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Speeches - SEC Staff

ADDRESS

of

JAMES J. CAFFREY,

Chairman, Securities and Exchange Commission

to

THE INVESTMENT BANKERS ASSOCIATION

Palm Beach Biltmore Hotel,

Palm Beach, Florida

December 4, 1946

Mr. Chairman, Gentlemen:

We, of the Commission, are glad to be with you today. We thank you for your gracious hospitality and for this opportunity to meet informally with you. We want to get to know better those who share our common problems, to learn their points of view and exchange ideas with them.

Investment banking is integrally related to the development of the investment process as a whole. It is bound to be affected by any movement affecting the investment process. It is, therefore, a business in which a high premium ought to be put on basic thinking. Today I want to talk about some problems which I conceive to be basic.

The investment banker, in the performance of his function, stands between enterprise and the public pools of capital. His business needs not only securities to sell, but a large class of investors willing to devote their savings to enterprise. Any factors which affect this vital condition also affect you.

The investment banking mechanism as it exists today is a fairly modern thing. The syndicate and selling group as presently organized with their accent on rapid distribution rather than on leisurely risk-taking, are recently developed characteristics. They evolved in response to changing conditions. Vast amounts of capital have been necessary to finance the accelerated expansion of our economy; issues tend in good times to stumble over each other to catch markets; markets are traditionally ephemeral things; and some of you have experienced the unhappy consequences of being caught with large unsold allotments.

What we have seen is an evolution of a complex method delicately adjusted to meet the mechanical needs as they appeared. The development has been largely a development in technique. However, I am going to try to show why it is just as important to foster also the development of the investment banker's role as servant of the investor.

In the short period since the early thirties that has accounted for the latest deveolpments in your business you have had demonstrated to you some of the factors which may constitute significant threats to its present methods. When you analyze them you will see that they all touch the vital predicate of your business which I mentioned before - the ability to satisfy a wide-spread public demand for direct investment in enterprise.

For example you all remember the days in the middle and late thirties when so-called "private placements" came into public prominence. It was a time of real fear in the investment banking fraternity. The growth of a system in which insurance companies and banks swallowed up increasing percentages of available investment was nothing to be complacent about. You gentlemen complained - and complained hard. Unfortunately and, I think, time has proved erroneously, some of your hardest complaints were against the S.E.C. and its basic laws.

Not alone private placements, but other means of by-passing the direct call on investors' savings constitute possible competition with the investment banker's distribution function. The degree to which corporations can finance additions from internal savings and the use of bank credits are other examples.

There are several common features in these examples. One of the most significant is that they are not, by any means, necessarily "depression babies". Private placements, bank credits, and internal savings are live factors in any stage of the business cycle. True, they are not as obvious when new financing is plentiful and is matched by active demand; but it is true too that they do not spring into being with depressions.

Depressions, of course, affect all of us. They have instant and marked effects on your business. One of the symptoms of a depression is the freezing of capital pools. Somehow indecision and lethargy seem to overtake us. There seems to be a desire to play safe, to shrink away from direct investment in enterprise. Good, job-making projects wither for lack of capital, and capital, hiding in safety, hungers for good return. At such times criticism of the investment banking fraternity tends to run high; and it seems an inevitable tendency, nothwithstanding the political complexion of the time, to meet depressions by supplanting the investment banker and by using government capital to help keep employment up.

Whether adverse factors to the investment banking business are or are not depression symptoms, they can be met by one good antidote - strengthening the confidence of issuers, of the public, of the man in the the street with savings to invest, in your functions. Your industry has many fair-weather friends. It is comfortable to know that a seasoned corporation seeking a refunding to take advantage of falling rates will probably be knocking at your door; that a few large institutions will be glad to relieve you of a major part of a prime issue; that you can get active dealer participation in a sure thing in a rising market. But the important question is how solidly you stand with the public - with the large classes of investors whom your industry is primarily designed to serve. They are the ones who form the essential backbone of your market. It is in their service that the industry is, ultimately, justified - morally and practically. You are the investor's primary direct channel to enterprise. That is why issuers come to you and that is why the investor comes to you. You cannot afford to have that channel closed up, to have either issuer or investor lose confidence in you and therefore search for means of by-passing that channel. And, in that very real sense, your interests and the interests of the investor are identical.

For a moment let us take a quick glance at the legislation administered by the Securities and Exchange Commission. Several things stand out clearly. You will recognize immediately that this legislation is predicated on the same bases that underly your own business; this legislation assumes the existence of large classes of investors who wish to invest their savings in enterprise and it assumes the necessity for protecting these people and serving them well. The working of these laws has demonstrated that they are not, by any means, intended or administered to be destructive of your business. They recognize that your business is a vital part of our economy and their broad aims are to help lay a firm basis in the American economy for the growth of sound public investment. It is the intention behind these laws to help, and not to hinder, informed investment. And it is our intention at the Commission, in administering them, to follow that spirit.

In past addresses I outlined some of the projects we have undertaken at the Commission to improve the machinery for getting adequate, accurate information out to investors, for simplifying the filing of information and for expediting the registration process.

These proposals do not exhaust either the full scope of a program to inform the investor, nor can they in themselves make a reality of it. Registration statements should be prepared carefully and with an honest intention to disclose. They are processed by people who do their work efficiently and thoroughly. We have no intention of speeding up the handling of registration statements and other filings by doing the job sloppily. If the job is to be done well, no amount of efficiency engineering can get it done quickly without enough people to do it. In spite of the heavy load now being carried by the staff of the Commission primarily engaged in the processing of registration statements, and despite the fact that we have had to burden that staff with added duties as a result of wartime reorganization, our staff is doing its utmost to carry through our program of expediting processing. It is our hope that the good sense of our program will be recognized, that we will be able to increase the number of people engaged in the handling of registration statements and come nearer the fulfillment of our hopes for expedited processing.

But in my view, a sensible program cannot be fully achieved merely by revisions in the Commission's procedure. No matter how carefully we adjust our methods, the prime responsibility is with those who prepare the material that the investor will be given and which he should read. Clear and full information is impossible unless those who prepare material for consumption by the investor honestly try to make their presentation at the same time simple and completely accurate and unless the investor reads the material given to him. It is a sad fact that not enough investors read prospectuses, that too much investment is made on the basis of the tip and hunch. We will probably never be able to get all investors to read what they should read; but we should never stop trying to serve those who want to read and to stimulate the others to use the information at their disposal.

That can be done in several ways. The first, as I have indicated is to make an honest effort to state the facts fully, but simply and directly. The second is encourage investors to use the information. By that I mean literally sitting down with an investor, opening the prospectus for him, explaining what it is and what it contains, and guiding him through it. All of us, I venture to say have had the experience of looking at financial statements which we did not completely understand. Imagine then the predicament of the investor who is frightened at the mere sight of a balance sheet or income statement. But, in that balance sheet, in the income statement, and in the other pertinent disclosures lie the grains of truth about what he is being asked to buy. The investment banking houses cannot be merely peddlers, they cannot be merely keepers of rummage shops; if, as you will agree, their professional obligations go beyond the closing of the sale and the ringing up of the cash register, then you must agree they should recognize and fulfill this obligation.

To stand as the intermediary between enterprise and investors can not, in the long run mean only that you have the goods to sell or the customers to buy without being ever conscious of the ideal of service embodied in your profession. Ignoring that ideal may not keep customers from coming in in the rising market. But without it you build a high wall between you and the customer when a real selling job is to be done.

I can well understand the temptation of the salesmen to shoot the stuff out, to pile up the commissions. As long as the salesman is a free lance entrepreneur who merely hangs his hat in your shop the temptation will continue to be a strong one. But neither the firm nor the salesmen should ever forget that, to the customer, the security comes with the firm's stamp on it. To profit by slurring over the importance of having the customer fully informed is to run the risk of loss of confidence and distrust; and, in the long run, is not to profit at all.

You gentlemen know as well as I how often your salesmen's volume or the success of a distribution depends on what the market did the day before. That is because so many investors have not formed, and have not been helped to form, the habit of buying a particular investment representing a particular grade and quality of earnings. Because he has no basis for independent appraisal, the investor too often buys trends instead of buying investment. That would be fine if markets went no place but up. However, markets do not do that. And, I should think, you would want to build a business which has the capacity to withstand the daily index jitters. I cannot think of a better way of doing that than by raising the general level of salesmanship to the point at which the securities' seller regards it as a matter of course to see to it that his customer knows what he should know about what he is buying. And that means seeing to it that the investor uses and understands the prospectus.

I think the sound and the long-range view is clear. The investment banker should be directly concerned with preserving the integrity of the standards and objectives of the securities laws and with translating them into tangible results on the firing line. That concern, further, should not stop with the Securities Act. It should extend to the others as well. Free, unmanipulated, and orderly trading markets are vital to public confidence in investment. It does a tailor little good to fit a suit perfectly if the suit falls apart soon after the customer leaves the shop. It does the investment banker just as little good to bring a sound security fairly priced to the investor and leave him to the hazards of a rigged market. The investor stays with the security. He needs, if he holds debt, a trust indenture that assures him an independent trustee performing the minimum of services necessary to preserve the security. If he has bought a utility or investment-trust issue it does little good to have made original disclosure if the investor is not to be protected against certain of the classical abuses in these fields.

We do not flatter ourselves into believing that there is perfection the last letter of detail in our laws. About six or seven years ago representatives of your organization, of the NASD, and of many exchanges sat down together with us for a survey of our legislation. We reached broad areas of agreement on revision of certain of the provisions of the Securities Act and of the Securities Exchange Act. The views evolved by the participating bodies were boiled down to a set of specific proposals and counter-proposals. Extensive hearings before a House of Representatives committee were had. The war interrupted that program. In the intervening years certain of the proposals may have become obsolete; I know that our own revisions at the Commission have already achieved some of the objectives, and many more may be reached without the need for statutory change. The experiences of the past few years have indicated to us, at the Commission, other areas in which statutory relief of unsound conditions is needed, and probably your own added experience may indicate that you want to change <u>your</u> minds about some of the proposals.

We have passed the war crisis. We all hope to set out for many years of peace to come. I am glad that in our relations with your association and other groups in the financial community we have already laid the basis for a joint well-considered effort at improvement. The Commission has already begun an intensive study of the documents relating to the statutory revision program, with the purpose of preparing a schedule of proposals that make sense now as a basis for further meetings and conferences to continue our task of reaching agreement on joint legislative proposals. That will take time. It is not something that can be done hastily.

But this is my first address to your Association and I believe in first things first. My most important message to you is that: we are committed to the protection of investors as public servants; you are committed to their service because, in the end, your livelihood depends on it. It is a mutual task we are engaged in and its success depends primarily on our mutual effort to preserve and strengthen the standards under which we work. Wisdom lies in assuring the American investor that there is a whole-hearted intention to preserve the standards necessary for his protection and to make them meaningful where it counts the most - in serving him honestly, efficiently and at a reasonable cost.