[ ]

ADDRESS

of

WILLIAM O. DOUGLAS

Chairman, Securities and Exchange Commission

before

Committee of the Banks and Investment Bankers of Cleveland

Chamber of Commerce

Cleveland, Ohio

Tuesday, July 26, 1938 - 1:00 P.M., Central Standard Time

35683

Regions and regionalism have presented one of the perennial problems with which this country has had to struggle. In these days however, it is more and more an economic rather than a political problem. We know that there is no one-sided solution to the economic side of regionalism any more than to its other aspects. We need a reasonable amount of centralization. But we also must make the economic structure of our major regions complete and strong. Entire political philosophies and economic theories have been developed around the problem of regionalism, mainly under the title of centralization versus decentralization. I propose to keep away as far as possible from both and shall restrict myself to the one field with which both you and I are in daily contact but on which only very meager information on a regional basis has ever been collected - the capital market.

The reconciliation of regionalism and centralization in finance is not a new problem to us in the Commission. Strong strands of regionalistic philosophy run through all of the statutes which we administer, and it is our constant endeavor in their current administration not to overlook the problems of the so-called provinces. In fact today I have presented to the American Bar Association my views as to why Section 11 of the Public Utility Holding Company Act affords unusual opportunity for reorganization of the utilities on regional bases.

An historian would be needed to trace or even to summarize the development of the centripetal tendencies in our capital market organization. In the early days, of course, whatever need there existed for borrowing and lending was met locally or, at best, regionally. As the 19th Century progressed, however, long term borrowing and lending and the origination and distribution of marketable securities became rapidly concentrated in three or four eastern leading cities. Later, from about the Seventies, the business gravitated more and more to New York. Many factors combined in this development. One of these was the stream of European capital which reached the United States through the intermediary of a few New York banking houses with European connections. For several decades, enterprises requiring large amounts of capital, such as railroads, were dependent on the cooperation of European capital. It was but natural that the small number of investment bankers who more or less controlled the distribution within the United States of capital imported from Europe (or who controlled huge sums under fiscal agency contracts with foreign powers during the War) acquired a tremendous headstart in building up an organization for the origination of securities and in cementing their current contacts with security distributors outside of New York into informal but very effective groups. More important still, American corporations came to look to these banking houses as their natural advisors and agents when they had to offer new securities.

The more important institutional investors now control the great majority of new funds available for investment in securities particularly in those of a fixed interest-bearing type. Some investment institutions raise and invest most of their funds locally; building and loan associations are good examples. Funds handled by these institutions frequently do not touch the central market at all. The same is true, of course, of the reinvested earnings of farmers and of small and medium-sized business enterprises. The largest institutional investors, however, collect their funds in many communities on a nationwide scale but invest them mainly in the New York market. Insurance companies, investment companies, the investment departments of commercial and savings banks and the trust departments of commercial banks and trust companies now operate to a large extent, in this fashion. Probably only a small part of the large holdings of securities under the administration of these institutions is invested through the intermediary of local or regional capital markets.

Why do we have a central capital market al all? Economists tell us that some parts of the country dispose of more savings than they can put into profitable use, while others (in the developmental stage) do not have the resources to finance all needed investment. It is the economic function of the central capital market to match the surplus savings of some regions with the excess demand for new capital from other regions, in addition to tapping the national market for those issues which by size or nature have a national rather than a regional appeal. This function is necessary under existing conditions. If we had no central capital market, interest rates would differ much more between different parts of the country than they do now and large parts of the country would be much poorer in capital equipment than they are. That is the theory. In fact, however, the central capital market does much more than match regional surpluses and shortages of long term capital. It is not only the final clearing house for surpluses and shortages which are left over after regional capital markets have attempted to match the supply of savings and demand for investment originating in their territory. Instead, the majority of the total supply of savings investable in new securities and of total new issues of securities go through the central market. That market combines to a large extent the function of a national clearing house with that of a dozen or so of undeveloped or under-developed regional clearing houses.

The real problem, then, is one of degree: To what extent could the matching of supply of and demand for long term capital, which now flow to the central market, be done regionally without impairing the efficiency of our national capital market? This is a problem which obviously can not be settled dogmatically. And it may be that it cannot be solved in the same manner in every region. Wherever a region has a very heavy excess of savings or a very large excess of demand for new capital, conditions for the development of a balanced regional capital market are not propitious. It would seem, however, that there are a number of regions in this country where both the supply of savings and the demand for capital are sufficiently large and sufficiently well balanced to permit the development of a sound regional capital market. It also seems to me that the Fourth Federal Reserve District is one of them.

A wise man long ago said that figures might not govern the world, but that they did indicate how the world was governed. And figures certainly indicate to what extent the American capital market is highly centralized.

Of the nearly 7000 brokers and dealers registered with the SEC, approximately 30% have their headquarters in New York. More significant is the fact that, of all underwritten issues of $1,000,000 or over registered, between July 1, 1936 and June 30, 1938, under the Securities Act of 1933, 84% were managed by investment banking firms with principal offices in New York City, and that the underwriting participations of New York firms in the same issues aggregated 72% of the total, leaving but 28% for bankers or dealers in the provinces. 1/ Most of our larger insurance companies, with policyholders in every state in the Union, are domiciled in New York (and environs) and even those which are not conduct most of their investment business through the New

1/ The participations in selling groups of the out-of-New York firms (about which comparable information is lacking) were of course, somewhat larger.

York market. About 70% of the total assets of our investment companies are held by companies domiciled in or around New York City, although their stockholders are spread over the entire country. Most of the larger investment counsel firms which have been administering a rapidly increasing amount of funds of clients residing from Maine to California have their headquarters in New York City. Even of the total security investments of all banks in the country, about one quarter is held by New York City banks. Similarly, of total trust funds under the administration of commercial banks and trust companies, it is estimated between one-fourth and one-third are in the hands of about a dozen large New York institutions. And finally (a striking though well-known figure) of all stock trading on exchanges, about 95% takes place on the New York Stock and New York Curb Exchanges alone, leaving only 5% for the other 27 registered and exempt exchanges. If I were to lump together all of the available indicators, I should say that, at the present time, well over one half of our capital market, so far as it is represented by the current investment in marketable securities, is concentrated in lower Manhattan.

Now, to return home. The Fourth Federal Reserve District, although covering only about 2% of the area of the United States, represents, economically speaking, about 10% of the country. You have in the District about 9% of our population; you bought in 1935 9-1/2% of all of the goods sold at retail in the country; you account in good years for about 12% of our industrial production; and you pay about 9% of all Federal income taxes. The share of the Fourth District is, of course, much higher in a few large industries. Of rubber products, for instance, considerably over 50% is produced in the Fourth District; of steel and steel products, about one-third; and of stone, glass, and clay products, about one-fourth. If statistics were available, comparable high percentages would be shown for a number of important but more specialized industries.

We may expect that a region of this importance and structure will also be an important source of savings funds and, at the same time, originate a large demand for new capital. Indeed savings deposits in commercial and savings banks in the District aggregate, we estimate, nearly $2,000,000,000. Building and loan associations in the District have assets of over $1,000,000,000. The savings of residents of the District in the form of premium reserves with life insurance companies should amount to over $2,000,000,000, if population is an indicator. Interest in regional problems has in the past, unfortunately, been too small -- and statistical difficulties too forbidding - to permit the citation of more exact and more comprehensive figures on the volume of saving and investment in the Fourth District. We know, however, that a considerable part of total new securities issued during the last few years was floated by companies whose plants are wholly or in part within the Fourth District. A rough calculation which I had made indicates that, of total underwritten industrial and utility issues of over $1,000,000 registered under the Securities Act between July 1, 1936 and June 30, 1938, approximately 12% were of enterprises which may be regarded as domiciled in the Fourth District.

Is the investment banking and capital market machinery of the Fourth District commensurate with its economic importance or its position as a source of savings and an originator of securities? I doubt it. Of course, you have a number of important investment banking firms domiciled in the District, some of which have more than regional importance. Statistics, however, indicate that of the more than 9000 offices of registered brokers and dealers, less that 5%

were located in the Fourth District. 2/ Similar relationships appear on investigation of the underwriting participations of firms domiciled in the Fourth District. Of underwritten issues of $1,000,000 and over registered under the Securities Act between July 1, 1936 and June 30, 1938, they took but 5.2% of the purchase group participations and they managed only 2.7% of such issues, measured by the total dollar amount of offerings. This is to be compared with a ratio of about 12% of issues of Fourth District enterprises. There are only a few sizable insurance companies with head offices in the Fourth District. Your commercial banks, of course, make considerable investments for their own and for trust accounts, but mostly, again, in securities issued or traded in New York. Finally, you do have three of our 27 securities exchanges in your district. But during the years 1936 and 1937 they accounted for not much over 1/400th of the total dollar value of the sales on all registered exchanges.

Undoubtedly, then, there is a considerable supply of funds available for long term investment and a large demand for long term funds originating in the Fourth District. Much of this might be matched regionally, but now goes to New York to be matched there. Suppose a part of these amounts were handled locally to form the basis of a regional capital market. What would that mean to you and to the Fourth Federal Reserve District?

I hardly need to tell you that it would mean more business for the investment bankers of the District, for the trust and registrar departments of your commercial banks, and for lawyers and auditors of the District; for printers of the prospectuses, etc. It would, indirectly, mean more business for your banks in the form of loans on new securities and wider opportunities for investment. All of this is an important aspect of the problem, no doubt. To me, however, there are other aspects of at least equal or greater consequence, though they may seem somewhat intangible.

First and foremost, I should expect simpler and more conservative finance, where finance is brought closer to the locus of business and where investors are brought closer to finance and investment.

Second, I should hope regional financing would produce better planned financing, since under that system, there might be greater freedom from the scramble in the central capital market for the issues of temporarily popular industries.

Third, I should hope that regional finance might be able to develop an adequate organization for the supply of long term capital, particularly in equity form, to enterprises of moderate size. 3/

Fourth, I should expect that a reduction in absentee financing would result in a reduction of absentee ownership and management, with all of the advantages which flow from keeping business at home for the home folks.

2/ Moreover, of these offices, approximately one-fifth were branch offices of firms with headquarters outside of the District, mainly in New York City.

3/ All of our plans recognize that specialized institutions, which may be tried as a solution, should be of regional character. So do the bills introduced during the last Congress by Senator Pepper and Congressman Voorhis.

Finally, I should expect that the development of regional capital markets would bring new capital and new brains into the investment banking industry and the financial management of local business. This is not meant as a reflection on its present personnel. But regional capital markets of sufficient stature should help retain and employ the best of its own sons at home.

The development of regional capital markets seems to me to be eminently desirable but it will not come just by talking and writing. Regional capital markets, even under the best of conditions, can grow up only if local bankers and local businessmen want them. With local patronage, development of regional capital markets is possible. Without it, it is impossible. The problem therefore at this stage is largely in your hands.

---oOo---