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RESEARCH IN THE CHANGING STRUCTURE AND ECONOMICS OF THE SECURITIES MARKETS

An Address by

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I am pleased to have this opportunity to discuss the role and future of investment research at this conference of the Financial Analysts Federation.

I am a strong believer in the importance and the value of research to investors and to our economy. Research is basic to the ability of the market to perform its critical function of allocating capital where the needs of our society require it. Certainly, the 13,000 professional analysts who make up the membership of your Federation represent a capability which is unique in the world. The work you do is a major element in attracting savings from all over the world to our capital market, not to mention the fast increasing flow of institutionalized savings into our equity markets.

We at the S.E.C. are particularly aware of the contribution of professional analysts who sift and evaluate the mass of material filed by the corporations. Our work in implementing the public policy of disclosure of all material facts would bog down in a sea of detail without your analysis. The mass of information is truly staggering: it reflects the financial reports of some 10,000 corporations four times a year, plus disclosed material developments by these companies a total of some 13,000 times per year and the reporting of some 100,000 insider transactions yearly. From this data, some 100 million pages are sent around the country on microfilm every year.

Thus, the work of our Commission and the members of your Federation is heavily interdependent. We provide the raw material. You do the sifting, selecting, comparing and evaluation, providing the basis on which thousands of institutions and millions of individual investors make the decisions which establish securities values and set the direction of our economy.

At the S.E.C., we have a keen appreciation of the critical importance and value of your work. In particular, we have a strong interest in seeing your work not only maintained but deepened, broadened, and made more widely available. We consider it very much in the public interest that investment research and money management services be made more readily available to the individual investor.

There have been strong forces of change at work in the securities industry for some years now. Today I would like to review with you how the research function can adapt to those forces and what the Commission may be able to do to help you make a still greater contribution to a broader, more open and more sensitive market in the years ahead.

Let me plunge right into the area of your greatest concern, the impact of competitive commission rates on investment research. Our analysis shows what you already know: that this development is likely to have its heaviest impact on the research oriented institutional firm. About one-third of you work for brokerage firms. Although I don't have any exact figures on this, I'm told research activity is concentrated in some 20 institutional firms, some 40 regional firms and in the institutional departments of 10 to 20 predominantly retail or underwriting firms. In these firms, the challenge will be to adapt. As you know, the Commission is preceding with competitive rates on a basis designed to test their impact and provide time to adapt.

In considering how to adapt, a little history may provide valuable perspective. Your Federation has doubled in membership in the last 10 years. During that period institutional trading increased by 360%, and, brokerage firms competing for this institutional business were ready to give up more than half of the fixed commission on these large trades. The practice of allocating commissions for research and for fund sales as well as for collateral purposes and services came into being. A whole industry began to treat commissions presumably paid for brokerage services as a form of currency that could be tossed around as payment for services whether or not they were related to the purpose or to the benefit of those who paid the commission. Research services were likely to have the most direct relationship to the commission paid, but even that was sometimes tenuous and frequently unclear. At any rate, from the standpoint of the public interest, it wasn't a very good system because it enormously enlarged the ability of large investors to get quicker, better, more comprehensive research than other investors.

In an era of competitive rates, how can research best adapt? Some suggest that unbundling is the answer. They say: Let those who want research pay for it in cash. I view that as a poor answer. It's perfectly alright for those who want to sell research and those who want to buy research for hard cash to do so. But to require research to be separated from brokerage would, in my view, make no sense at all. It is doubtful that voluntary unbundling would make any significant contribution to maintaining our national investment research capability or, more practically, find any great public demand. Only a handful of firms have found any worthwhile market for selling investment research for cash and it is questionable whether this market will ever exist in any size.

As you know, large brokerage firms commit 2% to 3% of total expenditures for research, and most institutional research firms commit less than 10% of their outlays for research. These figures do not indicate that the elimination of research costs would significantly reduce commission charges. And a stripped down, "bare bones" type of brokerage service would, in my view, significantly increase danger of loss to the public and, jeopardize public confidence. The Commission has spent almost 40 years seeking to develop a higher degree of professional obligation by brokers to investors. We have, over this time, imposed an obligation to make information available and to determine the suitability of a particular investment for the client. I, for one, am not about to reverse that course and weaken that obligation -- all to save a portion of a $5,000 investment that would be equivalent to the cost of adding a cigarette lighter or a new automobile. And I am particularly relecutant to embrace the stripped-down brokerage concept when I consider the possibility that the $5,000 investment experience for the small investor may increasingly be one where his $5,000 becomes $3,000 or $1,000, because of the loss of research. I believe it important that research be retained as an essential part of the service rendered in a continuing brokerage relationship -- with all that entails in the way of continued responsibility

Where does that leave us? As I see it now, there are two sound ways to properly maintain the research function. One is to build research into quality brokerage service -- service which can, in an era of competitive rates, command a higher price and attract more customers. The other is to offer research as part of a money management service, which will itself provide the additional revenue to support the research component. Both of these ways stand to make additional research and advice available to smaller investors and help to equalize the information resources available to large and small investors.

In the Commission's policy statement on the future structure of the markets, we stressed that money managers should have the option of paying for quality brokerage service embodying research. We said it would be wrong to cut off beneficiaries from sources of research which could contribute to better performance. Let me quote:

> " . . . brokers who do in-depth research might prefer to charge higher commissions than other brokers whose research activity is narrower in scope or of lesser quality or value. Concern has been voiced that under such circumstances institutional managers charged with a fiduciary duty would be reluctant to pay a higher commission rate which reflected research. The Commission believes that they should not be. In our opinion, the providing of investment research is a fundamental element of the brokerage function . . . It should be disclosed to investors that their money manager is willing to exercise discretion in seeking the best information and research available and does not consider that there is an obligation to get the cheapest execution regardless of qualitative consideration."

We elaborated on this in a release issued May 9:

> " . . . Requiring managers to seek the lowest possible commission cost could interfere with the purpose and obligation of managers to seek best performance by excluding the accounts they manage from information, analysis and service which may be of value to them. An advisor should have the flexibility to select a particular broker if the broker selected provides bona fide investment research or other services which he believes are valuable to the beneficiary's interest, and if he believes the broker can properly execute the transaction. Similarly, the adviser should have discretion to pay a commission rate that will assure reliability and quality of service, provided that it is reasonable."

What the Commission is seeking here is to clearly establish that commission costs should be considered as payment for a professional service and should no longer be treated as a special kind of currency which can be used to pay for extraneous services.

Specifically, we seek to encourage brokerage firms to maintain research as part of quality brokerage service that will make research more available and worthwhile to small investors as well as large investors; that will lead away from a tendency to hoard research for large investors who can "pay" for it by "allocating" commissions; that it will create a broader base for the support of research and a greater obligation to make research evenly available to all customers. We see this contributing to a fairer market and, I believe, that in this direction, the research-oriènted brokerage firms can have the flexibility to reshape their charges and their services in a manner that will permit them to operate effectively in an era of competitive rates.

So far, I have been talking about adaption to competitive commission rates by building research into truly professional brokerage service. The other avenue, it seems to me, that research can pursue for revenues to offset commission rate declines is money management. Individual investors have great difficulty obtaining management for small amounts of capital. I believe that the development of money management services for individuals who prefer to invest directly in the market is vitally important to maintaining individual participation in our equity markets. Just how this will occur I cannot foretell. Primarily, it will depend on the imagination of brokers, money managers and analysts. We are prepared to review with an open mind methods that may be developed to bring research and money management services directly to smaller investors.

In our policy statement last February on the future market structure we said:

> ".....We believe that those members of the investing public who invest directly rather than through institutions are in need of additional money management services and that the experience member firms have accumulated in the area of money management can be valuable in meeting this need."

One view often expressed in reaction to the difficulty which the individual investor has in obtaining money management services is that it is better for the individual to invest through an institution. I believe investing through an institution is the answer for many people; I find it presumptious to view it as the answer for all.

As a matter of public policy, I believe we have a clear obligation to keep open the route both to direct investing and pooled investments --- and to foster the development of necessary services for those who choose either route.

I would like to turn finally today to the real nature of the product you prepare, to the question of what is research.

Let me begin by describing what it is not, by drawing the distinction between research and inside information I refer specifically to the practice of paying for inside information by allocating "research" commissions to a brokerage firm. To insure the integrity and fairness of the markets, the Commission has made it clear that the professional who comes into the possession of inside information has the obligation neither to act on this information nor to pass it on. I think you can see the receipt of such information, far from being helpful, as good research can be, becomes a positive danger.

This concept flows logically from the fudamental view of the Congress in enacting the Securities Exchange Act of 1934. A free and open market for securities -- which is, incidentally, the thrust of the Commission's February policy statement -- requires that the buyer and seller are exercising enlightened judgment as to what constitutes a fair price. Inside information mocks that concept and destroys public confidence.

Fox example, we are finding too many instances where inside information is being passed on in the guise of research analysis. Sometimes this involves one or several analysts or securities salesmen getting a peek at a company's financial results several hours or days before the information is publicly released. This information is then circulated to preferred clients. I do not regard this as financial analysis. I do regard it as demeaning to your profession. I can assure you that our efforts to halt these and other practices involving inside information will receive the highest priority at the Commission.

Indeed, inside information is a far cry from the real nature of securities analysis, which is the sifting and investigating of disclosed financial information by investment professionals. The evaluation and judgment that emerges from this process is invaluable not only to the institution, but to the individual, who otherwise would have to swim for himself in an ocean of financial data.

There is an additional aspect to research, particularly as it relates to money management, and that is its scope. There is the view that a fund adviser who takes a money management fee thereby incurs an obligation to provide all the necessary research. It is true that he does incur an obligation to make the necessary investment decisions and to do so in a sound knowledgeable way. That implies that he will rely on a research function. But it should be realized that it takes judgment and skill to evaluate research. It should also be realized that the research universe is quite infinite, convering thousands of companies and products and the impact of an endless number of variables. Even a money manager who does employ analysts cannot claim to have all the research he needs. Selection, cross-checking of opinions and breadth of coverage is important. The research function here, more often than not, consists of screening the research of others.

As I have indicated earlier, there are close to 100 brokerage firms offering specialized research services. These firms collectively employ a few thousand analysts, the larger employing about 200. In the largest institutions, the number of analysts doing specific industry and company work do not exceed 30 to 50. In organizations with 1 billion to 3 billion dollars under management there are likely to be 10 to 15 analysts. Many smaller institutions will be likely to have no more than 3 to 7 analysts. Thus, no institution can permanently cut itself off from the research resources which brokerage firms offer and I see no likelihood that an adequate substitute for this research will become available for cash. Outside research is a valuable service that the money manager is justified in making use of for his clients.

I have tried to talk candidly with you about the task of shaping the conduct and the economics of the research function to the changing structure and economics of the market. In the process you, as well as others, forsee difficult problems of readjustment. If the research function is as valuable as I believe it to be and with the creativity you have demonstrated in developing it to its present role, I have no doubt that the adjustment will be successfully completed.

Over the last 10 years, research has indelibly established its importance. This research boom developed from the explosion in institutional trading that has produced a virtual doubling of your membership over the last decade and intense competition for analyst talent. Now, with institutions intent upon reducing commission costs, the challenge is put to you. It is a noble challenge. It calls upon you to assume a big role in the shaping of the market structure. You have helped tip the scales in favor of the large investor, now you have the opportunity -- and the Commission wants to encourage you -- to help balance the scales for the individual investor.

Thank you.