

REMARKS OF RICHARD B. SMITH, COMMISSIONER,  
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,  
BEFORE THE PUBLIC RELATIONS SOCIETY OF AMERICA,  
PHILADELPHIA, PENNSYLVANIA - November 14, 1967 "Some  
Aspects of Company Communications with Shareholders"

It is a little difficult to speak to a gathering of financial and stockholder experts such as this and at the same time to say something which the audience does not already know. Moreover, I have the feeling that anything I might say will already have been said, or is planned to be said, by my very knowledgeable co-panelists. I fully expect to gain more wisdom here than I shall impart.

Nevertheless, it might be of some small value for me to review a few current developments in the area of stockholder communication. Mr. Lawrence suggested that I might "touch on areas of shareholder communication which come under the purview of the SEC." With an unexpected perversity, however, I have instead chosen to touch on areas which may not customarily be considered as of SEC regulatory concern. Because of the necessary time restrictions I shall limit my comments to aspects of three developments:

First, per share presentation of income information to shareholders;

Second, management letters to shareholders; and

Third, institutional advertising.

I.

(As to Accounting)

The Accounting Principles Board of the American Institute of Certified Public Accountants issued an opinion last December which will govern reporting of operating results to shareholders for fiscal periods beginning this year. Thus, annual reports for 1967, published next spring, will be subject to these auditing standards. While the opinion dealt with a number of matters I will recall only two of them to you at this time.

The first is the requirement that all gains or losses, whether normal or extraordinary, whether recurring or non-recurring, be reflected in the income statement determination

of net income. A previously acceptable practice of charging large, extraordinary items directly to retained earnings, so that they had no effect on reported net income, will no longer be available. Except for certain prior period adjustments, dividends and distributions and transactions of a clearly capital nature, the net income figure for the year will reflect all transactions affecting the net increase or decrease in the book value of the common stock. However, extraordinary items as defined will be required to be shown separately.

A second part of Opinion No. 9 will require a calculation of earnings per share as part of the income statement. The per-share data would show separately income before and after extraordinary items. Moreover, the opinion would require a pro-forma calculation of earnings per share reflecting the potential dilution resulting from outstanding convertible senior securities as well as outstanding stock options, warrants or other commitments to issue additional stock.

As you also will remember, in January of this year the Commission's proxy rules were amended to require that comparative two-year financial statements be included in annual reports to shareholders.

The net effect of these accounting requirements, we would hope, will be to provide additional and better comparative information to shareholders. They, hopefully, will focus investors' attention on all the items that go into the production of income, with some identification of the various items, and will alert shareholders to the potential dilution of their equity reflected in shares reserved for future issuance at fixed prices.

There is, of course, a cost to everything and the cost of this additional information is undoubtedly some increased complexity to the income statement. I personally am not sure how much further down this road we should go. Nevertheless, a company that creates, albeit for very good reasons, a highly complex capital structure should not and cannot be permitted to mask that complexity behind a simplistic presentation. All too often companies with complex capital structures are evaluated by investors only by reference to bottom-line figures which do not and cannot always tell a meaningful story.

Another development in the accounting area is that concerning more detailed financial reporting by the so-called

"conglomerate" or diversified companies. (One of these is represented on the panel here today.) There is a great variety, and a certain lack of comparability, in the manner in which such companies report their results of operation to shareholders. If financial statements are to be a meaningful measure of management's performance, and to represent a meaningful accounting to the owners of the business, sufficient information must be contained in the income statements upon which analysis can be based.

The Financial Executives Institute is currently engaged in an extensive study of conglomerate reporting, and the American Institute of Certified Public Accountants is also studying the problem. It is a complex subject indeed. A breakdown of consolidated results could follow a number of different courses. (1) Products or product-lines, (2) broad industry groupings, (3) markets, and (4) organizational divisions within the company, are among the most likely, but each of these contains difficulties. I do not mean by this that the job cannot or should not be done, but only that a complete study and thorough analysis of the problem have to be made. The Commission, with a sense of urgency, has encouraged these studies now in progress. This, however, should not be mistaken for any prejudgment by the Commission of the criteria for additional reporting requirements, or any predetermination that uniform criteria should be applicable to all companies (although, obviously, comparability is a worthwhile objective).

There has been significant voluntary improvement in reporting by many diversified companies. The extent and quality of voluntary disclosure will be important considerations in determining the eventual need for any Commission rules in this area.

## II.

### (As to Annual Reports)

The Commission's proxy rules require every company registered under Section 12 of the Exchange Act to furnish its stockholders with an annual report containing certified financial statements. Any difference in accounting principles between these statements and those filed with the Commission must be noted and the effects of the difference stated.

The only requirement as to other material the company may elect to include in the annual report is that such other material not render the financial information misleading. With this single restriction, management is given a free hand, subject only to the general antifraud provisions of the Act, to communicate its accomplishments, projections and plans to its stockholders. The Commission has felt that it is generally beneficial for management to have this means available to communicate freely with shareholders without conforming its presentation to a prescribed or established mold.

Unfortunately, there have recently been a few instances where it appeared that management had utilized portions of its annual report to stockholders, and especially the traditional president's letter, to argue in favor of proposals to be acted upon at the shareholders meeting. This use of the annual report to present arguments which would not be proper in proxy soliciting material and thereby to evade the requirements of the proxy rules, raises questions as to the applicability of the proxy rules to the annual report, or the extent to which they should be made applicable. I personally feel that it would be extremely unfortunate to invade the present freedom of management to tell its story in the way it deems most effective. I think this freedom would be severely lessened should the textual material in the annual report be judged by the standards applicable to the proxy statement and subject to review by the Commission's staff.

However, if management is to retain its present freedom unquestioned, it should be careful not to abuse it by seeking to counteract or circumvent the protection provided security holders in other areas.

I might call your attention in this regard to paragraph (f) of Rule 14a-11 of the Commission's proxy rules. That paragraph provides, despite the treatment of the annual report as not being proxy "soliciting material," that during a contest where a comment or reference to proxy solicitation is made in the annual report, the portion of the annual report making such comment or reference must be filed with the Commission five business days prior to its usage. So far, this is as far as the Commission has gone. Let us all hope we need go no farther.

III.

(As to Institutional Advertising)

I am sure you have all noticed, and some of you may have drafted, advertisements in magazines and newspapers of general circulation, particularly by diversified companies, which call attention to the nature and identity of the various businesses in which they are engaged, their recent growth and success, and sometimes suggesting that the reader request a copy of the annual report to stockholders.

The prospect that a company's advertising may attract investors to its securities, either inadvertently or advertently, is, of course, not a novel one. There is a great deal of advertising which cannot be said to be directed to any particular single purpose. This is especially true of so-called institutional advertising. Even strictly product-oriented advertising, by placing a company and its activities before the public, may arouse interest in the company as an investment. Moreover, companies have long engaged in organized programs of financial or stockholder public relations. It is in this context that company officials address gatherings of financial analysts and other groups. And, of course, to the extent that this yields increased dissemination of accurate public information concerning the company, it is all to the good.

More recently, certain advertisements appear to be increasingly directed at public investors. It is true that such advertisements may serve other purposes, such as to draw the attention of sources of non-public financing, or of other companies which may be prospects for acquisition, or of prospective new employees, or to make consumers conscious that the product-maker is part of a presumably larger and stronger financial whole. However, if not its only or primary purpose, it is a possible effect of such advertising that it will serve to whet the appetite of investors for the company's securities.

I would not want to imply that I or the Commission consider institutional advertising to be necessarily improper. We have certainly not made a study of it, and at this point I don't believe the volume of such advertising, which by its financial overtones would appear to be directed at public investors, while apparently growing, is too widespread. Indeed, as I have already indicated, to the extent that such advertising

does disseminate accurate and properly balanced investor information, it may be beneficial. But in certain situations and done in particular ways, such advertising could be abused and create problems. Questions not necessarily new naturally occur, of gun-jumping or preconditioning the market, in anticipation of a public offering by the company or a distribution of securities by controlling persons. Particular usages during proxy solicitations could raise questions. There may be others, but it is an apparently growing practice which invites some attention to its effects on the securities markets and individual investors.

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I would be remiss in closing not to applaud the efforts of the Public Relations Society of America to produce and follow the ten-point Code of Financial Public Relations adopted in November 1965. That assumption of essentially professional obligations, and adherence to them both in spirit and in practice, cannot help but contribute to the strength, fairness and efficiency of our great American public capital markets.

Thank you.