to carry out our mandate of helping continue and strengthen our system of well-capitalized securities markets serving millions of informed investors. As investors you have a right to expect meaningful, straightforward information on which to make your decisions and you have a right to expect to exercise your judgments in liquid markets where the best possible price is available to you. I believe this is the road we are on.

I would just like to say in closing that as a practicing lawyer, I served my clients to the best of my ability. I still think like a practicing lawyer. What has changed is my clientele. My clients now are the investors of America. And I view what I have said here tonight as a progress report to those clients. I trust that this group of my clients found it satisfactory.