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of

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before

THE FOUNDATION FOR THE ADVANCEMENT OF THE SOCIAL SCIENCES

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A PROGRAM FOR GOVERNMENT AND BUSINESS

I

The Securities and Exchange Commission is one of the outposts of capitalism. There are those who say that it is one of the last of such outposts. But I think (at least, I hope) they are engaging only in wishful thinking. At this outpost we are engaged in patrol of the capital and the securities markets. It is not the kind of patrol exercised by the Capital Issues Committee in the war period where an attempt was made to determine into what industrial channels capital would flow. Nor is it a patrol designed to protect investors against risk of loss or depreciation in investment. Risks of investment still persist under this phase as under the earlier phases of capitalism. The onward sweep of technology is not arrested. As there have been losses in the traction industry during the last few decades, so there will be similar losses in other passing industries in the future. The S. E. C. has no power and makes no attempt to prevent such losses. Those risks are by definition part and parcel of capitalism. Nor does the S. E. C. in its patrol of the securities markets have the power, or undertake, to iron out the ups and the downs of stock markets. Again by definition these are supposed to reflect basic economic and business conditions. It would be a dubious form of economic planning were we to indulge in any attempt to stabilize investments in enterprise or to turn the hills and valleys of the stock markets into plateaus.

Under the Securities Act of 1933 and the Securities Exchange Act of 1934, our powers are aimed at fraudulent, deceptive and manipulative practices in the sale of securities either on or off the exchange markets. We aim, so far as possible, to the elimination of those artificial influences

and restraints which in the past have frequently made the stock exchanges not an open, old-fashioned auction but a casino. We strive for the ancient standards of simple honesty in the sale of securities - the disclosure of the truth, the whole truth, and nothing but the truth. These are all earmarks of a genuine brand of conservatism in finance.

In the public utility field we exercise somewhat different powers than under the Securities Act of 1933 and the Securities Exchange Act of 1934. There our powers are not restricted to patrol of fraudulent, deceptive, and manipulative practices. We are entrusted under the Public Utility Holding Company Act with supervision over various activities of holding companies and their subsidiaries. These involve not only the issuance of securities but various types of financial practices of dubious validity. But though our powers here are of the approval rather than the disclosure type, they also have as their objective the inculcation of old fashioned conservatism into that area of business and finance. Take for example the problem of excessive capitalization. The issuance by holding companies of securities in amounts not justified by property values or earnings resulted in consequences so serious and so widespread as to become a national problem. Investors, consumers and to an extent our entire national economy suffered and is still suffering from this condition. In public utility holding companies (registered under the Act) and their subsidiaries, there are about \$432,000,000 of unpaid, accumulated dividends on preferred stocks. These stocks are widely held. Many of these investors can justifiably claim that their failure to receive what their contract provided is chargeable in the main to over-capitalization. This condition is not only a grave one

from the viewpoint of investors; it is also significant in terms of our national economy. For this condition stands in the way of new financing for the important programs which lie ahead for many private utility companies.

Now conservative financial practice for public utilities contemplates (e.g.) that a reserve be set up to retire and replace equipment made obsolete by technical improvements in the Act. But here again the effects of over-capitalization are noticeable. Companies which had more service on securities than could be taken care of in accordance with conservative methods were tempted to cut corners in order to make their income appear to be more than it really was. One of the first things frequently done was to cut down the amount spent in keeping the property properly maintained. Another was to reduce the amounts deducted from operating revenues for the depreciation reserve. In other words, many companies failed to charge against their operating income amounts sufficient to represent the depreciation, obsolescence and retirement of property used in producing that income. At times this reached ridiculous proportions. For example, as of 1933 one major holding company had on the books of its subsidiaries almost \$31,000,000 representing properties which had actually been abandoned. Many other abuses arose by holding companies, partly at least as a result of over-capitalization. To produce the appearance of earnings to service its securities, the holding company resorted to all sorts of devices. In some instances various bookkeeping entries were arranged with its subsidiaries which resulted (on paper) in showing earnings, permitting the subsidiary to pay dividends to its parent. In other cases, the holding company did not rest content to rely upon fictitious sources of income; it milked its subsidiaries to cause a flow of cash into the holding company bucket.

These practices obviously injured investors. If you held preferred stock or bonds of an operating company which was forced to pay dividends to its parent when its earnings did not justify them, money which should have been preserved for your protection was being dissipated. If you were an investor in a holding company, you were being deceived by an illusion of earnings. Consumers also suffered by these desperate efforts to sustain an intolerable load of securities, for over-capitalization had its indirect impact on rates. As one court aptly put it, "every expenditure, every dereliction, every share of stock, or bond or note issued as surely is finally reflected in rates and quality of service to the public, as does the moisture which arises in the atmosphere finally descend in rain upon the just and unjust - willy nilly".

So you see what I mean when I say that we are seeking in the utility field old fashioned conservative practices. With the aid of legal and accounting legerdemain, holding companies separated values from things, perhaps to a greater degree than in any other area of finance. Values and things cannot long be separated. The day of reckoning is always close at hand when that happens. Our task in large measure is to see to it that that separation does not hereafter occur, Conservative finance will not tolerate it. Healthy and peaceful business does not go hand in hand with it.

It is evident then why the S. E. C. outpost in finance is an important one. That outpost is concerned with the preservation of capitalism by the inculcation of conservative standards. The philosophy is that only by such a course can we hope to preserve the capitalistic system. Only where those who handle other people's money are held to

a high standard of trusteeship can investor confidence in the integrity of our financial processes be maintained. Where investor confidence does not exist, capitalism as we have known it breaks down. The only recourse then is for government to step in and perform more and more of the functions, since private enterprise has become increasingly dependent on money of the public for growth and development. Nor can paralysis in the capital markets be allowed to persist to the point where business is stifled, for that has its reflex action on the problem of employment and on the welfare of our whole economy. Our direct powers should therefore be a healthy conditioning influence in our whole economy. If they will not preserve capitalism, none will be likely to do so. If we succeed, we will have given capitalism a vigor and strength which it has sorely needed. If we succeed we will have saved capitalism from its worst foe - high finance.

II

But government in such a program cannot succeed by playing a lone hand; at least it cannot succeed under a democratic form of government. Government needs wide acceptance of the philosophy of these new Acts by business and finance in order to do an effective job. Otherwise government is always in the position of propelling by legal mandate unwilling business and recalcitrant finance down the highway which leads to a more stable, conservative era. Legal mandate is an inferior method of getting the work of the world done. Furthermore, government without the support of business and finance on these problems is constantly under the compelling necessity of intruding more and more into the details of business, so that from industry's viewpoint it becomes not only a drain in the national

treasury but a bureaucratic blight. Thus in the stock exchange field self-regulation and self-policing could easily curb the conduct of another Richard Whitney. But the corps of Federal investigators necessary to keep contact with the hundreds of thousands of customers accounts throughout the land would be staggering. The Whitney case was not in issue between us and the New York Stock Exchange last fall, since we had no inkling of the matter for more than about fourteen (14) hours before the public knew it. But it is typical of the issue on which we parted ways in November, 1937. And you know the aftermath - a reorganization of the Exchange; a disappearance of the Old Guard philosophy of obstruction and delay; an acceptance of the philosophy of the Act; a constructive, cooperative endeavor that has few equals in the annals of American finance.

This is the tempo of the times. It is illustrative of the trend towards cooperative endeavor by government and business. What has transpired in the New York Stock Exchange is taking place on some of the smaller exchanges. And I have seen hopeful signs of similar character in the investment banking field. I have talked with many investment bankers during recent weeks. Many of them were not newcomers to the business. Others had entered the business for the first time since the advent of the new regime in 1933. An increasing number of these men are a constructive influence. They are not mere apple polishers - expending their constructive energies on that pleasant pastime at conventions. They do not sulk in their tents or waste their energies on personalities in the manner of the Old Guard. They accept the changing times; they realize their own vital importance to capitalism; they are anxious to live up to their position of trust and responsibility; they want to

accept the new rules of the game. Unlike the Old Guard they are anxious to form a partnership with Washington to work jointly on the common problems. Unlike the Old Guard they do not maintain a sit-down attitude and do not insist that unless they dominate political as well as economic power they will wait until Washington comes to them as a suppliant on bended knee.

I see the same types of influence working in parts of the utility industry. When Congress passed and the President signed the Public Utility Holding Company Act of 1935, but a few in the industry concluded that it was the law of the land. Instead of setting to work to rectify the obvious malpractices which had brought large segments of the industry into disrepute, they carried the battle into the courts. After two and one half years of litigation their efforts were again frustrated. The Supreme Court upheld in March of this year the constitutionality of the registration provisions of the Act. But even before then, a new spirit was exerting its influence in parts of the industry and endeavoring to shake off the heavy hand of reaction. As a result of the victory of the government in the courts those elements in the business are now more in the ascendency. They are working cooperatively with us in the solution of the intensely practical problems which arise under that statute, in an endeavor to make up for the two and a half precious years which have been lost - two and a half years in which the industry could have been well prepared to make its contribution to revival of the capital markets; two and a half years in which but few steps were taken to prepare for the reconstruction and financing which the industry and our economy sorely need.

These forces which I have mentioned and which are working constructively with us in the field of finance are the forces imbued with

the spirit of youth. Many of the individuals are members of the rising generation. Others are not. But the spirit of youth does not necessarily pass with the years. It persists in those who have a social consciousness. It is reflected in an understanding that the business of today rather than the desires of yesterday make up the current agenda. It is present in an attitude of forthrightness and directness in meeting the problems of change. It is evident in a failure to confuse personalities with issues. A paucity of these qualities distinguish the Old Guard. Their undiluted quality in the rising generation makes that generation peculiarly well fitted for the consummation of the constructive program between business and government.

III

There is such a constructive program. At times it has seemed faltering. But that is due largely to the fact that some elements in business have conceived that the one condition to cooperation is to forsake the basic principles on which government has made its broad advance on economic and social fronts. Responsible government would be faithless to its trust if it forsook in administration of the laws the principles of the laws themselves; or if it granted away in the conference room the liberties which the people had won at the polls. Cooperation based on an implied or express condition that the will of Congress will be negated or that the outposts of reform will be surrendered cannot exist. Cooperation based on an implied or expressed condition that the philosophy of the new legislation will be accepted and that efforts will be made to make these statutes a constructive force does exist. It is evident in the S.E.C. workshop in a myriad of ways.

I have referred to our problems of supervision over national securities exchanges under the Securities Exchange Act of 1934. Our powers had been little exercised in the first three years of the Act. There was the hope that the exchanges themselves would recognize the existence and validity of the statute and make the adjustments necessary to adapt their private club management, and their methods of operation, to the philosophy of that Act. But after three years matters were in process of being stalemated. Lip service was rendered to cooperation; but little action was evident. But now, as I have said, there is a new management having no traces of the Old Guard philosophy. That new management and we instituted the round table method of work. Our items of unfinished business are agreed upon; our conferences have started. There is a will on the part of the new management to work out these difficult and practical problems under the philosophy of the Act; there is a desire on the part of government that it be done that way. I feel we will soon be out of the woods.

Under the Securities Act of 1934 we also have jurisdiction over the over-the-counter market, an important market for thousands of securities in the hands of the public. Last week the Maloney Bill was passed which would amend that statute by giving the Commission broader power over that market and by permitting brokers and dealers to form associations to perform in the over-the-counter functions similar to those performed by stock exchanges in the exchange field. Back of that bill were three years of round table work between the Commission and a group of investment bankers known as the Investment Bankers Conference. These sat at many round table conferences with the Commission working on a host of specific problems. The Commission promulgated rules grounded in part on the technical phases of these round table discussions. And the Maloney Bill, in part the

result of that cooperation, was endorsed not only by the Commission but by the Conference group.

Another example in the S.E.C. workshop is the current program under the Public Utility Holding Company Act of 1935. I have mentioned the two and one half years of litigation and the change which took place both before and after the decision of the Supreme Court on the issue of constitutionality in March of this year. A new climate of opinion was created in this twelve billion dollar industry. Once more did we adopt a round table method. Singly and in groups leaders of the industry came to Washington not just to talk but to make specific plans for adapting their companies to the standards of the Act. A committee of certain groups in the industry was organized to consult and advise with the S.E.C. on practical problems under the Act. Work at last is under way in an attempt on the part of many to put their utility houses in order in accordance with the standards prescribed by Congress. This is not entirely a case of a defeated group bowing at last to the law. Substantial groups in the industry are satisfied with the soundness of the statute. Others are less enthusiastic. But those constructively minded are indulging not in mere talk but in action. Development of concrete plans are under way in many utility offices today. This round table technique once more is about to bear fruit, beneficial to the industry, the investors and the public alike.

There are other examples in the Washington workshop of the round table technique between government and business. Those I have mentioned are not unique; they are merely conspicuous in our shop. Now this round table method is the sane and sound course. What the New York Stock Exchange and we have done, what the Investment Bankers Conference and we

have done, can be done by other groups. If one wants talk, he should choose the debating society. If he wants action he should choose the round table. What we need now in these perilous times is action - action by all groups on their common problems; action in specific terms, not in generalities; action on the constructive side with issues, rather than on the destructive side with personalities.

The round table technique in the hands of business is productive; the political technique in the hands of business is not. In the use of the round table technique business is exercising its basic skills on specific problems. In the use of the political technique those specific problems are neglected. With the political technique business heads for the trackless desert. With the round table technique business charts its way to the broad and open highways. This goes deeper than the fact that a lawyer is no statesman just because he has won a lot of cases, or that a business man is no economist (let alone a politician) just because he has made profits for his stockholders. It strikes at the very basis of our democratic form of government, for the political technique of business has as its objective negation of the will of Congress. That does not mean that there are no justiciable issues for the Supreme Court nor that the decision of agencies like the S.E.C. should be final and conclusive. But it does mean, in cases like the Public Utility Holding Company Act, that precious years are lost on the economic and business problems after Congress has acted. Years lost are costly in any form of government. They are especially costly in perilous times under the democratic form of government, for they impair its effectiveness to deal directly and forthrightly with the problems of change. Only by working together can we make democracy effective under a capitalistic system. Only by a united front

can we make certain that social and economic forces do not take subversive courses. We can ill afford to paralyze by opposition or inaction the power of government to act swiftly and decisively. We can ill afford to expend our energies on each other rather than on the problem.

It is the *rate* of change, not *change* itself, which constitutes the peril. Change has always been a fomenting influence. But a myriad of circumstances has accelerated the rate of change in recent decades. That rate of change is not only fomenting; it is electrifying. It, rather than change, constitutes the challenge.

This is not solely a challenge to government. It is a challenge to business and finance as well. In each there is an element of trusteeship. The powers which government holds are powers in trust for the nation. The powers which business and finance hold are likewise powers in trust. In many areas the law has recognized a public interest over and above the interest of investors. But that is not precisely the trusteeship of which I speak. I am not concerned with legal aspects here so much as I am with the broader, layman's view of the matter. The vast powers held by business and finance are so strategic to the welfare of our whole economy that they surpass the concern of scattered security holders. They must be exercised with the view of the public interest. To be used most constructively in that manner, they must be employed in partnership with government to solve the common problems of capitalism and democracy. Give us that united front and the solution of the difficulties which lie ahead become easy.

For these reasons the round table technique holds out such great promise from the national point of view. It is the method of making government effective. It is the method of solving intensely practical problems

and of bringing peace and profits to business. It will work in the manner in which the New York Stock Exchange and the S. E. C. are approaching their common problems only on implied or express acceptance of the will of Congress. It will not work where those sitting down at the round table operate as do some alleged leaders of the investment banking business - by polishing their own apples, when they are not attempting purely obstructive tactics.

The majority of business, I feel, recognizes these principles. And I also feel that there is an increasing willingness for business by the round table method to pool its technical resources with the powers of government. If the Old Guard in business who have found in it only easy perquisites of personal favor will not cooperate, it is time for them to step aside for youth. Youth in these matters will not brook delay. Youth with power and responsibility will do the job. Youth will not permit emotions, generated on the battle grounds of lost causes, to stand in the way of health and vitality for capitalism and democracy.

In these perilous times, youth will not be denied. Nor should youth be denied for its whole stake in the future of America is involved. The most crucial issues will be in balance during its term. The world forces which have resulted in plagues elsewhere need not result in plagues here. They can be harnessed under capitalism and democracy by a continuing constructive statesmanship imbued with the spirit of youth. They cannot be harnessed by the forces of inaction, smugness, and stodgy conservatism. Nor can they be harnessed by wails against these plagues nor by mere lip service to the need for change. The mental bankruptcy of those who want merely an opportunity to be let alone so that by some magic or other they may wander unmolested in the rosy haze of the good old days is not only a

danger. It is also the stimulus to youth for renewed effort to keep on the ascendency and to join the legions who are bent on preserving capitalism, and democracy for humanity.

These are not theoretical matters. They are live, practical issues. They are not created by political forces; they are the convergence of economic and social pressures - world wide rather than national. Subversive political influences abroad capitalized on them and canalized the resourcefulness and the energies of youth towards objectives destructive of capitalism and democracy. Your government is interested in canalizing that resourcefulness and those energies for the preservation of our inheritance - capitalism and democracy. The challenge of the day is for government and business, energized by the spirit of youth, to pool their resources and through the round table method to wake into living realities the broad social reforms which have been achieved.