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"CORPORATION MANAGEMENT AND THE SEC"

Address of

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before

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When I was invited to address the American Management Association I made careful inquiry to determine the nature of the Association's work and the character of its membership. I found out that you are an Association of what might be called the "shirt-sleeve" executives of business -- very often not the Presidents or the Chairmen of the boards of large corporations, but the Executive Vice Presidents, the Comptrollers, the General Managers. I found out, in short, that the primary concern of your Association and your members is how to make business operate more efficiently and more profitably, whatever economic winds may be blowing. I felt, immediately, that here was a group with which the SEC could and should establish a community of interest.

Not that we do not highly regard many of the Commanders-in-Chief of industries. But we recall the story of General Pershing's first visit to the front. After he had been traveling for some time he asked his aide how far they were from the front line. The question went down from Colonel to Captain to Lieutenant to buck private. The answer was relayed back in a whisper from the ranks: "We are 12 miles from the front." Sometime later General Pershing asked again "How far are we from the front?" The question went down the line and the answer - again whispered - was "ten miles." When the whispered question was next asked, the answer, still whispered, was "Six miles." Then Pershing, in a whisper, turned to his aide and said, "If we are still six miles from the front, what are we whispering for?" Nobody knew, so again the inquiry was sent down and the answer from the the buck private came back, "I've got a sore throat."

And thus often in industry it is the men down the line who determine what's to be done. So we, who are deeply interested in corporate management, must be deeply interested in the men, like you, who are really doing the managing. America needs courageous and enlightened management for its industries more than it needs almost anything else today. It is my feeling that management, as an agent of the investors, the consumers and the workers, must, in the last analysis, be the unqualified master of industry. It is on that general subject that I wish to address you today.

When I speak of management, I mean what I say. That is I mean real management, and not finance. Nor do I mean management dominated by finance. For the objective of management, when dominated by finance, can realistically be regarded only as the objective of finance itself. To be sure those two objectives may be, and sometimes are, identical. But often, alas, they are not. The objective of conscientious management is obviously to make the best possible record from the standpoint of investors, of labor, of consumers, and of the public generally. But when management is dominated by finance, too often the objective is to make the best record possible from the point of view of the dominating investment banker who -- and by no means improperly -- is living by selling and exchanging stocks and bonds, and who tends to think of industry not as plants and factories, workers and consumers, but as pieces of paper.

I recall a speech made in Chicago in 1936 by my predecessor as Chairman, now Justice William O. Douglas. He said:

"Finance occupies an important place in our society whether its functions are performed by government or private bankers. But finance moves into the zone of exploitation whenever it becomes the master rather than the faithful and loyal servant."

Let me, then, not be misunderstood. I fully realize that finance performs a highly important function, a vital function, in our profit economy. The investment banker supplies one of the means by which savings are converted into labor-producing plant expansion. Without the investment banker, America could not have grown as it did, and could not continue to grow. The indiscriminate criticism of those engaged in the important job of selling securities is most unfortunate. We on the SEC, who are perhaps better aware than most people of some of the outrageous abuses of which some investment bankers are guilty, are also aware, better than most people, of the fact that most men in that business have maintained high standards of business ethics. And we are aware, too, that a serious impairment of the function of investment banking would badly derange our economy. Investment bankers of the right kind are our allies.

We must, then, give the honest investment banker his due. But we must not overdo it. It is sometimes said of investment banking, that it is a profession. There can be no quarrel with that avowal if it be taken to mean that there are or should be observed standards of ethics in that business as there are in certain professions. But when the investment bankers go further and say that they are in the same relationship to a corporation as a doctor to his patient, then I think the analogy is being carried just a little too far. This portrait of the investment banker depicts him as a general corporate practitioner who is called in, because of his merit, by any corporation desiring a cure for its financial ills or an improvement of its financial health. It is undoubtedly true that some investment bankers are equipped to perform that service. But it is also true that sometimes the management of a corporation -- or at least its executive head -- is controlled by investment bankers. Such a business executive could scarcely be expected to seek the best financial advice available. He calls in the investment banker who controls him.

When you and I call in a doctor because we are sick, or don't want to become sick, we don't thereafter let him run every detail of our daily life. A physician knows when to leave his patient alone. To be sure, if we like him and trust him, we may take him on as our family doctor. But we do not let him take over the running of our entire household and tell us what grocer and what butcher to buy from and whom we should employ as our cook. If investment bankers were really like physicians, they would not, as some of them do, interfere with corporate management.

While I would like to see all managements made more independent with respect to most industries, that is not the job of the SEC. But it is very distinctly our job with respect to a large part of the utility industry. And that is not because five government officers, Commissioners of the SEC, one day decided that that was a good idea. It is not what some people call "government by discretion". It is because, some six or seven years ago, Congress, on the basis of facts ascertained in probably the most comprehensive study ever conducted by government, determined that many utility holding companies and the financial powers back of them had stifled conscientious management. And so, something over four years ago, Congress, in 1935, enacted the Public Utility Holding Company Act.

Now why was that Act passed? What was its purpose?

Let us take a few candid camera shots of utility holding companies as they looked to Congress:

These creatures of legal ingenuity were operated by a few clever men. They were used as the agencies for disfranchising stockholders of thousands of necessary and prosperous operating companies. They were used to take the control and direction of these local companies away from those who built them and place it in a city oftentimes far removed. Through the simple device of pyramiding, a small investment by those in control of the top holding company enabled them to do as they liked with hundreds of millions, and in some instances even billions, of other people's property. This pyramiding, supplemented by the use of service contracts and sometimes other practices, made for a concentration of management that was staggering to the imagination.

The holding company had developed to where control was exercised through a maze of intercorporate relationships, impossible to be understood by the ordinary man. The holding-company device had been pyramided to give a few small but powerful groups control of the billions of dollars of the public's money invested in the utility industry. This placed the great utility properties of the country in the control of men who themselves had only a small stake in their real ownership and who have shown neither prudence nor capacity in the management of these properties. And then the banking houses controlled the holding companies which controlled the operating companies.

Whole States were served with power, with gas, by operating companies in the charge of employees who had no authority, no independence of judgment. The people who complained of the high rates charged or of the quality of the service, had to carry their complaints to the men who had no authority to act, who had to get on the telephone or write a letter to New York City, who were subject to removal by those in the top companies without notice.

The manager of the holding company became the big boss for all the electric-light companies which were controlled by the holding company. The controlling figure appointed the presidents and managers of each electric-light company and he told them what to do. They could not have any money for improvements without getting it through the master in the far-away city. When the manager of a local electric-light company needed a new dynamo in the power plant, or the money to extend cables in a new addition to a town, he had to take the matter up with the super-manager in a holding company in another city. This big boss told him whether or not he could have the money to use in that town, how much could be used, what was to be bought with it, and more importantly, from whom he was to make the purchase, and how much he was to pay. Now, if the top man was interested in a factory manufacturing the machinery of a local electric-light plant needed, he could make the manager of the local company buy the machinery from the factory belonging to the big boss at the price he fixed. If the big boss in the far-away city charged the electric-light company in that town more for the machinery than it was worth, nobody knew it. Then when the city council fixed the electric-light rates, it had to fix them so that the local company could pay the high price for the machinery which the chief of the holding company made it buy.

What was needed was to take from the backs of the clean, honestly operated operating companies of this country these leeches and bloodsucking holding companies, who performed no service, but who were milking to death the local operating companies under their control and were milking those who had invested their hard-earned money in the securities of these local operating companies. Over *three-fourths* of the investor's money in the utility industry was directly invested in securities of the *operating* companies, not the holding companies. The average investor did not own any stock of a holding company but of an operating company.

I've been plagiarizing: my past five paragraphs are not my own. I lifted them from a speech by Congressman Samuel Rayburn made in Congress in support of the Utility Holding Company Act, on June 27, 1935. *

Fortunately, because we have had a distinct improvement in the feeling of social responsibility on the part of many business leaders in the past few years, and because we have had a holding company statute on the books for four years, the picture is not as black today. Many evils have already been eliminated.

The reports of Congress on utility holding companies do not make pleasant reading. Congress summarized those reports in the Holding Company Act. It recited evils and abuses of the utility holding company system. And it provided in very specific statutory language for the elimination of those evils and abuses. Congress did not merely write a letter to the SEC saying, "We want you, after your own fashion, to get rid of those evils and abuses." Congress set forth, painstakingly and at substantial length, detailed provisions directing the SEC how, with respect to many aspects of the business, it should protect the local utility companies from mismanagement by the holding companies. For example, you may not realize that one of the most important provisions of that statute -- the integration of the holding company systems -- is explicitly directed to the restoration of reasonably localized management. The purpose of that provision was precisely to restore vitality to the management of the local operating company.

The word integration, as defined in the statute is, as to details, somewhat complicated. But the fundamental notion is a simple one: It is to bring about compact geographical units "not so large as to impair (considering the state of the art and the area or region affected) the *advantages of localized management*, efficient operation, and the effectiveness of regulation." That is a direct quotation from the statute. And throughout the statute Congress underscored the imperative necessity of efficient localized management.

That statute, under the leadership of Congressman Rayburn and Senator Wheeler, was enacted at the end of August, 1935. But Congress wanted to give the holding companies time to turn around before integration began. And so it is said that it was "the duty" of the Commission to bring about integration "as soon as practicable after January 1, 1938". But the holding

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* I shifted the tense from the present to the past.

companies took that law into court to test its constitutionality -- as they had a perfect right to do. And it was not until March 1933 that the Supreme Court held that public utility holding companies were constitutionally a proper subject of regulation by Congress.* Consequently, the statute was virtually in a state of suspended animation for more than two years after its enactment. And so it is that integration, which the Commission was not to undertake for more than two years after the passage of the statute in 1935, is now just about to begin.

It had been our hope that during this period of necessary administrative delay, the holding companies would avail themselves of those provisions of the statute which permit them to institute, before the SEC, integration programs of their own. One or two companies have done precisely that, But most of them have not. Now I am not blaming them for that. I am merely describing what has happened. Most of them have indicated by their own inaction a definite preference for having the Government initiate this program of statutory compliance.

I make that statement to avoid future misunderstanding. When, in the next few weeks, we start integration proceedings it is not at all unlikely that some foolish or misguided or deliberately hostile person will say that the SEC is cracking down on the holding companies. More specifically, you will undoubtedly read in the press charges that we have begun a political campaign. When you read that sort of nonsense, don't believe it.

As I told you, Congress expressly directed us to see that integration should begin as soon as practicable after January 1, 1938. And here it is - after January 1, 1940. We will be -- somewhat belatedly and for the reasons I have given -- carrying out the explicit directions of Congress. We will not be "cracking down" on the holding companies. We will not be applying a death sentence to the utility industry. We will be carrying out the carefully planned Congressional purpose of *rejuvenating local utility management*. We will not be setting out to injure public investors in the local operating companies. We will be setting out to remedy, in accordance - and *only* in accordance with the express will of Congress - the horrible injuries done to these investors and localities by the fancy financiers of the '20's. There will be a lot of comment that we are setting out to destroy the investments of innocent investors. But we are not magicians. We can not destroy a second time what financial trickery or folly of the past has already once destroyed. Neither we nor the present holding company managements can bring back to life value that was stillborn or stifled in the mad '20's. We wish we could, and I know that responsible modern management wishes so too. But that is sadly impossible either for management or government today. Our task will be the long hard job of aiding those investors whose securities still have real value and restoring the public's faith in the future of one of the most important industries in the country, an industry which Congress and we, as the servants of Congress, are most eager to see expand and develop. I sincerely believe that in this task we shall have the valuable assistance of most of the holding company and public utility executives.

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* I do not mean that the Supreme Court has as yet considered the validity of the integration provisions of the statute.

I call it a long hard job. For it is one that cannot be accomplished in a few weeks or months. Many of those holding companies were created over night, by the magic-silk-hat-act of some reckless investment bankers. But our job is not of that kind. We have no rabbits and no silk hats. Ours is a slow tedious process which will take years. In the very wording of the statute, Congress directed that we should work out integration slowly and painstakingly. There will have to be long days of hearings and many days of conferences. There will be time for the filing of briefs and time for oral arguments and time for careful deliberation on the part of the Commission before any holding company system can be properly directed as to how it should integrate.

And let me remind you at this point that all through these proceedings we will be relying upon the testimony of the management and the bankers for the particular holding company under scrutiny. They will have ample opportunity to express any views and make any suggestions which they deem advisable. We want those suggestions. And, not even when we have reached that part of the journey where integration orders are entered, will we be through. Congress specifically provided that companies affected by our integration orders should have at least one year after they have been issued in which to comply. And the companies will have the unhampered and unquestioned right to have the courts decide whether our orders are in accordance with the statute and are based upon substantial evidence.

Now integration is not the only thing for which Congress provided in the statute. Many other aspects of the business of holding companies and their operating subsidiaries were subjected to our supervision. You have heard it said, and you will hear it said, that the SEC is interfering with utility management. There can be no denying that while utility holding companies continue to control widely scattered local operating utility companies, it will most certainly be the duty of the SEC to review the judgment of management and restrain the hand of management where its proposals conflict with the explicit standards of the law relating to management. But I repeat that that will be our task not because we arbitrarily decided that such scrutiny of holding company management was desirable, but because Congress found that it was necessary -- indeed imperative -- in the public interest. Where the holding company management, for example, attempts to mucker up the financial structure of the local operating companies, where it wants them to issue unsound securities, where it wants its operating subsidiaries to pay upstream dividends that have not been earned, where it wants to drain off earnings of the local companies through improper service contracts and other unbusiness-like devices -- there Congress unquestionably told us to restrain the hand of holding company management. And we shall continue to do what Congress has told us to do. But let me repeat that, progressively, as we carry out the provisions of the statute and thereby revitalize local control of local operating companies, our review of management - with real localized management - will dwindle to the vanishing point. Nothing would so effectively accomplish the purpose of Congress as for the SEC to bring about a situation where local management - management that knew and had a sense of responsibility towards its particular community - would be in the driver's seat and the SEC would retire to the background. In sum, our statutory duty is to oversee holding company management of operating companies only as long as that management is not "close to the rails".

Now when I say "oversee holding company management" I don't mean for a minute that Congress intended us to run holding companies or their subsidiaries, or that we do run them, or that we want to run them. Congress did not substitute the SEC for management. And we don't try to substitute ourselves. It is our job, under the statute, merely to see that, while holding companies control local companies, they are not guilty of those flagrant abuses of their control that led to the enactment of the statute.

Efforts of government to curb mismanagement of industry did not begin with the New Deal. In January, 1908, in his message to the Congress, the spokesman for the Republican Party, Theodore Roosevelt, with characteristic vigor asserted that prosperity was secondary to honesty in finance and industry. Heresy sometimes lacks an audience, but never a critic. The New York World, "watching the President with frightened disapproval," said: "When will the President's clamor for new legislation end? When will he give the legitimate business interests of the country a breathing spell? . . . The demand for new experimental legislation goes on before the older experimental legislation has been tried and tested. Confidence is shaken, and confidence is the mother of credit. Credit is weakened, and without credit the business of the nation cannot be carried on . . . It is time to call a halt. It is time to give legitimate business a breathing spell and to permit the restoration of confidence and credit. The country needs a rest from agitation."

Yet of this same message William Howard Taft, a conservative Republican, then Secretary of War, wrote in his diary: ". . . I am bound to say that the measures which he recommends . . , and the position he takes with respect to them, are all of a most conservative character. . . . No man can find within the four corners of the message anything to shake in the slightest the guaranties of life, liberty and property secured by the Constitution . . . Roosevelt leads his party as Lincoln led his . . . to meet the new issues."

And when William Howard Taft became President he sponsored a statute giving the ICC control over the issuance of railroad bonds and stock. He was bitterly assailed. He agreed, he said in answer to one critic, that that *"will interfere with the building of railroads in the West, in so far as the building of railroads is dependent on the issuing of stock for nothing . . . I think we have reached a time now in the development of this country when we can afford to be more conservative, and not permit such conditions, even at the risk of slower development in railroad construction, as were shown in the [illegible] transactions of Mr. E. H. Harriman."* He also urged the enactment of a federal incorporation law which would abolish holding companies that fell within its scope.

Holding Company legislation was not enacted in President Taft's administration. Now that it has been enacted, some of the executives who opposed it and were defeated in the halls of Congress are playing the old cuttle-fish game: They try to obscure the fact that Congress made the law and try, with the aid of some of their publicists, to make the public believe that the rules and orders of the SEC, issued in accordance with that law, are arbitrary SEC intrusions on managerial judgment.

I am reminded of the story of Mr. Zukor and Mr. Shaw. Mr. Zukor, who was eager to buy some of Mr. Shaw's plays and produce them as motion pictures,

learned, after inquiry, that Mr. Shaw was a highly cultured man -- well read, intelligent, and, above all, an esthete: a man of the Muses. So Mr. Zukor was advised to conduct his conference with Mr. Shaw on a high artistic plane. They met at luncheon one day in a midtown hotel, and Mr. Zukor at once began talking about the vintage of the wine, the character of the interior decorating in the dining room, the period of the furniture, the artistry of the musicians, and the more subtle nuances of Greek poetry. Mr. Shaw fidgeted, but listened. Mr. Zukor continued talking. Finally after a steady two-hour lecture by Mr. Zukor on art in the modern and ancient world, Mr. Shaw interrupted: "Mr. Zukor," he said, "one moment, please. It is apparent from your conversation that you are an accomplished esthete. I, however, am a businessman. Let's get down to business. What's your proposition?"

And so, in that spirit, we on the SEC say to some of the businessmen, who adroitly employ the familiar devices of the politican to charge the SEC with playing politics because they do not like the laws which the SEC administers, "You are obviously accomplished politicians. But we are businessmen. Let's get down to business."