THE INADEQUACY OF CURRENT LEGISLATION ON CORPORATE DISCLOSURE

In reply to a letter on this subject from the Attorney-General's Department in Canberra, Mr. R.G. Lander, Editor of the original JASSA article and Vice-President of the N.S.W. Branch of the Australian Society of Security Analysts, wrote as follows on 15 January, 1974:

...... I note your interest in exploring what we meant by a "longer catalogue" of items which should be disclosed to the investing public.

Clearly one cannot be definitive here, one can only have priorities as disclosure is an evolutionary subject. In the article in the Oct./Nov. 1973 issue of JASSA the Australian Society of Security Analysts set forth what it considered the most pressing deficiencies in disclosure in Australia at present.

Items which would improve disclosure standards in this country but which were not included in our list of priorities include the following, presented in random order:

* gifts to political parties, charities and outside organisations (refer UK regulations);
* statement showing salary brackets of executive directors and senior staff (refer UK and SEC regulations);
* statement by internal auditors (e.g. J.P. Morgan & Co.);
* executive officers - names, ages and family relationships (refer SEC regulations);
* directors' shareholdings;
* directors' outside boards;
* pending legal proceedings (refer SEC regulations);
* basis of voting for shareholders;
* retirement age of staff and directors;
* publication of Chairman's address at AGM and questions and answers;
* area and purpose of plants (e.g. IBM);
* available credit facilities;
* management chart - names and photos (e.g. Ford);
* depreciation policy;
* statement on commitment to and policy of pension fund;
* summary of costs included in stock valuation;
* analysis of capital expenditure by division or by product.

To answer your final question, "The Inadequacy of Current Legislation on Corporate Disclosure" was prepared following contributions from a wide cross section of our own membership. Other bodies such as the AASE were not consulted as we were simply putting forward our own views but it is to be hoped that our work will stir interest in the general subject of disclosure.

PROFESSIONAL STANDARDS FOR FINANCIAL ANALYSTS

The Institute of Chartered Financial Analysts

(The following policy statement on professional standards for financial analysts was adopted by the Board of Trustees of The Institute of Chartered Financial Analysts on 6 May 1973. Its purpose was to inform the U.S. public, financial community and government about the position of the Institute on professional standards, but it is apparently not final in that comments and suggestions were invited in relation to both the policy statement and the covering letter regarding the Institute's grievance procedures. The Institute has agreed to our publication of its policy statement with this covering note, and we acknowledge our indebtedness to the helpful work of our professional colleagues in the U.S.A.)

Professional Standards for Financial Analysts

This is a policy statement of the Board of Trustees of The Institute of Chartered Financial Analysts. This statement pertains to the professional standards to be met by financial analysts in discharging their responsibilities to the investment community and to the public. It develops a rationale for the conviction that improvements in professional governance are in the public interest, and that such improvements may be achieved by formulating professional standards for financial analysts and by encouraging observance of such standards by financial analysts.

Definitions

Because the terminology in this field is sometimes ambiguous, several terms are defined here for purposes of clarity.

Financial Analyst. In general, a financial analyst is a person who devotes the majority of his time and effort in the capacity of an investment advisor and/or a security analyst.

Investment Advisor. An investment advisor, sometimes called a portfolio manager, trust investment officer, or investment counsellor, is a person who is primarily compensated by clients, subscribers, or an employer for making investment recommendations or decisions which are intended to result in the purchase, sale, or retention of marketable investment securities owned by clients, subscribers, or an employer.

Security Analyst. A security analyst, sometimes called an investment research analyst, is a person who is primarily compensated by clients, subscribers, or an employer for conducting independent research which results in written or oral security analysis reports. A security analysis report is defined as an analysis of industries, corporations, or other issuers of marketable securities, giving consideration to a security's (or securities') investment characteristics, investment risk, possible future return, or estimated current or future value.

Need for Professional Standards

Efficient financial markets are a prerequisite to a strong and prosperous economic system. They assist in providing the optimum allocation of scarce resources. It follows that the suppliers and users of capital funds should be well-informed, skilled, and ethical if they are to contribute to an efficient, liquid, and orderly capital market. Poorly informed, unskilled, and unscrupulous persons may contribute, on the other hand, to a capital market which is characterized by inefficiency and economic waste, disruptive or violent fluctuations, and a misallocation of capital, all of which can lead to general business instability and to an impediment in growth of or a possible contraction in economic activity.

Therefore, from the standpoint of the public interest and the protection of the vital interests of millions of individual and institutional investors, the time is now long overdue for the establishment of universally recognized, uniform, minimum professional standards for financial analysts. At least five reasons justify this need, especially at this time:

1. At no time since the industrial revolution has the American economy developed money and capital markets with publicly owned and publicly traded investment securities on such an enormous scale. The New York Stock Exchange alone has 19 billion shares of stock listed at a market value of over $800 billion. This compares with only $76 billion in 1949. In 1972, $96 billion of new investment securities was publicly sold in the United States. Of this amount, $13 billion was equity capital, $29 billion was corporate bonds and notes, $23 billion was state and municipal bonds, and $17 billion was U.S. Government securities. Consequently, an enormous responsibility is placed on the task of management of marketable securities and of allocation of capital within the public and private sectors of the economy. How this capital is allocated and managed will determine the extent to which public and private economic objectives are reached in terms of production, employment, and government services, and will determine the level of financial well-being reached by over 50 million American investors and their families.

2. With the enormous growth in the corporate sector of the American economy, financial markets and securities arrangements have become considerably more sophisticated. Industrial methods and scientific technology used in production, distribution, and commercial services have become incredibly complex. Accordingly, the process of intelligently analyzing investments and managing portfolios has become far more challenging.

3. The public depends on and benefits from a well-developed specialized investment management and investment research profession. A considerable body of knowledge and many analytical skills may now be acquired and advantageously used by financial analysts in conducting investment research or in making investment decisions. These skills and knowledge are concerned with theories, principles, concepts, mathematical techniques, technical terminology, and quantitative relationships. Formal disciplines of study useful to a professional analyst include economics, financial analysis, accounting, investment management, ethics, investment legal requirements, and other fields of business administration.

4. Professional study, training, and the development of sophisticated analytical skills are of considerable value to a financial analyst because he now has a greater opportunity to apply this background to the vast wealth of information and data resulting from the expansion of corporate disclosure requirements and from the availability of computerized information systems, the greater precision and uniformity of corporate financial statements, and the growth in the dissemination of economic, industrial, financial, monetary, social, political, international, and security market information.

5. Because of the greater opportunity for public reliance on investment management and research, the financial analysis profession has exhibited extraordinary growth. Individual investors, investment institutions, investment advisors, and securities salesmen rely heavily on security analysis reports as a basis for making investment recommendations

and decisions of professional investment advisors. Given the growth of the financial analysis profession and the institutionalization of savings and investment, over half of all marketable equity and debt securities are held by financial institutions or managed by investment advisors. The investment performance of these professionally managed portfolios contributes to the financial well-being of many millions of Americans in their retirement years, for financing the reserves for insurance claims, for supporting trust beneficiaries during their years of financial dependency, and for financing all kinds of educational and charitable programs.

Evidence exists that incompetent and unscrupulous financial analysts contribute to poor investment performance, unnecessary investment risks, and losses for clients and employer institutions. Given the present ease of entry into the profession of financial analysis, untrained, unseasoned, and unethical financial analysts, operating simultaneously in the aggregate, may occasionally contribute to speculative booms in the stock market, which are followed by severe downward corrections and a collapse in sub-market sectors. The most recent example was the cycle of 1967-70. Such professionally unsound and unethical practices result in public scandals, inflict losses on thousands if not millions of investors, create economic disruptions in the capital market, and contribute to a general lack of public confidence in the American financial system and the financial analysis profession.

Based on the foregoing background, it appears to be clearly in the public interest that financial analysts comply with appropriate professional standards of conduct.

Other professions whose work affects the public interest, such as physicians, attorneys, public accountants, and securities salesmen, are subject to standards which may include educational requirements, training, experience, examination, and licensing. Considering the importance of financial analysis to the national interest, it is indeed appalling that so little recognition is given to the need of professional standards for practicing financial analysts.

Another justification for standards is that the competence, skills, and ethical conduct of a member in a highly specialised, technically sophisticated profession may not be readily ascertainable by clients and employers who may not themselves have the professional background or opportunity to evaluate properly the qualifications of the member. Under such circumstances, if financial analysts are not subject to appropriate standards, the interests of clients and employers are exposed to greater jeopardy. A widely recognized approach in those professions which render vitally important, though technically sophisticated services, is to administer standards in four ways.

1. Identify appropriate standards of professional performance;
2. Require members of the profession to meet and to observe these standards;
3. Exclude those individuals from entering the profession who fail to meet the standards; and
4. Take sanctions against members who violate the standards of conduct.

If this approach is used by the financial analysis profession, it will protect the vital interests of the public and of investors. This is not to say that establishing and enforcing minimum professional standards will guarantee that all financial analysts will produce an optimal investment service for their clients and employers. The enforcement of such standards will, however, raise the general level of performance currently being rendered by less qualified or less conscientious financial analysts, and will discourage the practice of financial analysis by incompetent and unscrupulous individuals.

Several references were made to the U.S. economy and investment community for illustrative purposes. A comparable justification for professional standards for financial analysts is obviously applicable in Canada and other countries.

Implementation of Professional Standards

Several elements must be employed to achieve standards of performance in specialized and technically sophisticated professions. Comparisons may be made with the professions of medicine, law, and public accounting. The essential elements of workable standards of performance for a profession can be viewed as:

1. A recognized, formal body of knowledge and a group of skills exist which the competent professionals must master.
2. This knowledge may be acquired by formal educational programs or by systematic self-study. The skills may be developed by practice through the application of such skills in class projects, course assignments, seminars and laboratory experiments, or in internship, apprenticeship, or on-the-job training and work experience.
3. An examination can be designed, administered, and graded so that it is possible to distinguish objectively between those persons who show evidence of a minimum level of professional competence and those who do not.
4. Competent and ethical practices can be identified and distinguished from incompetent and unethical practices.
5. The members of the profession act in the best interests of their clients and employers.
6. The members share the responsibility for the administration and enforcement of standards of performance.

It is believed that these six elements have been and will continue to be developed by the financial analysis profession. By having financial analysts individually observe and comply with high standards of performance is the best way to achieve competent investment management and investment research, which will protect the vital interests of investors.

The responsibility for many of the functions performed by financial analysts, which include conducting security analysis research, formulating investment advice, and making portfolio decisions, are assigned to individuals. Consequently, it is believed that the major responsibility for complying with professional standards should centre on individual financial analysts rather than on the employer organization. The quality of the financial analysis performed in the name of an organization, especially in a large organization, depends to a significant degree on the abilities of the individual financial analysts who are responsible for carrying out their duties.

The same professional standards can be applied to both investment advisors and security analysts alike. The responsibilities, knowledge, and skills required of both investment advisors and security analysts are similar. In the investment decision-making process as a whole, it is unclear how the tasks and responsibilities between security analysts and investment advisors can be easily delineated.

To protect the interests of all investors, it is desirable that all financial analysts comply with the same professional standards, regardless of the type of investment organisation which employs the analysts. In the interests of fairness and equity, all investors should be entitled to the benefits of good investment practices.

Financial analysts are employed by or their services are used by the following types of organizations:

1. Commercial banks and trust departments;
2. Foundation and endowment funds;
3. Insurance companies which underwrite annuity, casualty, life, pension, and property insurance contracts;
4. Investment advisory publishing firms;
5. Investment companies, or mutual funds;
6. Investment counsel, investment advisor, and investment management firms;
7. Investment research and investment advisory departments of broker, dealer, and investment banking firms; and
8. Private and public pension and other retirement funds.

Another reason for advocating the same professional standards for all financial analysts is that the financial analysis functions performed by several of these organizations are changing and broadening, so that the once unique nature of these organizations is tending to disappear. Several different types of legally constituted entities are serving the same types of investor. For example, banks, investment counsellors, insurance companies, investment brokerage firms, and non-financial corporations are managing commingled equity portfolios of group retirement plans. Surely, the prospective beneficiaries of such plans have comparable needs for good professional performance regardless of whether the investment portfolio is managed by a bank, investment counsel firm, insurance company, or investment brokerage firm.

Recommendation

It is recommended that all certifying analysts comply fully with the type of professional standards of financial analysts as described above. A certifying analyst, sometimes called a supervisory analyst, is defined as a financial analyst who has the authority and the responsibility within his or her organization to approve investment recommendations, decisions, and security analysis reports as to their quality, appropriateness, and compliance with laws, regulations, and ethical practices before they are transmitted to or implemented on behalf of clients, subscribers, other investment advisors, and registered representatives.

It is recommended that junior or subordinate (non-certifying) financial analysts comply fully with the same professional code of ethics and strive toward the development of a reasonable level of professional competence.

In the opinion of the Board of Trustees, those financial analysts who meet the professional qualifications and comply with the "Code of Ethics" and "Standards of Professional Conduct" of the Institute of Chartered Financial Analysts, successfully meet reasonable, minimum standards to qualify for the practice of financial analysis. The content of the C.F.A. candidate study program, the C.F.A. examinations, the eligibility requirements, and the I.C.F.A. "Code of Ethics" and "Standards of Professional Conduct" are described in a brochure entitled "The C.F.A. Program", which is available free on request from The Institute of Chartered Financial Analysts.