

For Release Upon Delivery

"PROBLEMS OF THE PROSPECTUS"

Address by

Harry A. McDonald

Chairman, Securities and Exchange Commission

Before the 3rd Annual Convention
of the
National Federation of Financial Analysts Societies

The Hotel Statler
New York City

March 2, 1950

In a sense this convention is a milestone of progress. Corporate executives, bankers, economists, analysts, representatives of government have met to pool their information and interchange their ideas on broad problems of our economy. Both the range of subjects discussed and the topics themselves demonstrate that a good deal of informed thinking is taking place in the formation of modern investment policy. It is to the credit of the National Federation of Financial Analysts Societies that it has planned and provided this occasion, and I am proud of the opportunity to meet and talk with you.

The keynote of the afternoon conferences of this convention was the word "outlook". Experts talked about the outlook for banking, for the auto industry, for chemicals, farm buying, petroleum and the stock market. It was to my mind a happily chosen word. Outlook is based on insight, and insight in turn is based on information. The patient accumulation of facts and the free interchange of ideas built our science and technology. Patient accumulation of facts and the free interchange of ideas are just as necessary if we are to develop workable ways of dealing with our problems as businessmen, administrators and citizens. The further back we push the domain of ignorance, the nearer we approach the power to control - within a democratic framework - the technological and social forces which we must master in order to keep them from overpowering us.

The financial analyst may not pretend to an importance beyond his own field. But I think he has such importance. He is, at the same time, one of the causes and one of the products of our growing awareness of the need for information in dealing with modern business and investment problems. He is ever hungry for more particular and more extensive data; he is a perpetual reminder both to those who invest and those who create investments that there is a high premium on outlook and information, and that an informed view of the present is the best look at the future.

It is, I think, particularly fitting that a representative of the S.E.C. should be addressing you tonight. The S.E.C. is today the world's richest storehouse of financial information and the financial analyst is one of the direct beneficiaries of that information. Your objectives and ours are, in many ways, parallel. Out of the era of hunch, tip, and hysteria grew a set of federal laws administered by the S E.C., each of which was a major attack on the domain of ignorance.

In these laws Congress turned the light of information on the process of investment in new issues, on securities trading, on the affairs of our giant public utility holding company systems, on our investment companies. The aim of the Congress in passing these laws and our aim in enforcing them is to protect the investor; and these laws are based on the same philosophy that underlies the profession of financial analysis -- that to be reliably informed is the first step in being protected.

The usefulness of a storehouse depends as much on what you can get out of it as on what goes in. Of course, material filed with us is available for public inspection and, as many of you know, we fill annually, at cost, requests for many thousands of pages of photocopy material. But, because of our limited resources we can collect, organize and publish in statistical form only a minute fraction of the information filed with us. I will describe a few of our publications and, as I do, I think that you will see that they are important tools of overall financial and economic analysis.

We publish quarterly data on the working capital of United States corporations, showing principal items of current assets and current liabilities of domestic companies and demonstrating at a glance the net current position of American corporate enterprise. Together with the Federal Trade Commission we publish the so-called Quarterly Industrial Financial Reports which show, for many classifications of manufacturing companies, both aggregate and size-group estimates of balance sheets and income items. This is the only source I know of for a comprehensive look at significant financial estimates for these industrial groups.

In cooperation with the Department of Commerce we prepare and publish quarterly data on actual and proposed plant and equipment expenditures showing what business has spent and what it proposes to spend in coming periods on plant and equipment.

Of equal importance in measuring economic activity is our series on the volume and composition of individuals' saving -- which presents net changes in various components of individuals' savings, such as securities, cash, insurance, and durable consumer items.

Our findings and opinions in specific cases have been valuable tools of financial analysis. When I first came to the Commission I shared with many businessmen the belief that these findings and opinions were too long and complicated. If our Commissioners had more time to devote to actual drafting much could be done to shorten and simplify them. But there is good reason for their length in many cases. For our findings and opinions serve multiple purposes. In passing on plans of utility holding company reorganizations we not only want to tell the people affected by the plan our reasons for holding the plan fair or unfair but we want the courts, which must also pass on these plans, to have before them explicit data and reasons for the Commission's action. Further, these findings present facts about underlying system companies which have proved invaluable in accelerating the seasoning of newly distributed securities.

If the S.E.C. were compared with a hospital and the financial analyst to a private physician, the services I have commented on up to now are, so to speak, primarily our services to the profession. How about the patient himself - the investor?

Under our laws the single most important vehicle intended to be of direct use to the investor is the prospectus covering securities registered for public offering under the Securities Act. Whether the prospectus is doing its job and what can be done to improve it are questions with which the S.E.C. has wrestled for over ten years.

The problem of the prospectus is not a simple one. Separate difficulties are presented in considering what it is and how it is used. And any satisfactory answer to those difficulties must take into account not only the basic function of the prospectus, which is to inform the buyer, but the underwriting process itself - that process of which the prospectus has become, under the law, an integral part.

If a security is required to be registered under the Securities Act, it is unlawful to offer or solicit through the mails or facilities of interstate commerce before the registration statement becomes effective. When the statement does become effective, the first written solicitation

is required to be the full prospectus -- which is, in most instances, the registration statement less the exhibits. With negligible exception, the term "prospectus" is so defined in the law that any communication in writing or by radio broadcast which attempts to dispose of a security is a prospectus unless it is accompanied or has been preceded by a full statutory prospectus which complies with the requirements of the Act. Thus, selling literature other than the prospectus may be used only as long as it accompanies or is preceded by the prospectus.

However, notwithstanding the fact that the prospectus is intended to be the first significant written communication which offers the security or solicits an offer, the law permits the prospectus to be withheld until the transaction is confirmed or the security is delivered.

These provisions create the setting of our problem. In a highly competitive and risky business the law imposes a period during which the mails or interstate facilities of communication cannot be used to set up a distributing organization or to solicit buyers' interest. When the registration statement is effective offering can take place only by word of mouth or at first through the full statutory prospectus.

What have all these restrictions added up to? Securities are sold by word of mouth. Business is done by telephone. While the law condemns offering before registration is effective, the S.E.C. encourages broader dissemination of information, particularly to dealers, in a document that is a prospectus in everything but name before registration is effective; I am referring to the so-called "red herring" prospectus. Except for institutional buyers who often insist on seeing prospectuses before they buy, customers are sold securities long before they ever see either a prospectus or any decent set of facts about the investment. Sometime later the investor sees the prospectus - a document which is often formidable and beyond his comprehension and which amounts, under the circumstances, to showing the menu after the dinner is over.

What have been the reactions to this situation?

First: Every proposal for revision of this Act, whether it has originated within or outside of the S.E.C., has carried with it a proposal to do away with the ban on offering and solicitation before the registration statement becomes effective. It has been universally

recognized that with effective protections to the investor this restriction of offering has become an unnecessary limitation on a business which is highly competitive and risky, and in which commitments naturally carry with them the pressure to take steps to measure anticipated demand and to cut down risk.

Second: Every proposal to amend the law, whether arising from inside or outside the S.E.C., has included a proposal to liberalize the use of written offering material in addition to the prospectus. While there have been disputes as to how far the law should go in permitting written offering material which did not amount to a prospectus, there has been agreement on the proposition that we should eliminate the present requirement that the prospectus be substantially the first piece of informative literature.

Third: It has been recognized that the prospectus, in order to be useful to the average investor, needs streamlining. But it has been proposed to do the streamlining by government fiat and by dispensing official immunity for condensation. And it is still the view of many, with which I cannot agree, that the same document, the prospectus, should serve a combination of purposes which, to my way of thinking, one document simply cannot be made to serve in many cases. It is hoped that the document can be full enough to contain, in one package, all the material legal representations of the issuer and the distributors about the security so that they can defend themselves against liability for misrepresentation or omission. Also, it is hoped that the document can be ample enough to satisfy the searching analysis which many institutions and financial advisers will want to give. But, at the same time, this same document is intended to be a useful, streamlined piece of literature that will invite the lay investor's perusal and be simple enough to satisfy his capacity for absorbing information about investments.

What is the answer?

- Mr. Hooper, who preceded me on this platform, has commented on the problem of the prospectus in a recent issue of the New York Security Analysts' Journal. His diagnosis coincides with that of others who have devoted their attention to this problem. In essence, Mr. Hooper has said that the prospectus is not serving its function of informing

the lay investor because it has come to be a legal document rather than an informative piece of selling material. He would preserve the prospectus because he agrees with many that the prospectus is useful to dealers, institutions and professional analysts, and he has caught the essential point that the requirement of the disclosure itself effectively nips in the bud many schemes that would wither in the light of full disclosure. But he has expressed doubt whether any condensation of the prospectus pursuant to government order would transform it from a legal document into a useful adjunct to the distribution process as far as the ordinary investor is concerned. While he would preserve the prospectus in its present form as a useful tool for dealers, institutional investors and financial analysts, he would give complete freedom to distributing houses to circulate selling literature, and he has suggested that the prospectus be available on request to anyone who thinks he can use it.

In sharp distinction to these views are the ideas of those who insist that we should still rely on the prospectus, as we know it today, as the primary vehicle for information for all investors and who think that the prospectus should be delivered to every buyer, whether lay or professional, a given time before sale.

This is a dispute in which it is easier to isolate the problems than to solve them. Suggestions such as those made on his own behalf by Mr. Hooper have the merit of flexibility and recognition of the practical problems faced by distributors. However, those suggestions raise certain difficult problems. Many securities distributors do not want a system of unrestrained selling literature. They fear the constant pressure in this competitive business to stoop to the lowest level of their competitors. They welcome uniformity and restraint in selling literature as the price of maintaining a high ethical level of business practice. They recognize that license in the use of selling literature may entail more stringent regulation than now exists, and perhaps make it more important than ever to give prospectuses to all customers as an assurance that a scrutinized document, containing all the permissible representations, has gotten to the buyer and will help to foreclose the possibility of suits in a falling market.

The truth may lie somewhere in between. Essentially, as I have indicated, the prospectus is, and must continue to remain, the place where the seller says all that the law requires him to say. It is, and should continue to be, the source from which the dealer, the institution and the analyst can get the full information they want. It is not, to my mind, crucial whether or not the average investor shall get this document. Certainly, if he wants it, let him have it - and promptly. Certainly, if distributors' liability must depend on whether or not they have provided this document to investors, let them provide it. What is crucial to the present issue is that the ordinary investor - the man for whom this law was passed - shall get something he can use and in time for it to be of use. We have a prospectus for the professional; why not try to achieve a prospectus for the public?

Disclosure is like the spinning of a generator -- it yields no light until the current enters a circuit and is channeled into a bulb. As long as we try to make one document do three jobs we cannot pretend that we have brought light to the investor merely by requiring that this document be prepared, distributed, or held available.

No amount of pious hoping will transform our lay investors into financial analysts. There are some who think that if we did no more than step up the time in the distribution process when the investor gets his prospectus there will be better general use of the prospectus as we know it today. There may be a lot to that. How much there is to it is a matter of speculation. But it is certainly not speculation to believe that brevity invites reading while bulk repels it; that a representation 90% accurate may as well not have been made if it is going to be lost in a maze of qualifications to achieve 100% accuracy; that a minutely detailed description of a funded pension plan or elaborate footnotes on inventory valuations will not help the average investor to make any decision except throw his hands up in despair.

These are real problems. How they will eventually be answered I do not know. They can be answered only by an unremitting determination to find the best answers. It is to the credit of those who believe in the Securities Act and have lived with its traditions that they have voluntarily undertaken to make a serious study of its operations and to consider methods of revision. They cannot be expected to embrace,

without extremely careful analysis, proposals for revision of a law that has been the keystone of our federal system of securities regulation. On the other hand, the honest securities distributor is expected to believe in his own merchandise and in his own potentialities of service to the investor, and to emphasize the practical difficulties encountered in complying with regulation. It is my sincere hope that in this give and take we will be able to find the answers soon.

It is in this area that the financial analyst can be of extraordinary service. To the extent that the financial analyst is professionally devoted to the ideal of more and better information, to the extent that he has no axe to grind for the securities distributor, and to the extent that he has no stake in any given system of regulation, he can bring to these problems a valuable independent point of view. We would welcome your help and the benefit of your experience.