

CAUTION - ADVANCE
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"REGIONAL FINANCING"

ADDRESS

of

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Chairman, Securities and Exchange Commission

Before the

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I find that no member of the SEC has visited Cleveland since former Chairman Douglas was here in 1938. That is much too long a time. As it is one of the leading financial and industrial centers of the nation, we are very much interested in Cleveland and its problems. In fact, we have, as you know, opened one of our few branch offices here within the past eighteen months, under the direction of your distinguished former State Securities Commissioner, Dan T. Moore.

Mr. Justice Douglas, when he was here, some two years ago, addressed the Cleveland Chamber of Commerce's "Committee of the Banks and Investment Bankers of Cleveland." I wonder if you recall what a resounding challenge it was to the financial leaders of your city. He pointed out that the proportion of the magnitude of your industry and wealth in the Fourth Federal Reserve District far exceeds your geographic proportion of the nation, but that your financial leaders were not obtaining their pro rata share of the nation's financial business. He pointed to the concentration of financial business in New York and showed that, although in the two years just preceding his talk, the Cleveland Federal Reserve District had been the domicile of corporations offering 12 per cent of bonds and stocks, dealers in the Cleveland district had participated in only about 5 per cent of all issues and had actually managed the distribution of only a little over two and one-half per cent of all issues.

In conclusion he said:

"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 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.

"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.

"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."

I understand from friends of mine in Cleveland, that Mr. Justice Douglas' talk made a great impression here and, what is more important, that at least some leaders in your community decided to do something about it. I understand that, as a result of their activity, the pro rata share of the Cleveland District's participation in stock and bond issues has substantially increased.

I entirely agree with what Mr. Justice Douglas said about the importance of regional finance -- and not only as to its importance but as to the fact that the initiative in fostering it must, in the final analysis, rest with the leaders in those regions. They have it in their power to give more substantial aid in promoting the promising small business enterprises in their respective localities. And many small businesses need and deserve such aid.

When I say that I am not to be understood as being opposed to all bigness in business. I believe that there are some industries where bigness is today almost indispensable. But to say that bigness is necessary and desirable in some industries is not, by any manner of means, to say the same thing of all industries. There are many areas of American life in which there is no need for bigness. It is foolish, therefore, to make an antithesis between big business and small business. Each has its legitimate place in the American scheme of things.

Do you remember the First Grade Reader story of the little pig and the big giraffe? The little pig said it was better to be small and the big giraffe said, no, it was much better to be big. They argued all morning, but neither could prove his point. Finally, as they walked along, still arguing, they passed a high wall. Now, on the other side of the wall there was an orchard, and both the little pig and the big giraffe wanted to go inside and eat the apples and the tender leaves. The little pig looked and looked, but could find no entrance. But the giraffe had no trouble in reaching his long neck over the wall and eating all the leaves he wanted. "You see," he said, "it is much better to be big." Then they walked on until they came to another orchard enclosed by a high wall. This time the giraffe found he could not stretch his neck over the wall to eat the leaves. But the little pig found, at the bottom of the wall, a hole which was just large enough for him to squeeze through. Into the orchard he went and ate his fill of the apples. Then he returned to the giraffe and said, "It is really much better to be small."

Bigness as such is not a virtue. Neither is littleness. To worship either, as such, is a neurotic obsession. To fear either, as such, is a neurotic phobia. The fear of size, as such, is silly. The worship of

littleness, as such, is equally silly. In some situations, bigness is more desirable. And the situation in which it is better varies with technological conditions. Bigness and littleness are relative terms. Life is not static and no size-formula can be static. Moreover, there can be no perfection: There is, usually, not a "best" but merely a "better." And, when bigness is preferable, devices must be sought which will offset, if possible, its defects. It will not do to show the defects of bigness, in any given context, without asking whether littleness, in that same context, would not be worse. And when it comes to reducing bigness, one must ask, "How much reduction is now desirable?" There is need for scepticism concerning the dogma that the biggest is always the best. There is also need for scepticism as to the opposing dogma that littleness is always the best. Both dogmas are equally fallacious. As to any specific industry, the question is always pertinent: "What, at this particular moment, is the most desirable size?"

It is, accordingly, folly for anyone to say either "I am for big business" or "I am for small business." It is wiser to say, "I am for both, each in its proper sphere." The result of not recognizing the folly of any basic antithesis between the two is that a false issue is presented and that, as a consequence, many persons, who quite rationally defend the rights and needs of big business in certain industries, pay altogether too little attention to the rights and needs of small business. In many sectors of American life, small and medium sized businesses will always be the backbone of American business. They often receive insufficient consideration from financial leaders and government.

Local industries and regional industries must thrive and prosper. It is imperative that they, as well as the giant corporations, should have credit and capital facilities. And, with Justice Douglas, I feel that, as a general rule, the fountain head of capital and credit for most local and regional industries should, as far as possible, be in the locality or region where they are located.

Now I know that you have heard a great deal of talk about how the SEC interferes with small business, and you may wonder how I, as a member of what is said to be such an obstructionist agency, can consistently express sympathy with the needs of small and medium size business. The answer is a simple one:-- By and large, the SEC has practically no effect on small business. That it has is a popular misconception. The fact is that, out of the million or more businesses in this country, the SEC has in its entire life come in contact with probably no more than a few thousand. By and large, we affect only those who want to sell their securities to the public.

Naturally, I think you here in this audience know that those are not small businesses. They are medium sized businesses. As you know, issues under \$100,000 are exempt from the SEC requirements. And a one-hundred thousand dollar issue is a small issue only from the standpoint of a big company. From the standpoint of the very great majority of businesses in America, such an issue is a big issue. I assume that most of you are representatives of small and medium sized business and I am sure that few of your companies have much more than \$100,000 of stock or bonds outstanding in the hands of the public.

But very likely there are many of you who have felt that your capital and credit facilities were not what they should be. You have felt that it is much too hard to obtain the money you need for the legitimate expansion of your business - even when you have orders on the book which would justify such an expansion. That, at least, has been the problem of thousands of small businessmen all over the country. And there is no possible question that it is a very serious problem, not only for the particular businessman, but for the country as a whole.

We have stories of retailers and small manufacturers who could not obtain bank loans without pledging as collateral so much of their inventory that to conduct business became virtually impossible. We have stories of other businessmen who have had to go to the commercial loan companies or to the factors or even in some cases to actual usurers to obtain vitally necessary capital at interest rates so large as to be literally staggering. And we have other stories of businessmen whose crying need was for partners to invest equity capital and who could find only creditors who piled the business debt so high that the shadow of bankruptcy was often visible around the corner. I am not to be understood as blaming all those who make such loans for the harsh terms they may exact; for, frequently, the nature of those loans, by ordinary lenders, justifies such terms.

There are two distinct problems involved: The first has to do with relatively small loans for working capital. The second has to do with funds to be used for plant expansion. It is with the latter, because of my SEC experience, that I am primarily concerned.

As I have said on many occasions, I am in favor of seeing a great deal more equity money and a great deal less debt money go into business, especially where funds are needed for plant expansion. There is very little elasticity in debt. Interest charges are fixed, regardless of economic conditions. American business is a growing, changing, thing. But an excessive amount of interest charges, on funds used for capital expansion, is a static thing. The two are, to my mind, often incompatible. Let me give you a word picture of what I mean. On the one hand you have a spirited horse (American business) - rarin' to go. On the other, you have a huge stake in the ground - representing debt created in the past. Tying the horse that wants to go forward to the stake which holds him to the past, you have the stout rope of fixed interest charges on the debt. On the other hand, to carry my picture further, if you release the horse and give him an able rider in the form of a partner with equity money, he will really go places.

It is significant that, for many years since the last world war, an increasing number of our giant industrial corporations in our prosperous expanding industries have issued few, if any, bonds, but instead, have done their financing largely through stock.

The following editorial in the Wall Street Journal, for February 5, 1940, is apposite: "A news article in a recent issue of The Wall Street Journal recorded the fact that many corporations are now applying cash in excess of immediate working capital requirements to the reduction of debt, retirement of preferred stock or reduction of arrearages in cumulative dividends on senior issues. Better net earnings of the latter part of 1939 have accelerated these processes and it is anticipated that good earnings of the current quarter will carry further this work of simplifying and improving the capital structures of a considerable number of corporations. *Reduction of mortgage or floating debt obviously fortifies any unit of business*

enterprise, both for the performance of its economic functions and for the compensation of those who have committed their investment funds to the use of its management. Retirement of preferred shares and reduction of accumulated unpaid dividends are measures of a somewhat different order but still they help materially toward a stronger capital structure, one better adapted to meet contingencies either of suddenly expanding operations and the borrowing that may entail or of contracting business volume and resulting smaller earnings.

"It was noted in the article referred to that these applications of earned income will in many instances bring nearer the time when dividends on common stock may be resumed or begun. That means more than merely the pecuniary benefit of common stockholders. A large corporation of which the common shares are so remote from dividend possibilities as to be little more than trading chips is far from an ideal set-up from any point of view, whereas a corporation able to pay common dividends, not only enlists the active interest and support of all its security holders but also, under favorable general conditions, may obtain needed capital for expansion without incurring the potential disadvantage of fixed interest charges."

Once that would have been considered heresy; once it was thought that it was always good business for a corporation to issue an immense amount of bonds at low interest rates to procure money which the corporation could employ to earn a much larger rate of return for the stockholders. That kind of margin trading was once considered invariably wise.

But many of those who manage many of our prosperous big companies no longer adhere to that business doctrine. And, if it has proved unsound with reference to many big businesses, surely it is even more unsound for a small or medium sized business, which frequently has less capacity to stand up under the impact of a business slump at a time when it has a large amount of interest to pay or a large amount of debt principal to refinance. A proportionately large amount of bonded debt for big business, and even more for small business, is a constricting thing. It produces lack of elasticity, the inability to adjust to bad business weather.

Since much big business has found it wise and possible to avoid the constriction resulting from a large proportion of bonded debt, every effort should be made to make the same possible for small business. And that means that there must be more equity financing of the small, promising business enterprises.

A large proportion of financing by such enterprises through bonds involves dangers to the investors in those bonds and to the owners of the stocks in those enterprises. The chief danger is that, if, because of a default in interest payments or the arrival of the maturity date, the bonds come due in a period of recession, bankruptcy or reorganization is precipitated; and bankruptcy or reorganization is, generally, harmful to all investors.

More and more that fact is coming to be recognized. In October 1938, a committee consisting of some of our leading conservative bankers, insurance company executives, and other business men, publicized such views in an important book called "Debts and Recovery." I earnestly recommend that you read it.*

* You will find that theme expanded in a speech of mine, *Too Much Interest in Interest*, which I made on September 22, 1938. See also my book, *Save America First* (1938) pp. 385-386.

To avoid any possible misunderstanding, let me say, parenthetically, that my preference for increased equity financing is personal and must not and does not affect my conduct in helping to administer the statutes which the SEC enforces. Under the Public Utilities Holding Company Act of 1935, the question of lawful financing of gas and electric utilities companies does come before us, frequently. But there we must make our decisions in accordance with the standards set forth by Congress in that particular Act, and the application of those standards does not authorize us to disapprove of bond financing of such utility companies, if it conforms to those statutory standards. In other words, if the management of a utility company elects to issue bonds, we have the power and duty to interfere with its judgment only to the limited extent that its judgment flies in the face of these statutory standards; on a few occasions, we have been required to hold that a proposed utility bond issue was excessive and violative of that Act; our position, in such cases, was substantially the same as that of the Interstate Commerce Commission which, under somewhat similar provisions of the Transportation Act of 1920, has, not infrequently, over the past twenty years, refused railroad companies permission to issue an excessive amount of bonds in violation of the standards of that Act. But, except for cases, relating solely to bond issues of utility companies within our jurisdiction under the 1935 Act, the SEC has no power whatever to pass upon the amount of bonds a corporation may issue. Accordingly, when I express a preference for increased equity financing I am merely stating my personal non-official attitude. That is, however, an attitude based upon a study of a very large number of cases involving insolvent corporations which have gone into bankruptcy. For, under the Chandler Act, the SEC makes advisory reports to the courts in connection with reorganizations of bankrupt corporations; and, in connection with such reports, we learn much about the disastrous consequences of excessive bond financing.

I know the problem of equity financing for the prosperous small or medium sized business is not simple of solution. But I believe the solution must, in considerable part, be regional. And I believe that communities like Cleveland, with its great financial, industrial and human resources, can solve it. I would like to relate to you one suggestion which I have made on several occasions. It pertains to the establishment of something which, for lack of a better name, might be called regional industrial capital institutions.

You are probably thinking, at once, in terms of further government control over business. If that worries you, let me say that it also worries me. If I felt that what I have proposed could not be worked out without giving the government ownership or control - either direct or indirect - of American business, I would be opposed to it myself. The institutions which I propose might require some financial support from the government. That would depend upon how much support could be obtained in the community. Under no circumstance, would the government contribution be made in such a way that the government might eventually take over any businesses which the institution might have aided. But I am getting ahead of myself.

In short, I know from my experience on the SEC that there is no way in which most small business enterprises can raise capital in amounts from \$50,000 up to even \$1,000,000, unless they have some special connection with an underwriter. Most individual underwriters are not equipped to handle security issues of this size except at an excessive cost to the issuer. This

is not a criticism of the spirit or motives of the underwriter, but it is a frank analysis of their capacities. Our figures show that for small issues of common stock registered with the SEC, the underwriting charges alone run to nearly 20 per cent of the issue. When the cost runs that high, even I, with my predilection for equity financing, must acknowledge that debt financing is unavoidable, no matter how unfortunate that may be.

I do not deny that it costs the underwriter a great deal to market securities of little known enterprises and that his risks may be high. I am not, therefore, blaming him for charging a large price for his services.

But I feel that money which costs that much is too expensive for most small American business. And for that matter, the underwriting charges for small bond issues and small preferred stock issues are also so very much larger than for big business that little and medium sized businesses are placed at a terrific competitive handicap in their race for their proper share of the nation's business.

So I have proposed the creation of these regional institutions. The plan has not been worked out as to detail, but roughly it is as follows: In each of the Federal Reserve Districts, a financial institution would be set up, with the common stock owned by private persons in the district. In order to stimulate private investment in the stock of these institutions, the government would invest in their preferred stocks, carefully safeguarded so as to have little if any voting power. But, the privately owned common stock would control the institution and elect the officers and directors. Each institution would, in turn, buy the stocks of deserving and growing local business enterprises, in good financial condition, which needed money for capital expansion. Generally speaking, the institutions would not make loans. They would supply equity capital instead of debt.

In other words, each of those institutions would be a sort of speculative finance company or investment trust. I want to emphasize that I believe they should not be eleemosynary institutions. They should be run for a profit. We all know that there are hundreds of persons in every community who think they ought to get capital for everything from making gasoline out of salt water to operating a rocket service to Mars. But we also know that there are plenty of good promising businesses which, with a little additional capital, can prosper. And you business men in the community know those situations better than anybody else. That is the principal reason why I believe so firmly in localized control of the proposed financing companies. An investment committee made up of local business men can judge better than anybody else which are the deserving situations and which are not. They can also judge the likelihood of success of a given venture in their particular community. They can know, for example, that a giant market might succeed in one neighborhood because of competitive conditions, while it would have very little chance in another. Those are judgments that cannot, nearly as well, be made from a distance.

Those regional finance companies, as I envision them, would not merely themselves invest in the securities of prosperous small business enterprises, deserving the opportunity to expand, but would also, in appropriate circumstances, participate with underwriters in the distribution of the securities of such businesses.

Naturally, it would be too much to expect that all the investments of the finance companies would succeed. Some, of course, would not. But I believe that, with a wise selection, most of them would. And I believe that, from time to time, it would be often found that some expert management advice, such as could be supplied by the institution, would pull a business, in which it had invested, into the black when it had gone into the red.

That at least has been the experience of private groups which, on their own initiative, have attempted that kind of project on a small scale. Not long ago, I was talking to a man in New York who does almost exactly what I believe these institutions could do. He takes a stock interest in a small business which appears promising at a price agreed upon as fair. He then sends one of his own men out to study the business and give management advice for as long as may be necessary - a month or six months. He supplies that management service at no charge. His only profit comes from an improvement in the value of his stock through an improvement in the affairs of the company. He tells me that, of course, he turns away a great many unworthy applications; but he also has to turn away many very promising situations. He is an enthusiastic supporter of the regional finance company idea. He says incidentally, that he has put none of his money into enterprises in New York City -- all in small business on Long Island, New Jersey, Connecticut, etc.

As a matter of fact, the investment trust bill now before the Senate makes provision for this type of company -- frankly speculative -- frankly for special situations. I believe that finance companies of this nature will aid materially in filling the gap, but I doubt whether such companies, managed from New York, can get down into the local situations. By and large, I think they will have to place their funds with companies a little larger than those I have in mind. But size is no measure of potentiality. A small business venture, in many industries, has relatively as much chance of success as a large one. I would be worried about America if I did not believe that. And I think it requires a knowledge of local conditions adequately to know the prospects of the local industry.

There are two things I want to say about my proposal. First, I do not regard it as a panacea; I am not a perfectionist and therefore do not believe in panaceas. I merely regard it as a step in the direction of filling the gap in our underwriting machinery which presently makes it too difficult for small and medium sized companies to obtain capital. Second, I do not suggest it as an alternative to, but rather as supplemental to, the plans sponsored by Senator Mead of New York, which would provide governmentally aided credit facilities for small business.

I want, once more, because it is so important, to stress the desirability of regionalization. Greater regional autonomy is important because, I repeat, in many areas, local needs are best known to those in the locality. Regionalization, as to security issues for capital expansion, seems to me to be of very considerable importance. For not only is there need, in general, for assistance to the growing small business enterprise, but there is specific need for stimulating business activities in the several regions of our country where today there is too little such activity.

Now if I am correct in thinking that there are internal frontiers which call for development, then it seems to me that it follows, that, insofar as such internal frontiers are to be opened up through financial assistance to business enterprise, it is necessary that there be localized or regional finance companies for that purpose, so that the regional possibilities will be studied by those who are interested in and sensitive to them. Centralization of all such financial institutions in any one city is likely to foster insensitivity to local potentialities almost to the same extent as now exists as the result of excessive centralization of investment banking in New York. The urge for regional development must come from, and will receive its most intelligent encouragement in, the several regions.

What I have been discussing is, of course, part of the larger problem of stimulating an increase of the flow of savings into capital expansion, in order to add to employment and to our national prosperity. In connection with that entire problem it is well worth considering whether some form of tax exemption should not be given to those who make investments that augment capital expansion which would not otherwise occur. That is a large topic and I can do no more here than suggest it for consideration.

And while I am talking of tax laws it may be well to refer to another pertinent problem: One deterrent to equity financing is to be found in provisions of the income tax law which permit the deduction of bond interest (as distinguished from dividends) from gross income in determining taxable net income. There would seem to be a need for considering some revision of that provision of the Revenue Act so as to stimulate equity financing; that is a problem not too easy to solve and I shall not attempt to work out a solution of it here.

I have said that the government could stimulate interest in the regional industrial capital companies by subscribing to their preferred stocks. It is by no means certain that such governmental participation will in all cases be needed. There is no reason under the sun why a group of Cleveland men should not get together and do the job themselves -- form a corporation to be known as Cleveland Enterprises, Inc., or Cleveland Industries, Inc. If you did, I believe it would succeed. I believe it would also increase the prosperity of Cleveland and reveal again the private initiative that has made Cleveland the great city that it is. And I would like it better if done entirely by private funds than if with government participation. I am not urging it on you, because it is not my business to do that. But I would be happy to discuss the idea with any of you to whom it appeals.