

HOW THE SECURITIES AND EXCHANGE
COMMISSION AFFECTS THE INVESTING PUBLIC

(An address presented by Victor H. Stempf of Touche,
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There is in session today in Columbus, a regional conference of the National Association of Cost Accountants, an international organization of over seven thousand accountants and financial officers of Industrial companies; dealing with the problems of management in the control and administration of business. The Conference is considering this afternoon the subject of "Accounting Problems Involved in the Registration of Securities". The subject is being presented by Mr. Carman G. Blough, the Chief Accountant of the Securities and Exchange Commission.

The powers conferred upon this Commission under the Securities and Exchange Acts involve a vital Public Interest relative to the protection of investors, and the maintenance of fair and honest markets trading in securities.

We are fortunate in having available for this broadcast, a National Director of the Cost Accountants' Association, who is also Vice-president of the New York Society of Certified Public Accountants and Chairman of the Committee on Federal Income Taxation of the American Institute of Accountants, who has had broad contact with the preparation of financial reports filed with the S.E.C.

We take pleasure in presenting Mr. Victor H. Stempf, a partner of the firm of Touche, Niven & Co. in New York who will address you on the subject of: "How the Securities and Exchange Commission affects the investing public".

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How often have you heard the cry – There ought to be a law against it? When thousands of bewildered people lost their life's savings in the stock market in 1929, it was not

surprising to hear the demand on every side that something should be done about it. The pocketbooks of thousands had been sorely affected!

Heeding the hue and cry of the investing public, Congress passed the Securities and Exchange Acts in 1933 and 1934, stating that such trading in securities involves a National public interest requiring the regulation of matters related thereto in order to assure the maintenance of fair and honest markets.

The Securities Act relates to the character of financial reporting required for new issues of securities, offered to the investing public in interstate commerce. The Exchange Act governs the character of financial reporting required of companies whose securities are already listed on licensed exchanges, or who seek such listing. The forms of registration statements required by both acts are basically the same, although somewhat more elaborate reports are demanded for new issues. Is such registration and reporting new? No! For many years, State Commissions operating under so-called Blue-Sky Laws, have required corporations to file financial data for approval, as a condition precedent to sale of securities. Similarly, the larger stock exchanges have, for many years, required the filing of listing applications serving the same purpose.

However, all of these prior forms of financial reporting met with criticism following the stock market crash – much of which was based upon objections to their brevity and inadequacy. Some of this criticism was justified, but more of it was based upon hindsight; ignoring traditional practices and the fundamental optimism of the times. Congress, heading the demands of the masses, ran to extreme in this legislation, bearing down heavily upon all, concerned with the flotation of securities.

How does this legislation seek to accomplish its object? (First) by demanding the disclosure of all material facts which would influence a prudent investor in reaching his conclusions; (Second) by imposing heavy penalties upon those responsible for registration reports:

- (a) by restitution – measured by the losses suffered by investors and
- (b) by penalties involving fines, not exceeding \$5,000.00, and imprisonment, not exceeding five years, or both, for failure to disclose material facts or for misrepresentation;

(Third) by placing the burden of proof upon the defendant, in other words, by holding the accused guilty unless he proves himself innocent. These are indeed heavy burdens upon those involved in security offerings. The shifting of the burden of proof, particularly, is a radical departure from the fundamental principles of Law, understood by the lay-man. Under our American Jurisprudence, a man is innocent until proven guilty.

What is material fact? Broadly speaking, anything which may influence a man's judgment in deciding whether he will hold, buy, or sell a security is a material fact. Where, one may ask, may one find the super-man who can foresee all the facts which would influence every investor? Naturally, an urgent demand continues, insisting that only specified disclosures be required – be they ten or ten hundred. The S.E.C. combats this demand, it seems, on the basis that such specified disclosures would often involve matters inapplicable in some cases, while precluding disclosures pertinent although peculiar to other cases.

Fortunately the Commission has construed the Acts liberally and practically; their rules and regulations are establishing a reassuring body of precedents concerning the reasonable disclosure of material facts which allay these misgivings somewhat. It should be said, that in all

criticism offered by the S.E.C., it has sought to protect the issuer, investment banker, and allied experts, from the liabilities of the Acts as well as to protect the investor.

What is financial reporting? What information does the intelligent investor require? Business Managers rely primarily upon two financial statements – the balance sheet, which expresses in classified sums all of the resources and obligations of an enterprise, and the Statement of Operation – which reflects the elements of income and expense which determine the net profit for a period of operation. These two statements, supported by many schedules of related details, are the principal tools of management in charting the course of business. These two statements may be used in historical form concerning the established facts related to the past, or in the form of forecasts dealing with the future. In either case, they remain the prime groundwork for business planning. Serving management as they do, it follows that these same financial summaries must serve the same essential needs of investors. As in the past, these two statements continue in a position of fundamental importance under the Securities and Exchange Acts. – Whereas in the past the preparation of these statements was influenced by a fetish for brevity, the effect of these Acts is to compel a spelling-out of the data shown in them. This spelling-out involves further sub-classification and more exact description of items – a disclosure of the accounting methods employed by the issuer, the further disclosure of changes in accounting methods made by the issuer, and explanatory notes which clarify the character, purpose, and proposed disposition of items. The preparation of these statements involves a highly developed technical knowledge, and time does not permit a more detailed description of the many interesting aspects of the subject. It is important, however, that the investor should understand more clearly the true character of financial statements. The lay-man is prone to assume that financial statements present facts, which may be measured or weighed as simply as a

ton of coal or a bolt of cloth. Decidedly, such is not the case! The facts may be measurable in the first instance, but beyond that they must be evaluated. Someone's judgment or opinion must be applied to state the reasonable price of slow-moving merchandise or to estimate the probable collectability of accounts justly due. It should be stressed, therefore, that financial statements seek to present facts upon the basis of recognized traditions of commercial practice and sound accounting principles, but, depending essentially upon judgment and opinion of those responsible for the representations.

In that connection industry in America owes the National Association of Cost Accountants a large debt of gratitude – starting with the elementary principles of historical cost accounting and adapting modern engineering developments relative to time studies, wage incentives, and pre-determined specification costs, there has emerged, under the leadership of the National Association of Cost Accountants, during the past 20 years, our modern methods of Standard Costs, Budget-Planning and coordinated industrial accounting without which Industry would be hopelessly lost in these days of Utopian Social Evolution through Federal Legislation. All of these noble legislative experiments dealing with Social Security, Price Discrimination, Labor Relations, and Trading in Securities involve highly complicated accounting procedures. N.A.C.A. has given to Management many ingenious working tools for the intelligent administration and reliable planning of business, without which industry could not cope with these new laws.

There is much good in all of these laws which seek to legislate into being that which is called the More Abundant Life, but all of these Acts bear the mark of impractical, academic idealism; gravely complicating an economic situation already jammed with perplexing problems.

The N.A.C.A. is alert to these problems, and by research and study has aided significantly in meeting these new demands upon business.

Most of these reforms have probably come to stay! Business will find the way to meet their demands, and accounting will keep pace with the requirements of Commerce.

Particularly as to the Securities and Exchange Acts: If the law succeeds in eliminating some of the alleged abuses formerly present in the marketing of securities without unduly choking the wheels of Commerce, and succeeds in making investors more conscious of the need for a practical working knowledge of corporate finance, the burdens imposed upon business may be fully justified.

In conclusion, this securities legislation hopes to serve every investor, be he large or small, in obtaining readily the information which he should have in forming his judgment of securities. It must be borne in mind, however, that the S.E.C. does not place its stamp of approval upon security issues granted registration. Certainly, the S.E.C. does not guarantee their worth. The investor must still think for himself, and must learn to appraise the facts made available to him. This requires patience, and the desire to study the theories and practices of business; but the S.E.C. is endeavoring to give him the material upon which he may base his conclusions.