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FINANCIAL PROBLEMS OF SMALL BUSINESS

STATEMENT BY

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before the

TEMPORARY NATIONAL ECONOMIC COMMITTEE

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The subject of small business has been assigned to the S.E.C. for study. In making this report, I want first to say that the views expressed here have not been considered by the Commission as a whole and do not therefore necessarily represent their views. Secondly, it should be stated that neither this report nor our studies pretend to cover the entire subject of small business. Because of the limited time and resources at our disposal we have not attempted a complete study of small business, and we are not in this report attempting to cover the entire subject. There are many aspects of small business which we have not explored. The small business problem needs continuing study. It cannot be met by occasional examinations such as this one. For the purpose of this presentation it should therefore be made clear that we are concerning ourselves solely with the financial aspects of the problem.

Even within this restricted area our studies could not be as exhaustive as we would have wished. It has been necessary to confine ourselves largely to statistical studies and to the sampling of the small business situation in what we believe to be representative communities in various parts of the country. From this sampling, however, we can draw certain conclusions.

First, it appears that certain important avenues of credit which were formerly available to the small business men have disappeared or that their characteristics are so altered as to make them not readily recognizable. This conclusion, however, must be based largely on conjecture, for few records are available. It seems probable that the small business man of twenty or thirty years ago received both new capital and long term credit from either his local bank or the wealthy man in the community. Now, most banks limit their accommodations to short term credit, and the wealthy man leans towards limiting his investments to nationally known securities, with

an eye to the income tax schedules. A small business can usually obtain loans for working capital needs, such as inventory and the like. But the business which needs to modernize its plant by putting in up-to-date machinery in order to meet changing competitive conditions is too frequently up against it. Banks usually won't do this kind of business and the normal investment banking channels presently available to big business are not open to small business. Investment bankers throughout the country have been slow to gear their facilities to the financial needs of small business.

Another aspect of the problem is fairly clear. This is that the established small business man is extremely wary. He often needs money but usually does not want a partner. He wants a creditor. He does not want to relinquish any part of his control over his business. And he wants the benefits of leverage for his own investment which accrue as a result of having debt above it. This may be unfortunate. Many persons feel strongly that debt money is dangerous money because of the heavy defaults - bankruptcies - which may occur in periods of deflation. But I doubt that we can, or should, compel a business man to take a partner if he does not want one; and equity money is partnership money. This reluctance to accept equity money exists to a much greater degree in the case of established enterprise than in the case of new ventures. An inventor, for example, will usually take almost any kind of money to get started.

Small business men are, for the most part, individual capitalists who have too frequently come to feel that their problem is the same as that of the great industrialist - and that the gist of the problem is simply "taxes and regulation." Of course, I recognize that it is to the advantage

of big business, large in dollars but small in number, to attempt to convince small business, with its great numbers, that their problems are identical. But I do not believe the problem of small business is essentially the same as that of large business and I think that this committee has seen evidence in many fields to indicate the existence of great differences. In general, I think it may be said that small business covers just about everything that is definitely not big business and the problems are just about as varied as there are numbers of small businesses.

We must probably face the fact that in many instances those who feel that they are most entitled to financial assistance are too often the very ones least entitled to it. Probably not very many propositions which show a real promise of profit go without some sort of aid—especially where the management has real ability and is able to present its case well. One great difficulty undoubtedly arises from the bald fact that not all persons who think they are business men really belong in that category. Bookkeeping and accounting methods are too frequently so sub-standard that the boss himself doesn't know where his money is until after it is all gone. An excellent salesman is not necessarily a good business manager, yet many companies are run by men who are good salesmen or other types of specialists but unskilled in or ill-adapted to business management. We simply must face this fact. We have all known personally too many men like that - good honest men who simply do not have the kind of managerial ability or experience which is essential to the success of any business enterprise. No amount of financial assistance can help this kind of man for very long.

This government has not stood still in its efforts to meet the broad problem of small business. The activities of the Anti-Trust Division of the Department of Justice and the Federal Trade Commission in recent years have done much to relieve the pressure of unfair and oppressive competitive practices upon the small business man. Perhaps these benefits have not been completely felt in all small business circles, but they are certain to bring real relief in many fields. And certainly a great part of the work of this Committee in its studies of the numerous aspects of monopoly and economic concentration impinges directly upon this subject. But it cannot be denied that compared with other major aspects of our economy, such as agriculture, small business has been relatively ignored.

Of course there have been the efforts to meet the financial aspects of the problem through the respective facilities of the R.F.C. and the Federal Reserve Board. The powers of the R.F.C. to finance small business have been broadened year by year until that agency is now empowered to purchase the securities and obligations of, and to make loans to, any business enterprise wherever it is demonstrable that capital or credit is not otherwise available at prevailing rates. This means that if a business enterprise, new or established, cannot get capital or credit through such normal sources as banks or the investment market, the R.F.C. may do the financing. These are pretty broad powers. But though I am convinced that the R.F.C. has tried to make the greatest use of these powers consistent with sound business practice, the small business man does not feel that his need is met. Perhaps this is because the R.F.C. approach is regarded as primarily the conservative banking approach. The Federal Reserve Board has had more limited powers in the same field. Its banks can make loans running up to five years exclusively for working capital purposes. Chairman Eccles, during his

testimony on the Mead bills last year, stated that these powers are so narrow as to be almost useless. Senator Mead has sponsored a bill which, as I understand it, would give the Federal Reserve Board nearly the same latitude as the R.F.C. and would permit the guaranteeing of member bank loans to small business up to 90 percent. Mr. Jesse Jones speaking for the R.F.C. has stated (if I read his testimony on this bill correctly) that he does not object, with certain reservations as to the source of the guarantee fund, to this expansion of Reserve Board powers and has suggested that perhaps the banks can make more loans than the R.F.C. because it is more normal for a business man to approach a bank than to approach an agency like the R.F.C. This would seem to be good sense.

As you see, these plans involve the use of government funds, either for purposes of making or guaranteeing loans or supplying capital directly or indirectly. Although the making or guaranteeing of loans has many things to commend it, the plans, however, give us the concern that upon default, the government might find itself directly or indirectly in control of private business. The objective of doing something to strengthen the financial position of small business, especially at this critical time, is one we all share. But if we should give the kind of help which might ultimately bring segments of small business under direct government management- or under the management of government sponsored institutions we could expect little long-range gratitude from small business or anybody else. We must make every effort to devise effective safeguards against this contingency. I am sure that Senator Mead, who has given so much thought to this subject, is more fully cognizant of this problem than we are.

For a time, we considered favorably the idea that the government could sponsor a system of regional industrial credit banks or regional industrial finance associations. Their purpose would be to contribute capital and long term debt to regional industries by purchasing the stocks and bonds of those industries. As the industries grew in strength, the security holdings of the institutions could be marketed to the public. The institutions would be created by private regional subscription to the stock of the institutions with the government putting in a sweetener in the form of sterilized preferred or non-voting stock wherever necessary. This solution, we felt, might avoid the risk of ultimate governmental control of private business since the government would not control the institutions. Numerous discussions with experts in the field, however, convinced us that this plan had another basic weakness. Nobody could tell how much money was going to be needed in a particular region and nobody could tell how long it might be before the investments made by these institutions (in local business) could be turned over. This uncertainty, we are afraid, would exist regardless of the quality of the issue, largely because the bonds or stocks bought by the institution probably would not for the most part be of a type or size readily marketable to the public. In fact, there appeared the real risk that these institutions might very quickly become frozen pools of capital. Under such conditions they could be enlarged only by additional subscription which would all have to come from the government because the citizens of the community would be very reluctant to put their money in again. Another weakness of this plan, obviously, was that it might involve the expenditure of millions of dollars of government funds. We were also warned that this idea had from time to time, been tried (to be sure, without government aid) in various communities and that it was too

frequently found that one or two bad deals spoiled reputation and ruined the effectiveness of the organization.

Notwithstanding our discouragement at this discovery, we felt that in any event we were on the right track in trying to put the problem into the hands of the local community. We still feel very strongly that it is a local problem which would only be complicated by any solution administered primarily from Washington.

We have more recently been interested in a plan which has been operating in Baltimore for many years. At the time of the First World War, a group of citizens got the idea of promoting business in Baltimore by giving real financial aid to new businesses. A fund was raised. During the first five years, the fund was reduced one third by losses. Why? Because they tried to make direct investments in these enterprises with the group funds - like a sort of combination of bank and investment trust, without thorough initial investigation. Thereafter, they changed their method. And for the past twenty years they have been operating primarily as financial counsellor both for new and established enterprises in that area.

This organization, known as the Industrial Corporation of Baltimore, is a semi-civic enterprise. Its board of directors is made up of representatives of the leading industrial, commercial and financial institutions of the community. It is not a Chamber of Commerce or Rotary Club activity, but it is the sort of scheme which might well have been sponsored by such civic groups. It is not a speculative venture, nor is it eleemosynary. Its purpose is to promote Baltimore business - not to make large profits for itself. It knows that to continue its usefulness it must keep its capital intact and make a small return on that capital. It has succeeded in doing so.

How does it operate? Suppose you are a small manufacturer in financial difficulties. You need \$100,000 or \$50,000. You go to the Industrial Corporation and tell your story to a financial expert. It costs you nothing. They look into your situation - go out to your plant - look at your books. They do all this quickly and admittedly superficially. If they decide that your proposition has merit and that your business can be made profitable, they agree to undertake a thorough investigation and to try and find someone whom they can interest in supplying the money you need. Of course, this investigation will cost you something, but these service fees are kept very low. In fact, the entire cost for the money you get plus the cost of investigation is rarely over 6 per cent per annum. In a month or so, after the facts are in hand and have been reviewed by the Corporation's board, they call you in. They tell you that they have found a man, or a bank, or a business creditor (or even the R.F.C.) which will supply your financial needs. Of course once in a while they have difficulty on this score. But they may tell you that you are a very poor bookkeeper and that they have therefore agreed with the prospective lender to put a bookkeeper into your office to help straighten out your affairs and make sure this money does not go down a rat hole. The salary of this man will be reasonable and it will be paid directly by you. They are to receive no part of it. In fact, if you want to suggest the man, they will exercise no more than a veto power over his qualifications. This addition to your payroll should prove very economical in the long run for it will substantially improve your business management. Now, if you want the money on those terms, they tell you they will complete the negotiation.

The Industrial Corporation has been working on deals like this for 20 years. Sometimes, they decide that additional funds are not actually necessary to pull you out of your difficulties - that simply an accountant or an engineer added to the staff will do the job. Sometimes they find you equity money, sometimes it is long term senior money - all depending on your own special needs. They have learned that each case has its own special problems and that very seldom are any two cases alike. Their's is simply the function of a financial clinic, administered by an organization which knows its community and knows the sources of capital in that community. Incidentally, it has been the experience of the Baltimore group that there is usually plenty of money available. The problem is to find it and to persuade its owners to invest it. That is a big part of the job of the Baltimore group and they have become expert in it.

The officials of the Baltimore venture are emphatic in one thing. This idea will not work in supplying capital for the neighborhood merchant. It works primarily for industrial enterprise needing from \$50,000 to \$1,000,000, and of course for commercial enterprises large enough to have that need. In fact, in their twenty-odd years of actual experience, they have been able to think of no plan which can meet the financial needs of the neighborhood merchant with any degree of safety for the person who contributes the needed capital. And naturally, if they are to keep their sources of credit and capital open, they must not recommend too many losers. They would have been out of business long ago if they had. They point out, however, that they have been able to help, time and again, small manufacturers, the financial collapse of whom would have thrown dozens if not hundreds of laborers out of work.

Of course, this is an isolated example, but I understand that the plan has been under careful and favorable study for some time by the small business committee of the National Association of Manufacturers and by such regional business-promotion groups as the New England Council, of which I happen to be a very inactive director. We know that other efforts to accomplish very much the same objectives have been in operation in other communities and should be examined by the appropriate Congressional committee if this suggestion is to be given the consideration which we believe it merits.

One thing that appeals to us very much about the set-up is this: - The sole objective of these people is to promote Baltimore business, to keep it financially healthy, to bring in new business where possible, to help small business get money. They are not restrained by the banker's legitimate concern in protecting his deposits or by the investment banker's concern in making a quick distribution of securities. Of course, they must make a careful investigation of any deal they sponsor, but once they decide a deal has merit, they are as eager to find the money as the business man himself. They are the agents of nobody else but the business man except, of course, the business welfare of their community. As I have said, they get their money where they can find it, whether it be a private or a public lender. They have used the R.F.C. and there is no reason why, if Senator Mead's bill passes, they should not avail themselves of the added lending facilities of the banks in the Federal Reserve System.

Right now, it seems to me, we need at least something like this in our leading industrial centres. You may be interested to know that for the past six months the Baltimore Industrial Corporation has been doing a very important job for Baltimore industry in the National Defense field. Just as soon as the Defense program got under way, they hurried down to Washington and found out everything they could about how things are operating, and they have kept in close touch ever since. The net result is that if a Baltimore

business man wants defense contracts or sub-contracts or wants financing of a defense expansion, or wants to know a lot of things about National Defense, he doesn't have to come to Washington and waste days of his time as well as of the busy defense officials. He can go direct to the Industrial Corporation and get his answer.

This is the sort of thing which I think we can well encourage in other leading cities throughout the country. Undoubtedly encouragement will be necessary in many instances. Encouragement will cost the government very little (at the most from \$50,000 to \$100,000 in each case to underwrite the first couple of years of operation) and it may go a long way towards meeting this acute problem. I don't pretend for a minute that these financial clinics are a complete solution of the small business problem, but I do think that from the experience of a number of such institutions in various parts of the country, we can get a great deal closer to the root of the problem than we are today.

Under this scheme, worthy small businesses, old or new, can get any kind of money they need, be it bank loans, working capital, equity money, new money, or what have you. There are no restrictions, and there should be none, because each problem is different from the one that has come before. It is a custom tailoring job as indeed it must be. And they will be getting this financial assistance through the normal channels, not through artificially stimulated channels. That, it seems to me, is highly important. We know the need for financial assistance is there, and we feel pretty sure that the money is actually there. The question is to bring the two together, with as little cost to the one and as much safety to the other as possible. You know of course that, with a little sound management advice, it is often possible to fix a company up so that a bank which has once refused a line

of credit will be glad to take it on. We have all seen that happen. This type of institution is also equipped to afford expert advice and obtain capital for new enterprises which need legitimate promotion. This might help answer the problem of the hopeful promoter of a new venture, now so lacking in the opportunity for sympathetic appraisal of his scheme that he is too frequently driven into the arms of questionable financial entrepreneurs. These are the kinds of jobs that these institutions are equipped to do. Of course, it is unnecessary to add that good business judgment, careful examination, etc., are just as necessary within these institutions as anywhere else in the business world.

As I have said, we believe this type of undertaking should be encouraged. Several suggestions have been made. An agency of the government could be instructed to underwrite the organization costs and the costs of operation for the first two or three years in cases where the community could not raise all of the \$50,000 to \$100,000 which would be necessary. Certain tax concessions might be granted to those who invested new funds in a business approved by such an institution. Of course I don't know how the Treasury would feel about this. The S.E.C. might be authorized to grant exemptions from Securities Act registration for issues similarly approved. A central Federal clearing house for the exchange of helpful information and ideas might be set up. Recognized institutions might be given the sanctions of a Federal license.

Of course, certain safeguards would also necessarily accompany this encouragement, but I think they need not be particularly onerous to any organization which is really trying to do the job as it is here conceived. Certainly I would not want to see the growth of such institutions stifled by excessive regulation. The charter and by-laws should not contravene the public interest. There should be some standards to assure that the board of directors is truly representative of the best

interests of the community, that profits on deals are not excessive and that the privileges which go with a Federal sanction are not abused. Because managerial judgment is so important, the Federal licensing authority should be given a veto power over the selection of the general manager of the institution, this power carefully restricted to the application of professional standards. It is of course conceivable that in a particular community, such an institution might fall into the hands of a group whose purpose would be to exercise arbitrary and selfish control over local business. That must and can be guarded against.

Let me repeat that the virtues of this plan, as we see it, are first, it recognizes the essentially local character of the problem; second, it involves little, if any, expenditure of Federal funds; and third, it encourages financing through the normal business channels. We hope the Committee will give this proposal serious consideration.

Let me state categorically that the S.E.C. is not seeking additional powers or new fields of administrative jurisdiction. On the contrary, it seems to us that perhaps the best way to handle this whole problem would be to set up within the Government an agency which might be called the Bureau for Small Business. This Bureau could administer such minor legislation as we have suggested here and more important, it could act as a clearing house between the various communities and make the kind of really thorough continuing studies of the small business problem that need so badly to be made. On the basis of these studies the Bureau could from time to time make recommendations to Congress. The membership of such a Bureau should be selected by the President with the advice and consent of the Senate primarily from among men who have first hand knowledge of and a genuine sympathy for small business. And the Bureau should be sufficiently independent to assure that its actions and recommendations are not colored by considerations alien to

the interests of small business. We recommend that this Committee should give serious consideration to the prompt creation of such a Bureau somewhat within the Government.

In closing, let me mention one other study which was assigned to the S.E.C. - that of investment banking. We presented several days of testimony before this Committee on that subject. We are not, however, prepared to make any specific recommendations at this time. The testimony before this Committee dealt with a narrow segment of investment banking. In the course of our work at the S.E.C., however, we are in constant contact with the wide ramifications of the investment banking problems. We have been considering, both formally and informally, with the investment banking industry many of the problems raised by the T.N.E.C. testimony which happen to fall within our statutory jurisdiction. Our rules, regulations and orders indicate our keen awareness of the existence of these problems and our attempts to meet them. However, we have not as yet reached the point where, without further study, overall recommendations can profitably be made. In addition to the considerations which arise in connection with the preparation of rules, regulations and orders in the normal course of our business, we have, for the past six months, been considering with the investment bankers, securities dealers and securities exchanges amendments to the securities laws. Some of the problems raised in the T.N.E.C. testimony have been covered in these discussions. When these discussions are over, we shall submit our joint and several proposals direct to Congress. In view of these considerations, we believe that it is in the public interest to defer any recommendations on investment banking at this time.