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THE ROLE OF THE ANALYST
IN THE EVOLVING MARKET SYSTEM

An Address By

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Securities and Exchange Commission

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NEW YORK SOCIETY OF
SECURITY ANALYSTS
New York, New York

I am pleased to have this opportunity to address the New York Society of Financial Analysts, and in particular to discuss the role of research in our rapidly changing market structure and investment process.

Actually, as the Chairman of an agency devoted to full disclosure, I must disclose that I would be far more pleased to stand before you in an atmosphere of great optimism and prosperity for the securities industry. As you know, however, the securities business is -- and has been for some time -- in a difficult period of transition. Some have recently characterized present conditions on the street as a period of deep gloom and doom -- a malaise from which there can be no recovery. But let me at least assure you, and the public at large, that in my opinion there is absolutely no reason for any lack of confidence in our securities markets or the national securities exchanges which form the cornerstone of all of them. Someone wrote me a letter recently saying that unless things get better I may have the dubious distinction of presiding over the demise of the securities business. I am absolutely confident that this will not come to pass.

The industry has a rich resource of creative individuals -- tough people who get going when the going gets tough. The system has survived worse periods of crisis. I am confident that with this fine leadership, the industry will emerge stronger than before.

I am not saying that the securities markets of our country will not undergo change. As technology changes, as competition from other world markets grows, and it will, we must adjust the delicate mechanisms of our markets so that they will continue to be the national asset they have been. And a key adjustment is the central market system concept set forth in my speech to the New York Financial Writers a fortnight ago.

I hope you will all believe that I was greatly surprised at the uproar caused by my speech. The approach we are suggesting is consistent with the Institutional Investor Report of 1971, the recommendations of Bill Martin, the famous February 2, 1972 Policy Statement and all of the many comments we have made since then. Our Market Structure Advisory Committee did split on the issue and did suggest two alternatives, from each of which we have taken, but, all in all,

we do not feel that the approach set forth in the speech is a departure from what the Commission has been saying for the last two years. We are now completing and will soon release a more detailed position paper on this crucial reconstruction policy.

Let me re-emphasize at this point that the Commission's position paper will not be a biblical entombment written in stone. Many problems in our markets are subject to more than one solution. We are for evolution after a procedure of comment and deliberation -- not revolution merely for the sake of change. We are not attempting to dismantle the capital raising mechanism of this country which has guided vast amounts of national savings into the securities markets.

In talking to you as professional analysts, I would like to demonstrate how a restructured network of markets for listed securities really can work for the investor. Most important, I want to relate this thinking directly to the research function.

The central market system we expect will evolve should insure that investors get the best available execution for listed securities, no matter where they are traded. This will mean full and immediate disclosure of

prices and quotes for these listed securities in all of the markets in which they are traded. It will mean preference for public orders to encourage a predominantly public character for the securities markets. It will mean open competition between market makers -- on and off the exchanges -- operating under comparable regulation. It will mean a system as free as possible from manipulation and well regulated in its trading practices. The overall effect will be to bolster liquidity, and to assure best execution for the investor.

But the best of best executions in the world is of little value if the investment judgment which triggered the order is not an informed one, based on professional analysis of comprehensive and reliable information. The central market is only part of an improved investment process. Of equal or greater importance is the concept, spelled out in our February 1972 Policy Statement, of making professional investment services broadly available as economically as possible, without diluting standards of service and responsibility. This involves maximizing the dissemination of professional investment research,

with the emphasis on the word "professional". Good research is an indispensable part of the investment process. Research is basic to the ability of the market to perform its critical function of allocating capital efficiently. The Commission has repeatedly made clear that the public interest requires investment research and money management services to be more readily available to the individual investor.

1. Research and Commission Rates.

Many of you are concerned about the continuing and growing impact of competitive brokerage commission rates on the future of research. As you know, the sphere of competitive rates is scheduled to be expanded from its present order level of \$300,000 to \$100,000 by April 1974, and the Commission is committed to this progression toward the \$100,000 breakpoint. However, the Commission has determined not to require a reduction in the level of fixed commission rates at this time. This decision is being made on the basis of all the information available to the Commission and in line with Commission policy to move with prudent gradualism to the \$100,000 level.

A year ago, former Chairman Casey told the Congress, "We have been thinking that next April will probably see another reduction, and then with another year there will probably be another reduction." He stressed at that time, however, and Congress agreed, that flexibility in timing rate reductions was necessary and that the Commission would look carefully at the "state of the business and the ability of the firms to sustain the loss of revenue that would be involved" as well as "the impact on the nature of trading, the nature of pricing, and the functioning of the markets." Only after carefully weighing these factors against the determination of the Commission to reduce the level at which brokerage commissions must be negotiated has this decision been made.

Our decision was made realizing full well that the Commission is subjecting itself to possible criticism from supporters of "lower levels of negotiated rates at any cost." However, we believe that those who consider the impact of other changes being required in the securities industry by the Commission, and the present financial

situation in the brokerage community, will conclude that a reduction to \$200,000 or \$250,000 -- as a mere example of good faith -- would be an unwise and imprudent step. This decision does not in any way alter our intention to require negotiation at the \$100,000 level in the spring of 1974.

In light of the rate question, you as analysts should consider a number of factors which will affect your role in the changing securities industry. For one thing, the Commission has made it clear, both in its February 1972 Policy Statement and in subsequent statements, that investment advisers, who act in a fiduciary role, should seek best execution of their orders, which requires them to obtain the best available research in making investment decisions; this necessarily implies that advisers have broad discretion in seeking the best research. For many institutions, this means going beyond their own research capabilities when they feel it is necessary. For money managers relying solely

on outside research, a primary obligation also is to get the best available advice. In neither case should there be a blind obligation for the cheapest execution regardless of qualitative considerations -- providing of course that the additional expenditure is justifiable. I believe that flexibility in seeking out the best research, combined with the growing complexity of investment selection in today's markets, will definitely assure an important future for quality research.

The value of the research function has not escaped the Congress. The Senate has under consideration legislation which would amend the Investment Company Act to provide explicitly that it is not unlawful, or a breach of fiduciary duty, for an adviser to induce the investment company it advises to pay a commission to a broker that is higher than those commissions charged by other brokers effecting similar transactions if, among other things, the commission is justified on the basis of the research service provided to the investment company. In commenting on this legislation, we concurred in its apparent purpose to provide greater flexibility and discretion to managers of investment companies. We have repeatedly recognized that managers should

be encouraged to seek out the highest quality of research, analysis and other services which may be of value to the accounts they manage.

Of course, the Commission did indicate that the justification for the payment of higher commission fees should not be limited solely to those payments which take account of research services. We suggested that the discretion of investment managers in paying commissions should be broad enough to enable them to consider the full range and quality of a firm's brokerage services, including, but not limited to, research. In part, we did not wish to see in congressional legislation any implication that managers are encouraged to use portfolio commissions to "pay" for particular research done in the past. It is our view that research generally should be a part of the total brokerage function, although we consistently have stated that past as well as present availability of research and knowledge is a proper consideration in the selection of a brokerage firm for any transaction and in the commission rate which the firm is paid for its services.

2. Research and Inside Information

Let me turn to another area in which you as research analysts and we in our regulatory role at the Commission share a great concern. Any securities market system that is fair requires that both buyer and seller exercise informed judgment. The use of inside information erodes the system by destroying public confidence in our capital markets. It also calls into question the professionalism which is an intrinsic part of any sound investment process.

In recent years, we have seen a number of cases in which inside information is routinely disseminated under the guise of research in exchange for brokerage commissions. We have seen cases where companies trip all over themselves trying to protect friendly analysts from being surprised by a bad earnings report. These companies often wind up passing along to analysts non-public bearish information, which is in turn passed along to institutions, who then go out and clobber the company's stock. We at the Commission have seen too many cases where inside information has been cynically considered by analysts, corporate officials and money managers simply as coin of the realm.

Happily, we have also seen instances in which analysts, corporate people, brokers and others who have come into possession of inside information have refused to pass it along or use it in any way. There is increasing evidence that the impact of cases involving misuse of inside information is growing and is being felt by the professionals in your industry and also by corporate executives and money managers. There is also a great deal of evidence of considerable confusion and apprehension regarding the question of inside information by many people operating in good faith and with proper professional intent.

The Commission intends to pursue the crucial problem of inside information on two fronts. First, over the next several months, we will be completing a detailed report which will trace the legislative history and the intent of the law in this area, provide an analysis of what has taken place in the courts, present the Commission's view of the law, and, finally, set forth a series of guidelines for financial analysts, corporate management, investors, lawyers and the industry as a whole.

This clarification of responsibilities in the area of inside information represents a regulatory approach that we believe is preferable to allowing matters in this area to continue to proceed fortuitously on a case-by-case basis in the courts.

Our second approach will be one of vigorous enforcement of the securities laws on inside information. When I talk about guidelines I am not talking about creating loopholes. I have said in the past, and I repeat, by clarifying the professional responsibilities of those concerned, we are moving to prevent misuse of inside information. But where misuse is prevalent, we will not hesitate to exercise our enforcement muscle. In this regard, the Commission will be looking in the future toward more criminal references to the Department of Justice in inside information misuse cases.

3. Adequate Public Information.

If we are to limit inside information -- which we will do -- and to expect analytical professionalism -- which we do -- it is apparent that we must also take some

responsibility for assuring that there is adequate information as a matter of public record to serve the needs of the sophisticated professional analyst as well as the average investor.

Our most publicized activities have taken place in the area of forecasting. I doubt if you would let me escape today without some discussion of the Commission's recently expressed general policy on earnings projections and forecasts. This policy followed public hearings last fall, where 53 witnesses, the representatives of corporations, the securities industry, the academic community, self-regulatory organizations, and the accounting and legal professions, gave their views. The Commission statement, issued last month, followed extensive deliberation both by the staff and the Commission.

The major thrust of our policy is one of disclosure. In essence what the Commission has said is that corporate management should be left with the choice of whether or not publicly to forecast earnings and economic results. In doing this, we rejected for now the view of some that management should be required publicly to disclose its

projections. At the same time, we said that once a company elects to project earnings to anyone outside the corporation, it must immediately inform the investing public as well. We will require companies to file this information on special report forms with the Commission, if they elect to make the disclosure outside of normal Commission filings, and also in their annual reports to the Commission. We will encourage immediate dissemination of these forecasts at the time these reports are filed. Finally, we have said that companies who elect to issue projections should be required to update them both on a regular basis and in a timely fashion in the event of any material changes, and to explain major variations between projections and historical results. If the company wishes to stop this process of public forecasting, it may do so by filing a statement of reasons for such a change in policy.

I believe this policy takes into account some well-recognized practices going on today which have the effect of shrouding the whole business of management forecasts in a cloak of informal procedure which is not in the best

interest of the investing public, the corporations and the investment professionals involved. For one thing, we all know forecasts by management do exist, they are circulated, and they do affect market values. For another, projections are clearly material to an investment decision, a fact supported by the injunction obtained by the Commission in the 1968 Glen Alden case. Lastly, with various forecasts floating around in this fashion, the investors have great difficulty in knowing whether a particular forecast represents the judgment of management or the judgment of outsiders -- no minor distinction. This difficulty is compounded by the practice of "ballpark" responses by management to questions asked by analysts and others -- informal queries which ask management to confirm or deny the accuracy of forecasts generated outside the company. Finally, this cloak of informal procedure in forecasting in too many cases encourages the selective dissemination of company forecasts, a practice contrary to full disclosure.

The testimony of your Financial Analysts Federation at our hearings last fall on forecasts spoke to many of

these points. The Federation said the present availability of forecasted operating results is uneven and unfair, and that the availability of this information is biased in favor of analysts and sophisticated investors. The organization representatives also pointed out the need for a system of continuous forecasting which will provide general guidelines on forecasting as part of the system of disclosure.

The Financial Analysts Federation also made two other points which are reflected in the Commission's policy. The first is that the underlying assumptions used to arrive at earnings estimates are extremely important and should be included when these forecasts are disclosed. The second point, and this is closely related, is that guidelines should be adopted by the Commission to deal with the problems of management liability for forecasts made in good faith and based on reasonable assumptions -- but which turn out to be different than the actual results. The Commission is wholeheartedly behind this latter suggestion.

By mid-year, the Commission plans to issue for comment rules and guidelines which will detail and implement its

general policy on forecasts. These concerns expressed by the financial analysts and others will be dealt with in a series of proposals and guidelines that will bring forecasting by corporate management out into the open and at the same time provide management with the guidance and flexibility to provide reasonably based forecasts without undue fear of liability.

Forecasts are not the only form of additional disclosure which we are presently considering. As you know, last December we issued some far reaching proposals calling for additional disclosure and interpretation of historical data. These proposals require disclosure of the impact of alternative accounting principles on reported income, an analysis of the reasons for variations in effective tax rates and an analytical statement associated with the summary of earnings which assists investors in understanding the quality of reported earnings.

We have received many comments on these proposals which will be extremely helpful to the Commission in improving our proposed requirements. Analysts in general

have responded very favorably while registrants understandably are concerned about problems of implementation. When we produce our final requirements, I am confident our proposals will be responsive to the objectives articulated in our release and will constitute a major step forward in analytical financial disclosure.

Increased disclosure calls for improved analytical standards in the use of that information. Up to this point, there has been relatively slow development of generally understood standards of analysis. While the Institute of Chartered Financial Analysts has developed standards as to a minimum body of knowledge necessary for individuals to receive its professional credential, neither the Institute nor the Financial Analysts Federation has made any statements as to the minimum analytical work necessary before producing a public report on a security. Work needs to be done in this area. The analytical community cannot afford to permit the casual passing out of hearsay as a substitute for research.

We were quite careful not to treat the work of the analyst separately from corporate management in discussing standards for forecasting. We do not want to be in the position of limiting the responsibility for careful and good faith preparation of forecasts to management while allowing the analyst to set forth a "gut feel" with impunity.

The Commission can be greatly assisted in setting standards of responsibility for analysts by your participation. I was encouraged to note in the recent Financial Analysts Journal an editorial suggesting that such standards be drafted. I believe such a viewpoint reflects the emphasis on professionalism which I have tried to stress in these remarks. It is essential that we require professionalism of the broker in seeking the best execution for his customer, and professionalism of the analyst in sifting and evaluating financial data and making a considered recommendation. We are moving toward a market system manned by a corps of professionals in the securities industry -- professionals in the finest sense of the word. We at the Commission believe that with your support we will achieve this important goal.