REMARKS OF RICHARD B. SMITH, COMMISSIONER,
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE COUNSELORS SECTION OF THE PUBLIC RELATIONS
SOCIETY OF AMERICA, CHICAGO, ILLINOIS, NOVEMBER 17, 1968

"INFORMATION AND THE SECURITIES MARKETS"

Although I certainly appreciate the opportunity to speak to you this afternoon, I must confess that at one point I developed some slight misgivings. When I first accepted your gracious invitation to speak, the Texas Gulf Sulphur case had not yet been decided by the Court of Appeals for the Second Circuit. At that time I thought that I might talk about some interesting and relatively non-controversial topic like the European approach to disclosure or the general role of public relations counselors in the disclosure process.

In the meantime, however, Texas Gulf has come down, and the Public Relations News has stated that "The practice of financial public relations is threatened with extinction if ... [the decision] is permitted to stand." This is certainly strong language. When I first read it, I felt a bit as though, when this Sunday came, you might have some sort of sacrificial ceremony in mind -- with me the sacrifice. Despite this initial apprehension, I am happy to be here.

I should state at the outset that what I shall say are my own views and do not necessarily reflect the views of other members of the Commission or of the staff of the Commission.

I hope that I can use this opportunity to suggest to you that the concept in Texas Gulf is both a rather logical and a practical development, one that flows from our national commitment to broad private ownership of American industry and the present day environment where for the most part our citizens' access to such ownership is in the secondary trading markets, as distinct from the new issues markets. I shall try to develop these points later, because I think it essential to understand the broad policy context of these Rule 10b-5 developments before judging the propriety of their particular applications.

But, as to the fear of extinction, I ask you whether it is just conceivable that this is an overreaction? The burden of my message this afternoon, in fact, is that the eventual result will

be to increase rather than decrease the flow of corporate information and to make your function more rather than less important. After all, the Commission, too, must mend its public relations fences. It is important that both you and we see the same nexus between these developments and the unique nature and achievements of the American capital markets.

I do not mean to imply any criticism of your initial reaction to Texas Gulf. After all, lawsuits are never very pleasant things. And some corporate counsel have in fact advised their clients to restrict their public disclosures -- at least for the time being. It is expectable that counsel would lead their corporate clients down the road of caution, particularly when the law is uncertain. Probably some will continue to do so until the implications of Texas Gulf become more clear. But others have already recognized that this is only a short-term situation. Indeed, some knowledgeable people have claimed that any immediate decrease in corporate disclosures has been relatively slight.

It will probably be some time before the dust has fully settled, and substantial agreement is reached on the question whether Texas Gulf and other recent developments under Rule 10b-5 are consistent or inconsistent with the basic aims and philosophy of the securities laws. Until that time we can expect some continued uncertainty whether the wiser course for corporate officials is to increase or decrease the extent of the disclosures made by their corporations. If the result is a decrease, then clearly the Commission's effort has been counter-productive. But I don't think that the eventual result will be a decrease, and for a number of practical reasons.

For the some 6,000 widely held corporations that are subject to the periodic reporting requirements of the Securities Exchange Act the only open question is not whether to disclose any particular material development but whether to disclose it prior to the required reporting time.

Furthermore, if the corporation's securities are listed on the New York or American Stock Exchange, the corporation has certain contractual commitments to the exchange. In July of this year (a month before the appellate opinion in Texas Gulf) the New York Stock Exchange published a pamphlet entitled "Expanded Policy on Timely Disclosure." In the very first sentence it states "A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any new information which might reasonably be expected to materially affect the market for securities." I am sure that you are all familiar with the provisions of the company manuals of the two exchanges in this area.

Even if increased disclosures were not affirmatively required by law or contract, they would make good business sense. Unless important corporate information can be restricted to only the most select group of corporate officials, the risk of a breach of corporate security can only be avoided by prompt public disclosure of the information. Particularly for large companies it is unreasonable to expect all potential insiders not to buy or sell for extended periods because of their company's non-disclosure policy. If all significant information about a corporation is disclosed promptly and fully, then it will be difficult to suggest that the insiders of the corporation have engaged in improper trading. A prohibition against trading on the basis of inside information gives a corporate insider a personal interest in making available to the public as much information about his corporation as he can. Could not this aspect of Texas Gulf lead to increased corporate disclosures?

Finally, in the competition for investment capital, funds tend to flow in the same direction as analyst interest and public confidence, and that interest and that confidence must rest in the end on the availability of information and assurances of fair dealing.

In this regard, I recently had occasion to talk with an English investment manager who regularly visits the United States in order to keep in touch with businesses in which his clients are invested. Shortly before I entered his office he had received calls from two companies in this country canceling appointments that had been arranged for a forthcoming trip of his. The companies had given no reason, or the Texas Gulf decision as the basis, for their action. My English friend stated that one of the reasons he and other Europeans liked to invest in American companies is the ready availability of information about them, both in published form and in informal discussions with analysts and other interested persons. The American traditions of open access and open accountability to public shareholders is an impressive one to those accustomed to European practices. He was concerned that there would occur here a regression in this respect. It was fairly clear to me that this English investment manager would be markedly less attracted to the American capital markets if our corporations adopted a policy of silence as a result of Texas Gulf.

I told him that for the practical reasons I have indicated here today I thought any interruption in proper access to American

managements would likely be only temporary. I also said, while I was sure this was not what he had in mind, to the extent large investors sought such meetings simply as inside pipelines to special information, meetings for such purposes were self-defeating. They destroyed the very characteristics he professed to admire in the American markets. To the extent, however, that such meetings were a forum for testing the meaning of public information, for filling in interstices in analysis, for forming a direct impression of the quality of the management, and so forth, I did not think there was anything in Texas Gulf that should preclude such meetings. In fact, so long as such meetings were not devices to provide material information to favorite investors so as to enable them to get a jump on the market, they advance the philosophy behind the federal securities laws. My English friend, of course, assured me that he was not interested in special inside information but did want the opportunity to exchange views with management and to get a better feel of the company.

The concern in the investment community on how Texas Gulf may affect relations between corporations and outside securities analysts is understandable. In this particular area there may even be some conflict between the two underlying purposes of Rule 10b-5. On the one hand, disclosures to securities analysts do serve as a means of conveying information to the investing public. This is particularly true since analysts will often be in a position to collect, evaluate and translate information into more meaningful form than would directly interest the average investor in its raw state. On the other hand, disclosures made to particular analysts for the first time will necessarily reach their own subscribers before they reach the remainder of the investing public.

I do not think that this problem is insoluble, or that corporations can do no more than regurgitate their prior public disclosures to analysts. There is nothing inherently wrong in meeting with analysts either singly or in groups. In my opinion, management is not prohibited from giving previously undisclosed information to a particular analyst if the same information would be given to any other responsible person who took the trouble to ask, and if the information is not of such major significance that fairness requires that it be given to all investors simultaneously through the news media. Of course, we are all human, and there may be times when information of an extraordinary nature slips out, either in answer to a perceptive question or in the course of a heated discussion. In that case the corporation should issue a

press release as soon afterwards as possible. I understand this to be essentially the position spelled out in the New York Stock Exchange's Company Manual, and I am in accord with it.

I know that there are a number of definitional and procedural questions that are in your mind. It would be impossible for me by the nature of the matter to spell out precise guides in my brief talk here or in the question and answer period following. I am sure you are aware though, that the Commission in its cases has focused on extraordinary information, the matters relating to a corporation that could hardly help but be important to a reasonable investor in deciding whether he should buy, sell or hold securities of the corporation, matters that would be likely to have substantial market impact. As the Commission's distinguished General Counsel, Phil Loomis, said recently in Atlanta, inside information is significant information that has not previously been publicly disclosed and, generally, is "not merely one link in a chain of analytical information."

The president of the New York Stock Exchange in a recent talk said he thought a good rule of thumb would be to ask yourself: "Would you buy or sell securities for your own account on the basis of this information?" I would agree with him that in all but a few cases the judgment would be an obvious one. I also liked the Exchange's general approach -- "When in doubt, disclose." I found Harold Burson's article "Guidelines for Financial Disclosure" in the November issue of the Financial Executive magazine a good discussion of the definitional and procedural aspects. I commend it to you as a thoughtful treatment of the problems involved.

I do not expect that Texas Gulf can be the last word in this area. There are still some legal problems that must be worked out. Further elaboration of the application of the general standard of materiality to specific factual situations will be necessary. The problem of damages for misleading corporate publicity looms large. I would think that more flexible rules will have to be devised so as to afford some redress to injured investors without imposing Draconian monetary liabilities on the corporation and its innocent public shareholders. Problems such as these are not easy ones, but they can be solved if we continue to bear in mind the basic ends. I hope you can see that you and we are seeking the same basic ends, and that you should have nothing unreasonable to fear from the Commission.

There has also been some fear expressed that the Commission may use Texas Gulf to look over the shoulders of management every time it issues a press release. Let me make it clear that we do not expect to become after-the-fact rewrite men for all corporate publicity. The vast majority of corporate managements that diligently investigate the facts before issuing a release and then accurately summarize those facts in the release have nothing to fear from us. We are well aware that there are matters of judgment involved here. Press releases must often be prepared quickly, and we cannot expect them to be as precise or as artfully worded as registration statements.

I would like to conclude my talk by coming back to two points I suggested at the outset.

First is the economic context in which the disclosure concepts are being related to the trading markets. The vast bulk of securities transactions in the United States represent transfers of ownership of already outstanding securities rather than the purchase of new securities. In an interesting article in the August issue of The Institutional Investor magazine, Sidney Homer points out that in 1967 gross new issues of United States corporate equities, including stock issued on conversion of convertible securities, amounted to $4.7 billion. Looked at on a net basis, that is giving effect to repurchases and retirement of outstanding equities, the net new money raised amounted to only $2.3 billion. This compares with his estimate of gross purchases of equity securities, both listed and unlisted and including new issues, during 1967 of $151 billion.

Looked at another way, public offerings of common and preferred stocks for cash in 1967 aggregated $2.6 billion. In 1967 the volume of stock trading on the New York Stock Exchange was $162 billion. Thus, new offerings represented only 1.6% of the NYSE volume. Even in the immediate post-war years the dollar amount of new offerings never exceeded 12.5% of the volume on the NYSE and there has been a relatively steady decrease in this percentage since the Korean War to the less than 2% that existed in 1967.

Thus, when you look at the whole universe of securities transactions and the efficacy or pertinence of disclosure requirements, you can see that the trading markets are of overwhelming importance compared to new issues. There are many factors that

account for this, of course, including the enormous increase in institutional savings that has far outpaced the supply of new securities, the impact of mergers and acquisitions, the alternative of debt financing, and, most importantly, the accumulation of retained earnings by corporations in our prosperous economy which provides along with depreciation reserves the internal funds with which to finance new plant and equipment.

A factor in the retention of earnings is the willingness of American investors not to demand higher dividend payouts and to allow corporate managers to reinvest retained earnings. The capital gains tax advantages, I believe, account for only part of this investor willingness. I believe that an equally strong aspect is the confidence American investors have that they will be reasonably well informed about what management is doing with the retained earnings, and their confidence that when they wish to convert their equity interest in the corporation into money for whatever reason, they will be able to do so at a price representative of the value of the corporation at that time. Thus the liquidity and depth of the trading markets and the accuracy and fairness of their pricing system are important ingredients in investor confidence. These in turn depend upon a continuous flow of accurate information from the corporations.

I believe it is against this economic background that increasing disclosure attention is being given to purchasers and sellers of outstanding securities as distinct from the more classic disclosure provided to purchasers of new issues of securities.

The other point is the assumption or implicit premise in our securities laws, and in the standards of our national securities exchanges, that there is an affirmative public value for the society in broad private ownership of American industry. There is a strong national sense here in favor of having large numbers of the American population participate in the ownership and growth of the American economy.

The American public was first invited and encouraged to come into the securities markets in a massive way in the 1920's. It has been said that a basic mistake of that period was that the rules of the securities markets were then framed for the professionals and operated heavily in their favor and ultimately to the disadvantage of the large number of average investors who were coming into the market. As a result of the crash of 1929 and the ensuing depression there was a massive flight of confidence from the system.

Congress might have reacted in two ways to this development. It might have concluded that equity investment was too risky and not an appropriate vehicle for savings by the average citizen of ordinary means, that the purchase, sale and ownership of equity securities had better be left to the professionals, the very wealthy and institutions. Congress, however, never really considered this (an essentially European model) as a practicable alternative in a country with the large middle class that we have here. Instead, it opted in precisely the opposite direction.

Essentially, Congress reaffirmed the idea of wide private ownership of equities, and through the federal securities legislation established rules which it hoped would put the average American investor on a relative information parity. In effect, it said that the public belonged in, that investors were entitled to accurate and equal information and a fair and orderly market. Congress felt that this was the way in which confidence could be rebuilt in our securities markets. The expression of Congressional confidence in our private capital system is accentuated by its having determined on a disclosure system of regulation, rather than a rigid regulatory approach of a substantive character. It sought an effective balancing of the value of an individual's making his own decisions with the value of protecting him where he is unable to get the facts for himself, of the value of corporate management's freedom with its responsibilities to all the owners of the business.

It is a remarkable, uniquely American achievement. It is one that requires diligence on all our parts to preserve and to adapt to its phenomenal growth. We are on a course, compounded of faith in our capitalist ways and in the privilege of all Americans to participate, that speaks to the strength of our nation and its ideals. You here have an important, crucial role in helping to guide this course, and I have every confidence you will perform it well.

Thank you.