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ADDRESS

of

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Chairman, Securities and Exchange Commission

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I look to the time when Chicago can come into its own in the world of finance. What is true of Chicago, is true of other regional centers. Phases of these local problems vary greatly from those of Chicago. Yet they have common elements. One relates to the stock exchanges. Another relates to the financing of local industry including small business.

Symbolic of the common problem are the stock exchanges. They are an integral part of the machinery of the capital and securities markets. Their health and vitality are important to those markets. Management of them in the public interest is essential. Their growth and development as adjuncts to the financial community are basic and of deep concern to us in Washington.

Hence I am heartened by recent activities right here in Chicago. I viewed with great interest the survey which the Chicago Stock Exchange has made, and the recent proposal of the Governing Committee to turn the findings of this survey into a program of action. This program, as I understand it, would discard an admittedly archaic system for a modern one along business lines, with a paid executive staff fully authorized and responsible for administrative action. I want to emphasize how truly significant it is that Chicago had the foresight and initiative to take the lead. It is of significance because it indicates that the Chicago financial community is thinking about - and acting upon - its own problems, without waiting to see what the East intends to do. Too often, in finance, cities outside of New York have been content to sit back and wait for New York to assume the leadership. I am encouraged and gratified to find an important midwestern stock exchange proceeding under its own motive power and assuming a position of leadership in a movement of such great moment.

This effort of the Chicago Stock Exchange in the direction of a modernized stock exchange mechanism, and similar insistence on the part of the Securities and Exchange Commission, received hearty encouragement from the recent report of the Committee which studied the New York Stock Exchange. On past occasions I have been critical of stock exchange practices and methods, and, I am afraid, with good reason. But I think the report of the New York Stock Exchange's committee shows real wisdom and courage in an effort to solve a perplexing problem. I feel that the members of that Committee, like your Chicago group, have displayed a sound appreciation of the demands of the public interest as well as a far-sighted understanding of the business of the modern stock exchange and its members. They have recognized the public role that the modern exchange plays and the public responsibility that it bears in our economic system. In their report they have dealt realistically and forthrightly with the problems and the trends that any stock exchange must face today.

Their report recommends a stock exchange governed on business and democratic principles; an exchange organization in which the balance of power would be held by those whose interest is and must be to serve the investing public. It calls for a new type of exchange organization where the public interest has greater opportunity to remain paramount. Of course, to a major extent, the eventual success of this program must rest on the quality of the men who are chosen to head the exchanges. Given the power which these plans propose, there is no question that men of broad vision, wisdom and courage, approaching the problem with this fresh point of view, can do a really first class job.

In this connection I would like to lay a ghost. Persistent rumors have it that the Commission wants the power to elect the new President of the exchange (and even members of the new board) or at least to have a veto on such selections. There are several things wrong with those rumors. The only one I need mention is the fact that those statements are complete falsehoods. Management of such institutions is not, and I hope never will be, for government.

Yet I do say this. The advantages of going to the outside to seek men qualified to assume the new administrative duties of the exchanges have considerable weight. I recall that after the Hughes investigation of insurance companies, when the companies reorganized as a measure to regain public confidence, a great many of the major companies chose as their principal executives men who had never been associated with the business. In the case of the stock exchanges there is a further consideration. Some institutions by their very nature are excellent training ground for executive administration. But it may be doubted if, even in the largest commission houses, there is the opportunity which exists in a large industrial or other organization to develop this kind of ability.

But the choice of men for such posts is not ours. We have no candidates. It is not so much the method as the results which are of concern to us. Any exchange which demonstrates by action that it intends to assume (and actually does assume) a vigilant role in conformance with the letter and spirit of the Act will find in us its strongest ally. An exchange which does not will find in us a fair and honest but exacting taskmaster. In other words the job will be done.

This new concept of how a stock exchange should be run really has its roots in developments that began twenty years ago. It is the result of forces that have been in operation for a long time. Before the World War, stocks and bonds were, for the most part, bought and sold either by institutional investors or by individuals whose profession was finance. The savings of the individual found their way into investment only indirectly, through the investments of the banks and insurance companies with which the individuals left his money. Since the War, however, while the indirect investments of the public have been growing in several directions, there has been a great increase in the direct investment of savings by individuals who put their funds directly into the securities of corporations. The elementary steps of investing relatively small sums of money in corporate enterprises have become widely disseminated. To put it bluntly, the stock market has more and more invaded the American home.

Now I do not imply that this is bad; but it has created many new problems. The individual investor is not the well informed highly skilled security buyer that the big institutional investor is. For the most part, the small security buyer has purchased and sold on native business judgment and hunches. Yet, our whole system of converting the savings of many individuals into the invested capital of our national industries must rest, to a large extent, on the ability of this small, unskilled individual to invest successfully. It is in light of this problem that the stock exchanges are today beginning an appraisal of their adequacy and effectiveness. The exchange members who are supporting these movements for exchange reorganization are far-sighted business men who are facing their business problems realistically. They have discarded those friends in disguise who prefer to cling to an outworn system, who fear change of any sort. They are foes of those who cut corners at every opportunity; and of those few whose actions bring discredit upon the community as a whole. They are displaying that quality of business leadership which is so earnestly needed in these times.

Past attempts to improve the stock exchange mechanism or to bolster its regulatory powers have indicated, I think, that a sound reorganization of the exchange is a basic prerequisite to either effective control or management of them in the public interest. I also think it is absolutely essential for building up a confidence in those market places on the part of investors and for justifying that confidence which is created. There should be no doubt as to the desirability of such a degree of conformance of exchange practices to the law of the land as to make it possible for government to act in a purely residual role. That is my oft stated philosophy.

An exchange organized along sound lines would, I feel, be equipped to handle adequately many of the difficult problems posed by the Securities

Exchange Act of 1934. The delicate question of what constitutes fair practice on the floor of the exchange; the question of conflicting functions of broker and dealer in the same person; the task of controlling over-trading on the floor; the problems centering around the specialist and his relation to his customer; the practices of issuers and houses of issue; manipulation - these could be effectively handled by a properly organized exchange. On these problems exchange management can have profound prophylactic effect. Such questions as the proper use of discretionary accounts, the soundness of the capital position of all exchange members, standards of practice for customers men would be taken care of in exchanges run on sound business principles. The list is a long one. They are matters relating to the standards and business methods of all persons engaged in doing an exchange business. I know they are of such a nature as to lend themselves to ready solution by any forward-looking public-minded organization. While I appreciate that they may appear to be but the minutiae of our larger exchange problems, they are none the less fundamental in character. Here, there is offered to exchanges the opportunity for harmonizing exchange machinery with the law of the land. Compliance with the standards of the statute can be effected and business conducted on a high plane without the irksome presence of the policeman. In the movement towards this objective, I am gratified at Chicago's leadership.

As I have said, investment in this country in the past twenty years has undergone a shift from a few but very rich private families and individuals to the masses. There have also been substantial changes in the complexion of institutional investments. The banks are considerably larger investors in corporate securities, particularly bonds, than they were say, at the turn of the century. Life insurance companies are still the largest single factor in the bond market and have become more so in the last few years. The advent of the investment trust and investment company and the spread of stock ownership among life insurance companies has made the institutional buyer of stock a greater factor than it was twenty years ago. The most pronounced change, however, has been in the spread of ownership of corporate securities by small income people. A list of some thirty large companies on the New York Stock Exchange shows that the total number of stockholders from 1900 to the present time has increased tenfold. It was not so long ago when dividend and interest income was an unknown quantity to the great majority of American families. The spread of ownership of bonds and stocks among the masses has resulted in more than one third of the dividend and interest income now being received by individuals or families making tax returns of $5,000 or less; and 50% of the total was received by our large middle class whose total income is $10,000 or less.

This development has been accompanied by another shift - an increasing flow to New York of the local investment funds from many communities throughout the United States. Frequently, perhaps too often, these local savings have been attracted to the great national corporations at the expense of small local enterprises back home. It is true that as New York became the national clearing house for investment funds, Wall Street supplied capital to the larger local enterprises all over the country. Still there were many instances where worthy local enterprises suffered from lack of financing.

There was good reason for this. A New York banking house, for obvious reasons, could scarcely be expected to service all of the needs of local enterprises. The small local investor, following the trends of the moment, poured his money into the industries and the companies which at the time were the most favored. When airplane, motor, oil, or radio stocks are in the ascendancy on the New York exchanges, the less spectacular home industry has little chance to compete for the local investor's funds. Furthermore, there is the size of the issue. Wall Street as a general rule is not geared up for small local issues. The local job cannot be done there. Yet the backbone of this country's progress has been the small companies. The giants of today started under humble auspices and with small beginnings only a generation or so ago. The problem of financing small or intermediate companies is primarily the problem of local companies which do not enjoy as yet national credit (or which may never enjoy such a credit because of size) no matter how good the risk and no matter how good the prospects. The problem is intimately tied up with the development of regional capital and securities markets. It is a problem of how to develop, with the help of local financial machinery, regional capital centers so as to keep local capital for local needs.

Granted the desirability and the necessity of having a great national market for capital funds upon which the whole country can draw, yet the dangers of leaving the small local enterprise without an adequate mechanism for obtaining adequate capital cannot be overlooked. It is a major national problem which presses for local solution in almost every community.

Strangely enough many people fail to understand how extremely important small industry is to our whole economy. It takes no statistical analysis to indicate the enormous importance to our nation of the industry employing from 100 to 200 men and women. Out of a total of 411,000 corporations reporting balance sheets and filing income tax returns in 1934, 386,000 had total assets of less than a million dollars. Thus, the corporations with less than a million dollars of assets were almost 95 per cent of the total corporations. Large industry itself is to a large extent dependent upon small industry for its raw materials and for its markets. The small industry in most small cities and towns in the country is our basic foundation.

Small business in this country has almost invariably been financed by plowing earnings back into the business, by commercial bank credit, and occasionally by private financing. The very high percentage of risk which is involved in many of the offerings of small and unseasoned companies poses the question as to whether the public, and especially the small investor, should be urged to invest savings in this type of security. Naturally commercial banks, whatever their attitude may be toward established companies, cannot be expected to extend credit to a new and unseasoned business. But though the small company is seasoned it may still experience great difficulty in reaching the capital markets. There is thus a void in our capital machinery.

There are throughout the country old well-established companies which have given work to the citizens of their communities for years. Some have found that they can no longer compete with the larger ones unless they undertake extensive modernization. Such companies, and we have talked with the executives of many, must either restrict their activities to their most profitable lines on the present basis of operations - which of course means laying off men - or they must install up-to-date production methods. Others need capital to take advantage of new markets which lie at their doors. You must know of such companies, and the men at the head of them, in this great Chicago area. Yet investment funds here are likely to go to New York and into our national industries. The same thing is true of the investment funds of other cities throughout the country. Looking at it broadly, it means that while our national economic welfare rests on the welfare of small business, our national financial machinery is geared almost exclusively to large business. This is not a new problem. It is an old one. It is pressing at the present time especially because of the paralysis of our capital markets.

As I have said, essentially it is a national problem which presses for local solution both here in Chicago, and in other communities. You know the industries in your community which need capital, and you know whether their need is deserving. Furthermore, you know to what extent the welfare of the entire community rests upon the welfare of the local industry. It may be that what is needed is a reappraisal of the standards upon which investment is made and loans are granted. It may be found that the risks which lie in our own backyards here in Chicago are just as good as the ones which have become glamorous because they have caught the fancy of the larger markets.

Frankly, I seek your counsel and advice on this problem of financing the small company. We see the problem sharply focused in Washington. Small business must not be suffocated. In a capitalistic system dependent on individual initiative and freedom it must be served first. Can the ideal solution be found in the machinery of our capital markets? Can there be found or developed locally reservoirs of capital for the legitimate needs of small business? Or, as a measure of last resort, should the federal government do the job? We need business statesmanship on this pressing problem. We know that the glib answer that the Securities Act of 1933 has caused this closure of the capital markets is not the correct one. For we know that these problems of the small business antedated that Act. In a sense they have always been with us. But their acuteness has been increased over the years with the growth of bigness. Their importance has been marked because of current problems of unemployment and relief. Opinions on causes and remedies will vary. I leave the problem with you, as it is one of the paramount aspects of a balanced regional economy. We in Washington are your servants.

Financing of small business is only one phase of the problem of development of local or regional capital and securities markets. There are seasoned local industries of a larger size which are constantly in need of adequate and healthy securities and capital markets, and which frequently can be well served locally. But there is the tendency of your larger local industries to go into the New York market when they are in need of financing. I realize the predicament of your industries which have to select their investments out of the available investment media. At times the local or regional capital machinery is inadequate. At other times it is wholly adequate. In any event the call is clear for recognition of a regional service which will keep control and capital at home. In recent days a prominent business executive took a strong position in favor of such decentralization. He is quoted as saying: "I think New York would be better off with decentralization of management. We wouldn't have the load to carry here of justification of why there should be so much of the business of the country centered here. The advantages of moving back are obvious. The advantages to New York, I think, are equally obvious. * * * If your business is moved back you will be getting in with the local people. These local towns would have a stake in that industry. They would feel they had a greater stake than they have today." I heartily concur in that view. Its tangible and intangible values to the regions in question, to the nation at large and even to Wall Street are enormous. In many instances in the past, the New York market, because of its greater financial and technical resources, has been able to render this service on terms with which the financial machinery of other communities cannot compete. But this is not necessarily a permanent condition. Business and finance can will it otherwise. If the larger local enterprises were to patronize their local financial centers more extensively, these local financial centers could develop into healthy resorts for both small and large companies in need of financial assistance.

This is not to imply that it is our function or desire to urge the erection of arbitrary areas of business relationship nor am I proposing any program of economic planning. I merely appeal to the ample supply of brains, imagination and courage which is here to solve this problem for Chicago.

A trace of this philosophy is discoverable in various acts of Congress. Under the Securities Exchange Act of 1934 all national securities exchanges are a matter of our concern, We are under obligations to them. You will find those who question the economic value of the services performed by the small local exchanges. There are those who state that there is only one real security market and that there need be only one. The Congress believed however, and we believe, that the local exchange is providing a service in the securities markets which is of value to industries and investors of the various regions. In other words the Congress visualized a competitive decentralized system rather than a monopoly. One further example is the fact that under the Act exchanges may under certain safeguards have unlisted trading privileges in securities. Thus there is afforded an opportunity for an exchange market for issues in which there is a substantial local interest. And in the pending Maloney Bill governing the over-the-counter markets are provisions for the formation of local and regional over-the-counter associations. Local exchanges and local over-the-counter associations are pivotal factors in the development of investment banking machinery and hence development of local capital markets. Taxation on dividends of companies in holding company portfolios works for logical consolidations where that is possible and divestment where that is the more constructive way. Business men and bankers operating under the Public Utility Holding Company Act of 1935 can perfect their plans to keep their utilities at home. If and when that Act is sustained, it will call for a constructive unpyramiding of holding companies and a geographical integration of utility properties. These provisions should make it possible for the return of local or regional companies to local or regional management. In other fields, too, the holding company device is being seriously challenged. All of these movements afford increasing opportunities for local interests to assert themselves; to be rid of absentee management and remote financial control.

There is thus a great opportunity on which local banks, insurance companies, dealers, brokers, investment advisors, and business men should be able to capitalize. Leadership to do it is here. It can be done in the same constructive way in which the Chicago Stock Exchange has led the way on its problems. I hope it is done. It is an affair of business, not of government. But you will find in us a strong ally and a faithful servant if you will lead the way.

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