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"CAPITALISM AND THE MODERN CORPORATION"

Address by

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to

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Mr. Chairman, Guests of The Forum:

When the time came for the Temporary National Economic Committee (popularly known as the TNEC) to plan its report on the concentration of economic power it hired a word-expert. You would all recognize his name if I were at liberty to reveal it.

For a very fancy price he wrote a confidential memorandum on the wording of the report. His main idea was that certain words were irritation centers and should be avoided. One of his "bad" words, one of the words he cautioned against, was "capitalism". Instead he recommended using sugar-coated variants.

In recent years there seems to have been a considerable reluctance to use the word "capitalism" - as though there was something in its implications of which we might be ashamed. I have never understood that reluctance. To me it is a good word - grand in its history and meaning.

Within the space of a few generations we have, under capitalism, changed our world so thoroughly in its technology, its economic structure and the amount and forms of its wealth that it is not too much to say that we have been living through a revolution. It has brought about, by peaceful means, a spread of opportunity and of the real goods of life which bloody revolution has never been able to achieve. By natural development it has changed the face of our economy without shock to our social ideals or social values. Nevertheless, like any change, it has brought problems with it, and has created the need for vigilance in preserving those ideals and values.

Essentially, capitalism is a system of private productive enterprise, based on the profit incentive. It includes the local blacksmith who has saved enough to set himself up in business, and the giant corporation that organizes the savings of thousands of investors and the work of thousands of employees into productive, profit-making enterprise.

However, it is the corporation that is the outstanding characteristic of our business life and it is my view that the development of capitalism to the present high level of productive efficiency would have been impossible without the creation of the corporate form of organization. In other words, it is this unique, artificial personality which has made it possible to bring together the enormous pools of funds, labor, and management so necessary to create our modern productive and distributive machinery, and to keep it moving forward.

I may note, at this point, that when we talk today about the small businessman, we can no longer refer only to the blacksmith and small shop-keeper. Millions of American investors, whose savings are pooled to make giant corporate enterprise possible, are the "small businessmen" of our economic generation.

Perhaps the simplest way of understanding the importance and the special nature of the modern corporation is to see it as a government within a government; to recognize that the job of organizing the vast sums of investment, and the huge labor forces under corporate control are problems of government. When we see the corporation as a business government we can see in perspective many of its developments, and understand many aspects of modern corporate regulation.

We think of the concepts of "democracy", "bureaucracy", "oligarchy" and so forth as being related exclusively to established civil governments. In fact, all of us know from experience that government is a necessary attribute of any efficient collective action, whether it is civic, social, military or economic, and in all these forms of collective endeavor as the venture becomes larger and more complex the premium on centralized and efficient government becomes greater and the difficulty of preserving the direct contact of the individual with the affairs of the venture becomes magnified, and entrenched and irresponsible control, based on apathy, ignorance and misuse of the franchise machinery is a possibility in any group action -- corporate or otherwise.

Furthermore, in each situation, the full participation of the individual, based on information and a fair opportunity to exercise his voting rights is the only democratic answer to entrenched and irresponsible control.

Many of us are strangely double-minded about the problems of government. We accept as basic to our system a set of constitutional guarantees of our civil rights and civil liberties. We are proud of the entire machinery of justice that works to preserve those rights. Yet, when our Congress belatedly recognized in the 1930s that the very same guarantees should apply to the government of our business enterprises in which the public had a financial interest, cries of anger went up. We were, it was confidently observed, departing from the American tradition.

Understandably, one seldom hears that sort of criticism of our Federal securities laws today. Along with our acceptance of the corporation as a system of business government has come an acceptance of the notion that the citizens of that government -- that is, the investors, should have access to material information and the right to make an intelligent and informed use of their votes.

We tend today to accept the corporation and rules for corporate conduct as matters of course. It is natural that we should. Practically every type of business endeavor is now carried on through the corporate device and it is well-nigh impossible to state an accurate figure for the number of corporations, industrial, commercial, charitable, and so forth, operating in this country. But according to recent figures released by the Bureau of Internal Revenue, about 526,000 corporations

filed income tax returns in a recent tax year. Some idea of their significance can be gained from the fact that their total compiled receipts for that year amounted to the enormous figure of \$290 billions.

These statistics are staggering. They tell us how much of a change has taken place in historical methods of business organization when we compare them with the past. The aggregate wealth of publicly subscribed corporations in England in the middle of the 16th century was only about £ 10,000, and at the height of the speculative fever in 1720, in the days when the South Sea bubble grew and burst, their wealth amounted to but £ 50 millions -- an aggregate for the whole of England that would make one good sized enterprise today.

Historically in England and many other countries, a businessman had to petition the sovereign or the legislature for a special patent or a special statute in the event he desired to organize a corporation. There were several reasons for that. In early days the corporate form was often associated with monopoly privilege and the crown or the state was likely to grant that privilege only if adequately compensated for it. However, even though the appeal of limited liability drew more and more ventures of a competitive type into the corporate form, special acts of legislature continued until several of our States, in the last century, passed what the lawyers call "general incorporation statutes" -- laws under which any legal venture might be incorporated, with more or less freedom in the promoters to write their own ticket in setting up the venture and dividing powers between the investors and the management.

Unfortunately, the turn of this century brought with it a race among the States to liberalize their corporation laws in order to attract the revenues that come from incorporation fees. Almost as quickly as lawyers' ingenuity could figure out ways of making the sale of securities, the payment of dividends, the manipulation of participations easy and legal, the laws were amended. In analogy to another type of competition among States, the phrase "Corporation Reno" was widely used as a description of places where the law was bent to serve the promoters' aims.

Any survey of the corporate charters and practices which mushroomed on these liberalized laws will convince even the most dubious that while the laws certainly encouraged promotions in corporate form, they were also making possible such overreaching and abuse that if left unattended would soon have seriously threatened the very foundation of our capitalistic system.

An overall survey of the ills that resulted from these abuses is beyond my scope. But we have had an excellent sample of some of the financial consequences of this liberalization in the history of our public utility holding company empires. Here was an industry which by its nature should have withstood changes in economic cycles better than almost any other. Yet the standardless and unchecked pyramiding of these

empires, the creation of over-burdening and complex financial structures, the manipulation of accounts and of public investors' rights that characterized some of these enterprises, most of them "legal" under the enabling corporation laws of the states, made the structures so vulnerable that they levered adverse changes in the underlying companies into tremendous losses for public investors.

The frequency with which the corporation had historically been used to avoid contract obligations, defraud creditors, evade covenants and perform skullduggery generally, led people like Woodrow Wilson, who was certainly no rabid radical, to condemn the lawyers for letting loose on society this instrument for the subversion of individual obligations.

With the growth of corporations, with the wide spread of public ownership in corporations, operating in many states, with the ever increasing importance of public capital, something had to be done to preserve the integrity of the investment in corporate securities and the proper relation between the management and investors.

Federal regulation in this field was inevitable.

There are two lines of development in corporate standards and methods of financial regulation exemplified in the Federal laws administered by the Securities and Exchange Commission. One line is purely regulatory. It aims directly at prescribing the types of securities that can be issued, the conditions of issuance, the standards that are to be followed in dividend and other policies. That type of regulation is exemplified in the Public Utility Holding Company Act. However, it is limited in its field of application and has been, so far, incidental to major utility system reorganization programs prescribed by the law.

The other type is exemplified by the Securities Act of 1933 and the reporting requirements of the Securities Exchange Act of 1934 -- a pattern whose primary emphasis is on disclosure.

That we have, under our Federal legislation, made great strides in improving standards of disclosure is obvious. But the obvious is sometimes worth repeating. Not only the requirements of Federal law under the securities acts, but great strides in the development of accounting technique have ended, we hope for good, the "good old days." The good old days were the days when the Banker's Magazine took corporations to task for financial statements "notoriously incorrect, and in many cases made so systematically, for the purpose of concealing from the stockholders and the public violations of law and want of fidelity to their trusts," and when Merchants' Magazine & Commercial Review complained "Why should these officers be allowed to carry on their trust in secret, to keep from the public all knowledge of the changes in the value of the property? Indeed it is very much owing to the lack of such information that investors shun these securities." They were the days when William Z. Ripley called the disclosure practices of the 1920s "implicity."

A securities act and an S.E.C. were necessary because it was deemed wiser and more beneficial to buyer and seller alike to prevent loss at the outset through proper advance disclosure than to let mistake or design cause harm which litigation seldom cures. Yet the standards of disclosure under the Securities Acts are basically not new.

Companies which by inadvertence or design skate too closely to the limits of proper disclosure required by federal law are likely to attribute the S.E.C.'s concern with correct disclosure to bureaucratic idiosyncracies. But the obligation of one who sells securities to tell the whole truth about what he is selling predates the Securities Act. Lord Kilsant can tell you that. He was jailed by a British court because the company of which he was president sold securities under a prospectus which correctly stated average earnings of his company over a period of years but failed to disclose that there were losses in the later years and that profits in the earlier years were war profits. Our Supreme Court awarded heavy damages under common law against an underwriter whose prospectus failed to fix clearly the boundaries of areas in which the issuer had timber rights. That is the kind of disclosure that is sometimes branded as "technical" when required by the S.E.C. But these cases were decided by courts, and not by bureaucrats, and they were not decided under the Securities Act.

As a result of these laws and the increase in public confidence in our system of business enterprise, the corporate security has emerged as one of the most significant forms of modern wealth. Laws which protect the integrity of a security, as one of my colleagues in the S.E.C. once remarked, are as basic as ancient laws against clipping gold coins which were so necessary in maintaining the stability of early gold economies.

But I wish to add that protecting the integrity of the security is not merely a job of policing the relation between the stockholder and his management. One of the prime attributes of the modern security is its liquidity. Liquidity depends on fair and orderly markets. Therefore, protecting the integrity of a security involves also a surveillance of the market in which the security is traded.

To the S.E.C. has been delegated this responsibility.

Markets at their best are indices of values. The aim of our current system of market regulation is to keep them such. We must achieve this objective, for our securities markets are more than mere barometers of business conditions. They are direct causative factors as well. They not only record the weather, they make it. Businessmen are as sensitive to the behavior of the securities markets as they are to other business factors. Not only are plans of financing likely to be dropped or modified in response to market conditions (thus affecting the expenditure of funds for working capital or plant and equipment) but the general mood of businessmen, their willingness to risk expansion and to maintain full employment may be affected by securities market conditions.

Our activity in regulating the markets places its whole emphasis in keeping the markets from becoming an instrument of any particular person's or group of persons' idea of what price should be. A manipulator and an honest economist may join in believing that the market at any given time is underpricing a security. But neither the economist nor the manipulator is allowed to tamper with the market as a reflection of the collective judgment of buyers and sellers.

I wish to emphasize, however, that our anti-manipulative activities, coupled with the information requirements of the Securities Acts and the periodic publication of reliable information by listed companies, are not intended to guarantee that markets will not fluctuate sharply. We have been observing such fluctuations within the past few weeks. But these activities and wide spread information are invaluable aids in keeping the long run markets geared and anchored to reality.

It is hard to measure our success in the policing of our markets and in tempering market behavior with information and disclosure. I believe that we have had a great deal of success, and that the old fashioned rigs are largely things of the past. One measure of our performance has been the uninterrupted continuity of our markets. During the existence of the S.E.C. they suffered shocks from world events that could, in an era of unregulated high-binding, have driven them into such extreme disorder as to require shutting them down for a period. That has never happened under the S.E.C. and we will have to see events of unprecedented magnitude before it ever becomes a matter of serious consideration.

To keep markets free and open so that this vital barometer and causal factor in our economy shall not be a prey to manipulation, to keep markets orderly within reasonable limits by the best and most reasonable forms of regulation we could provide, are more than technical challenges. I hope that my discussion has shown that they are jobs of top priority in our economic system.

In view of the fundamental role of the corporation in our economy it follows that those who operate our corporations have a high responsibility for the maintenance of our capitalistic system. Unlike the big names of the last generation, the names of bankers whose primary emphasis was on finance and on operating the engines of finance, today's big names are those of the corporate managers who have the job of day-to-day running of these business empires.

How these managers treat with labor, how they react to the public needs, to government policies affecting the economy, and to the rights of investors will directly affect our strength.

As time goes on and we realize the depth of our commitment to a stable world, national morale becomes a top drawer concern. In measuring

the responsibility and performance of the management of American big business I do not think it too far fetched to suggest that management has as much to do with the national morale as it does with the national economy. The way of life which we defend is in large part defined by our corporate system, and the managements of big business cannot help but bear direct responsibility for the system and the values that Americans are called on to fight for.

I think that the signs are encouraging. More than ever before, management is forward looking, responsive to the needs of those affected by business, and willing to look at its problems in broad perspective.

Great tasks lie ahead of all of us, and without that kind of management we may fail. With it all our united efforts can be pitched toward a better America in a better world.