Speech by SEC Chairman: Quality Information: The Lifeblood of Our Markets

Remarks by

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Today, the unbridled forces of competition, technology, and globalization have converged to spur greater innovation, unleash new discoveries, and rekindle the belief that our potential is without confines. Every day we are seeing new ideas, new inventions, and new imperatives that are dramatically reshaping our world.

Vestigial barriers of the Cold War have all but disappeared. Countries once shut out from the sunlight of opportunity – from the free flow of capital, goods, and services – now bask in the illumination of grand possibilities. Through rapid technological advancements, the notion of geography as a barrier has been all but archived.

An explosion of on-line information sources, real-time news feeds, and TV channels devoted to business news has reinvented how we gather and disseminate financial information. Across the globe, a broad movement towards an equity culture has taken root as traditional bank financing takes a back seat to the emergence of globally interconnected capital markets.

But as the ground shifts, our mandate to protect the public interest remains absolute. Nowhere is that interest more implicated than in the evolving structure of our capital markets, and in the integrity and transparency of the information that binds these markets together. Tonight, I want to talk about the structure of our markets and then emphasize why continued U.S. supremacy globally depends on our total commitment to quality financial reporting.

Quality in the Marketplace

I have been talking about quality in the marketplace a lot recently. But quality – in concept and in practice – cannot be allowed to deteriorate with time or wilt with age. It is not a catch-phrase or a sound-byte for a marketing campaign.

Quality in our markets is a commitment to integrity and transparency in the way we do business; in the way we execute and report trades; in the way companies report their financial performance; in the way analysts communicate with companies and investors; and in the way auditors fulfill their mandate for independent and objective oversight.

As more countries embrace a true equity culture, and investors respond by allocating capital globally, a transparent and trustworthy global financial reporting framework has also become more important than ever.

Progress Towards Better Markets

A few weeks ago, I talked about many of the issues and developments unfolding as U.S. markets respond to the forces of technology and competition. Electronic communication networks – or ECNs – are challenging trading floors. The nation's stock exchanges are pushing forward in their plans to go public. Options contracts are now listed on multiple exchanges. Financial markets, at their most basic level, are being reconstituted. And the impending changeover to decimals, while benefiting investors, will create enormous challenges both to firms and to our markets. We should not underestimate the effect decimalization could have on profitability, on commission rates, and on market structure as a whole.

Significant steps are already being taken to address many of these developments. The Commission and market participants are working together on ways to craft a fairer, more open, and more efficient marketplace. In doing so, the SEC embraces free market principles to foster greater competition, while ensuring effective regulatory oversight to protect the investor interest.

For competition to flourish, anticompetitive exchange rules and obstacles must be eliminated and new market entrants must be free to compete with traditional markets. Towards this end, the Commission will soon vote on Intermarket Trading System Plan amendments that will give the NASD access to all listed stocks. Additionally, I hope and expect serious proposals will develop in short order giving ECNs entry to ITS. And lastly, we are working together with market participants to determine whether ECN fees – the fees that these electronic networks charge to access their trading platforms – should be eliminated.

Regarding the options markets, I recently expressed my concern to the heads of the options exchanges about the lack of progress in establishing linkages. In the next few days, we will issue an order that requires the options markets to implement an effective linkage plan. Linkages are simply essential to enabling a customer's order to receive the best execution available in any market, regardless of the market to which it was first routed. I'm convinced that technological obstacles can be overcome promptly. Now, I would prefer that the Commission not impose a linkage plan on the industry. But, if these markets do not take significant steps on their own initiative, we stand ready to act.

I've also asked the Commission's staff to prepare a public release requesting comments, proposals, and ideas on how we can effectively garner the benefits of centralizing orders without stifling competition. Specifically, we cannot ignore the possibility that aggregating limit orders across markets, and rewarding those that post the best price first, may produce better prices for customers. This moment in history – replete with technological opportunity – demands that every market participant begin considering and refining concepts that may move us towards a better market.

Lastly, effective regulatory oversight must never be sacrificed. The Commission has no intention of standing in the way of exchanges moving to for-profit status. But in any structure, the self-regulatory obligation must be vigorously fulfilled, adequately funded, and dedicated to serving the public interest.

I am optimistic about our chances for creating a marketplace worthy of the 21st Century. Never before have I seen such a broad range of market participants discuss thoughtfully and boldly the future of our markets. But, we can talk about liquidity and order flow, we can talk about barriers to competition, we can talk about new market entrants, and we can talk about linkages all we want. It's nothing more than an academic exercise if investors can't rely on the quality of the underlying financial information.

Quality Financial Reporting Under Stress

Quality information is the lifeblood of strong, vibrant markets. Without it, investor confidence erodes. Liquidity dries up. Fair and efficient markets simply cease to exist. As the *quantity* of information increases exponentially through the Internet and other technologies, the *quality* of that information must be our signal priority.

Over the last sixty years, our markets have been models for transparency and integrity. This is due, in no small part, to the professionalism of corporate management, financial analysts, accountants, and members of the legal community. My observations here this evening, however, arise from a perennial obligation shared by all of us: to be ever vigilant in shining the light on ethical gray areas before their shade becomes even darker, their effects more corrosive.

A little over a year ago, I voiced concerns over a gradual, but perceptible, erosion in the quality of financial reporting. The motivation to satisfy Wall Street earnings expectations was beginning to override long established precepts of financial reporting and ethical restraint. A culture of *gamesmanship* over the numbers was not only emerging, but weaving itself into the fabric of accepted conduct.

I thank those in corporate America who took to heart the call for greater integrity and accountability in the financial reporting process. I also recognize and applaud the efforts of private industry groups that strive to "raise the bar" in the investment management industry through voluntary compliance with high ethical standards. Your commitment and your efforts have made a real difference. While we have made strong progress, the gamesmanship, unfortunately, persists.

A gamesmanship that says it's okay to bend the rules, tweak the numbers, and let small, but obvious and important discrepancies slide; a gamesmanship that tells managers it's fine to cut corners and look the other way to boost the stock price; where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of numbers; where auditors are pressured not to rock the boat; and a gamesmanship that focuses exclusively on short-term numbers rather than long-term performance.

We've all seen what happens when a company misses an analyst's earnings target by just a few pennies. The stock plummets. It's remarkable, but today, a near miss is a miss by a mile. I can't tell you how many times an investor has come up to me – incredulous and exasperated – because a company's market capitalization dropped by millions of dollars simply because it was a penny or two shy of its earnings estimates. Unfortunately, there is no law of economics I can cite, no reasonable correlation from which investors can draw.

I can only point to what I see as a web of dysfunctional relationships – where analysts develop models to gauge a company's earnings but rely heavily on a company's guidance; where companies' reported results are tailored more for the benefit of consensus estimates than to the reality of the ups and downs of business; where companies work to lower expectations when they fully expect they'll beat the estimates; and where the analyst attempts to walk the tightrope of fairly assessing a company's performance without upsetting his firm's investment banking relationships.

Our review of the relationship between companies and the analysts who follow them indicates that analysts, all too often, are falling off that tightrope on the side of protecting the business relationship at the cost of fair analysis. Analysts are a fixture on business pitches and investor road shows – doing their bit to market their own firm's underwriting talents and to sell a company's prospects. What's more, analysts' compensation is increasingly based on the profitability of their firm's corporate finance division, and their contribution to the deals to which they are assigned.

Needless to say, you can see how an analyst who recommends selling a client's stock because it's overvalued would not be terribly popular. In many respects, analysts' employers expect them to act more like promoters and marketers than unbiased and dispassionate analysts.

An all too candid memo from a leading Wall Street firm's corporate finance department couldn't have framed the conflict more plainly: " . . . We do not make negative or controversial comments about our clients as a matter of sound, business practice. . . the philosophy and practical result needs to be 'no negative comments about our clients'."

An analyst who goes against the grain may find himself excluded from conference calls, or worse, as I recently read, even silenced by his own firm. Is it any wonder that today, a "sell" recommendation from an analyst is as common as a Barbara Streisand concert. And, is it any wonder that many Wall Street firms would prefer that analysts heed their mothers' admonitions: "If you can't say anything nice, then don't say anything at all."

How many times have we seen an analyst on television being asked to list his top five picks? And, how many times has that analyst taken the opportunity to caution viewers, "By the way, my employer recently underwrote three of these stocks?" More often than not, he hasn't. And that's because some firms claim that these recommendations are either "extemporaneous" or covered by a prior disclaimer, or that disclosure is just plain distracting or impractical. Frankly, I don't find any of these arguments very persuasive.

I think the time has come for the SROs to consider whether investors are told – in a meaningful way – when the analyst's employer has a recent investment banking or advisory relationship with the company that is being recommended. We cannot settle for boilerplate disclosure, cloudy language that masks a firm's position, or small type disclaimers at the end of the document. In addition, firms should reexamine their compensation practices for analysts and ask themselves this simple question: Do our payment practices ensure unbiased and quality information?

Let me turn to another important issue in the area of analyst communications: selective disclosure. The behind-the-scenes feeding of material non-public information from companies to analysts is a stain on our markets. This selectiveness is a disservice to investors and it undermines the fundamental principle of fairness.

In a time when instantaneous and free flowing information is the norm, these sort of whispers are an insult to fair and public disclosure. We've also all heard about those roadshows where the banker's analysts give some investors a select look at an IPO that's not available to ordinary investors. While roadshows obviously serve a valued purpose, they shouldn't be the vehicle for giving a *very* different look at the company that's not in the prospectus.

Unfortunately, there is no simple regulatory or legal fix to this problem. But the Commission is planning to take action where it can. Within the next few months, we will consider proposing rules to close the gap between those in the so-called "know" and the rest of us in the public. But edict can never replace ethic. I appeal to companies, in the spirit of fair play: make your quarterly conference calls open to everyone, post them on the Internet, invite the press.

Don't misunderstand me, analysts serve an important role in ensuring the efficiency of our markets by ferreting out disparate facts and offering valuable insights. In a market that increasingly demands that all participants add value to compete, analysts have positioned themselves well to do so. But if analysts continue to view the world through rose-colored lenses, they doom themselves to irrelevance. As more and more investors, even retail investors, recognize sell-side analysis as a marketing tool, they will increasingly turn elsewhere for reliable research.

Ensuring Quality Through Vigilant Oversight

Corporate management and analysts are not the only market participants who share the responsibility of assuring integrity and transparency. It is absolutely imperative that a cultural shift envelop all key participants, including corporate auditors and directors. Its foundation, as always, must be an unwavering commitment to quality. Its cornerstone – an undying commitment to the investor. This culture should be safeguarded by those entrusted with the public's interest. And this begins with an active and independent board of directors.

Directors and Audit Committees

A board must understand a company's operations – top to bottom. It must demonstrate both a keen interest in hunting down problems, and a genuine eagerness in finding solutions. This is especially true for a board's audit committee. Earlier this month, the Commission – building on the work of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees – proposed rules to improve communications through greater disclosure between management, the board, and outside auditors.

Outside Auditors

Let me turn to the responsibilities of this latter group. The audit profession has a long and distinguished history of guarding the integrity of our companies' financial statements. They must live up to their history and remain inquisitive, skeptical, and rigorous in their application of the highest standards.

Like all businesses, the practices of the biggest accounting firms have undergone enormous changes. Entities once devoted exclusively to auditing now resemble diversified professional practices. If recent industry trends continue, I fear that the audit process, long rooted in independence and professionalism, may be diminished in the name of these increasingly lucrative and commercial opportunities.

In 1981, management consulting services for traditional audit firms represented approximately 15% of their total revenue. Today, its share stands at 40%. Meanwhile, revenues from auditing services have dropped to approximately a third of total revenues. I can't help but wonder what impact this changing business mix has had on a culture that has prided itself on objectivity. Can the audit engagement partner truly be perceived as discharging his public duties while trying to sell his audit clients legal advice or consulting services?

Right now, a distinguished group called the "Independence Standards Board," drawing an equal number of representatives from inside and outside the profession, is wrestling with these very issues. The ISB's "balanced" structure will prove to be either a stroke of genius, or a fatal flaw.

But financial markets wait for no one. It has always been an unassailable truth that what markets dread most is uncertainty and a lack of information. Nowhere could that lack of information be more detrimental than in judging the credibility of the financial statements. Regardless of how this issue of auditor independence is ultimately resolved, wouldn't investors be better off knowing what other types of services their auditors are performing? With such knowledge they can more fully evaluate the question of independence for themselves. Without it, they are completely in the dark.

More generally, perhaps we should give some thought to whether the accounting profession has become so big and complex that we need an alternative self-regulatory approach. Under the current regime, that responsibility is divided under a multitude of entities. Is the alphabet soup of regulatory bodies – the POB, the AICPA's PEEC, the SECPS, the QCIC, the ASB and the ISB – really the best way to serve the public interest?

Reporting on the New Economy

The dynamic nature of today's capital markets creates issues that increasingly move beyond the bright line of black and white. New industries, spurred by new services and new technologies, are creating new questions and challenges that must be addressed. Today, we are witnessing a broad shift from an industrial economy to a more service based one; a shift from bricks and mortar to technology and knowledge.

This has important ramifications for our disclosure and financial reporting models. We have long had a good idea of how to value manufacturing inventory or assess what a factory is worth. But today, the value of R&D invested in a software program, or the value of a user base of an Internet shopping site is a lot harder to quantify. As intangible assets continue to grow in both size and scope, more and more people are questioning whether the true value – and the drivers of that value – is being reflected in a timely manner in publicly available disclosure.

These questions may have some merit. Groups, past and present including one sponsored by the FASB, have worked on variations of this issue. Nevertheless, I have asked Professor Jeffrey Garten, Dean of Yale's School of Management to assemble a group of leaders from the business community, academia, the accounting profession, standard setting bodies, and corporate America to examine expeditiously whether our current business reporting framework can more effectively capture these momentous changes in our economy. But let me be quite clear: The work of this group is not an invitation to delay any initiative currently underway, especially those involving business combinations. These projects must be evaluated on their own merits.

Building a Global Financial Reporting Framework

The very same forces driving our own economy are driving the world's economy. In today's hot-wired financial markets, modern technology allows traders to move money anywhere in the world at lightning speed, more than $1.5 trillion every day – a sum equal to world trade for four months. With markets around the world more interconnected than ever before, investors and companies are increasingly seeking opportunities beyond their own borders. As a result, the need for a common business language has become compelling.

International Accounting Standards

Financial reporting is a language, just like German, English, or Spanish. It is the language that companies use to talk to investors. It is what people use everyday to decide where to invest their hard earned dollars for financial security and future opportunity. These decisions can be hard enough. But try it in a language you don't understand, and it becomes all but impossible. Even worse, misleading.

If anyone doubts the disparate effects that different accounting practices can have, consider the case of Daimler-Benz. Under German accounting standards, Daimler reported a profit of 168 million Deutschmarks in 1993. Under U.S. GAAP, the company reported a loss of almost a billion Deutschmarks for the same period.

Progress in establishing worldwide accounting standards is already well underway. Earlier this year, the International Organization of Securities Commissions and the SEC began their assessment of a set of standards developed by the International Accounting Standards Committee.

But it has never been more clear that it's not enough to have a group reach compromises on a set of accounting rules and label them "international standards." The standards themselves must be high quality. By that I mean useful to investors in a way that provides transparency, consistency and comparability in the way companies report in a global capital market.

The process that produces these standards is equally as critical. Our experiences with our own domestic standard setter, the FASB, has taught us that for an entity to be credible it must select its members on the basis of technical competence and devotion to the public interest. The standard setter must be independent and objective, resisting the temptation to achieve diplomatic harmony by trying to accommodate everyone.

Finally, any global financial reporting system must include an infrastructure that extends beyond the standards and the standard setters. This infrastructure includes high-quality auditing standards, strong international audit firms with effective quality controls, profession-wide quality assurance, and meaningful regulatory oversight.

Profession-wide quality assurance is an especially relevant issue in today's environment. International auditing firms have been quite successful in branding their names worldwide. Today, you can't walk through an airport, ride a bus, or open a magazine without seeing ads for many of these firms. But don't mistake their omnipresence for omnipotence over world-wide quality control

An affiliated firm in South America or Asia is just that – affiliated. There is no guarantee that the foreign affiliate adheres to anything resembling the high-quality auditing standards that apply to U.S. firms. While the laws of many jurisdictions do not prescribe sufficiently rigorous audit standards, I see a compelling market need for firms to require their worldwide affiliates to subscribe to the highest possible global standards.

The organizing agreement between these affiliated firms and their parents must ensure a consistent quality audit on a worldwide basis. In the aftermath of the 1997 and 1998 crises, the World Bank questioned the quality of audits in the international arena and I must say, I share that concern.

The international financial institutions, key foreign financial regulators, and the SEC are now actively discussing how we can join together to ensure that we have high-quality, public-oriented, independent audits that guarantee credible financial reporting for both global investors and markets. I know that this is as much a concern for the profession as it is for regulators around the world. A global economy demands that investors have confidence in financial numbers on a global basis.

Conclusion

It's hard to imagine a time when financial statements were wholly unreliable; when fabricated earnings statements were issued in reckless abandon; and when most companies wouldn't even report gross incomes. But at the beginning of this century, this was, in fact, the reality. It may have been a free market, but it was far from fair. And America would soon reap the bitter harvest of misinformation and obfuscation.

Today, the stakes are even greater. No longer can we take for granted the international supremacy of U.S. capital markets. Technology has set into motion dazzling challenges to market mechanisms whose free market dynamism is being impeded by anti-competitive handcuffs imposed by participants and sanctioned by regulators. A free market is nurtured by a culture of disclosure and equal access to information that fuels rather than fetters the marketplace. The dangers are real and the opportunities abundant.

The efficiency and expanse of an unburdened open market is limitless. Tear down the barriers to competition, remove the obstacles to greater innovation, spotlight all conflicts of interest, and unleash the flow of timely and accurate information, and our markets – like never before – will be driven by the power and the brilliance of the human spirit.

I appeal to every financial analyst, every corporate manager, every board member, and every auditor to renew your covenant with investors and reaffirm your commitment to quality – for the sake of greater public confidence in our markets, for the sake of a better marketplace.

Thank you very much.

http://www.sec.gov/news/speech/speecharchive/1999/spch304.htm