Speech

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ADDRESS

of

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To one who cares about the direction of American life, the opportunity to address a Detroit audience is a privilege. Your city spells to the nation youth, growth, courage. Its pioneering achievements in the field of transport, of management and initiative have made its name a byword for industrial enterprise. Detroit, like other business centers has suffered intensely from the vicissitudes of the past years. Although it is hardly the place of an outsider to discuss your own difficulties, and their causes and cures, it is possible to consider, with Detroit as a background, the significance of these years and recognize the virility of American life exemplified here. Perhaps, also, the stranger within your gates may be permitted to pay tribute to the resiliency in the life of your community - that ability you show to rebound to the demands of a new day.

Perhaps not the least of these demands is the challenge to our ability to understand the growing complexity and the direction of our corporate life. The legislation which our Commission has been called upon to administer is an attempt to deal with some phases of this problem. Allow me, for the moment, to pass by the immediate and commonplace effects of the statutes that have been placed in our charge and try to give you, at longer range, a view of the more permanent problems which they present.

Perspective is obviously important in the consideration of any subject. Under the pressure of present day demands, too many of us tend to forget the shortness of years as contrasted with the decades that span our lives, or the greater spaces of time that mould the character of the civilization for whose permanence and for whose adequate functioning each of us strives.

Other commentators have characterized our century as the period of the corporate system, distinguishing it thereby from the industrial system of the nineteenth century or the mercantile system of the eighteenth. The correctness of that characterization seems apparent to any one who contrasts the familiar scene of today with the business aspect of our society of a century ago. The form which industrial enterprise assumed then was primarily the partnership. Corporations still had to be created by special act of the legislature. True, a few limited general incorporation acts had come into being but they confined the privilege of incorporation to aggregations of capital like banking, railroad and canal companies, which, because of their semi-public nature, were thought to be entitled to such a grant. Stockholders, where they existed, were limited in number because of a widely accepted policy followed by the states of placing a limitation upon the amount for which a corporation could be capitalized, an amount that rarely exceeded two hundred thousand dollars. These securities, it is true, were already being traded in upon stock exchanges but to a degree which made the existence of these exchanges of little importance in the financial life of their day. A glance at the list of securities then traded upon the New York Stock Exchange discloses but twenty-three corporate issues, none of which would today be classified as an industrial stock.

If one moves on forty years further to 1875, there can be found the beginnings of a general recognition of the desirability of doing business in the corporate form. But those years developed little in the way of a duty

on the part of management to report its results to its stockholders as the owners of the enterprise. A chief concern of stock exchanges seems to have been merely to prevent the secret over-issuance of shares of stock, a problem brought home by the Erie Scandal. Indeed, about this time, the effort of the New York Stock Exchange to secure financial information from issuers whose stock was dealt in on the Exchange, was met by the blunt rebuff on the part of the Delaware, Lackawanna & Western R.R. Co. that they "make no reports and publish no statements, and have not done anything of the kind for the last five years". Indeed, the necessity for such an obligation did not seem generally apparent. The broader public still had little participation in corporate enterprise; management was still a personal and knowable quantity to stockholders; and the theory of stockholder control by the New England town-meeting method was not only accepted in theory but was an actuality in practice.

The turn of the century gives a somewhat different picture. Wider public distribution of corporate securities made for the development of a stock exchange technique that would satisfy the resultant demand for greater liquidity of this part of the nation's wealth. This, in turn, reacted to make for greater participation by the general public in the fortunes of American business,--fortunes that in our rapidly growing country possessed an unusual tinge of brightness. With the rise of corporations, states were beginning to vie with each other to induce capital to seek their borders by a general relaxation of limitations upon incorporation. Intercorporate stockholding, which made possible the holding company, was given legislative sanction. Limitations upon the amount for which a corporation could be capitalized were abolished, although it was not until 1921 that Michigan finally permitted corporations to be capitalized at a sum greater than two million dollars.

The full implications present in wide public participation in the ownership of American business was then scarcely recognized either by statesman or economist. Such legislation as the growth of the corporation then precipitated was primarily concerned with the consumers of the goods of business enterprise rather than with the social issues that flowed from intracorporate relationships. The interest of consumers, for example, was the prime concern of legislation such as the Sherman Anti-Trust Act, the Interstate Commerce Act and the kindred state statutes, or to take the period of Wilsonian reform, the Clayton Anti-Trust Act and the Federal Trade Commission Act.

But the beginnings of a concern for the investor in corporate securities was shortly thereafter manifested. The Hughes Commission, created by the present Chief Justice when he was Governor of New York, stimulated by the recurrent manipulation present upon the New York exchanges, made an examination of exchange practices and in 1909 recommended some changes. A few years later the Pujo Committee of the House of Representatives returned to the subject but, though it stimulated some public discussion, brought forth no legislative action. About the same time a movement, primitive in character but powerful in its implications, was gathering force in the Middle Western states and eventually resulted in the system of blue-sky legislation which aimed to check the type of fraudulent stock promotions that lax corporation laws had made more possible.

This legislation, though it grasped the problem of the relationship of corporate enterprise to the prospective investor, was designed primarily to combat the more patent types of fraud in stock promotion. It did not grasp nor seek to deal with one consequence that followed upon this ever increasing stock distribution. Here and there far-seeing economists, such as Thorsten Veblen, realized that the broad public ownership of corporate enterprise was creating a new problem, that of the divorce of ownership from management and, as a corollary the creation of a new force in our economic society, that of the management of our large aggregations of capital responsible rather to itself than to the contributors and owners of that capital. The twenties served to make this fact plain. The general introduction of such devices as non-voting stock and the pyramided holding company made explicit the desire of management to free itself from the direction and control of ownership. But even without the patency of such devices, the fact of this divorce had already been accomplished by the very fact of a broadly diffused stock ownership.

The thinking man of the late twenties could no longer regard as practically operative the original American theory of a corporation as one where management was made responsible to ownership through the democratic process of the ballot. The attainment of the original objective of democracy in corporate activity was frustrated by the practical difficulty of conveying to thousands of owners, many of whom were neither wishful nor capable of understanding, the aims and conduct of management. And because of the difficulty of bringing these facts home to ownership, abandonment of the effort to do so became all too common.

True, some measures were being taken to counteract that tendency. Here and there a state would require feeble reports from those corporations that might choose to seek their domicile within its borders. The listing committee of the New York Stock Exchange, under the guidance of its able Executive Assistant, but subject to the limitations inherent in the very mechanism of an exchange, was struggling for more informative disclosure to stockholders. The listing committees of other exchanges, subject to much greater limitations, followed suit, though some gave up the struggle entirely. Advance in the science of accounting and the pressure of the leaders of that profession helped to buttress that portion of management which sought to maintain and make real those responsibilities that the very theory of the corporation implies.

Modern government, here as well as elsewhere, when faced with the question of how the complexity of its many problems can be made amenable to the processes of democratic control, tends to move in one of two directions. It may try to overcome this obfuscating factor of complexity by a simplification of governmental structures and by the persistent effort to educate the electorate to the issues faced by its government. Or government may move away from the democratic idea, rejecting wholly the theory of responsibility to an electorate. Power then becomes all important for it alone is the buttress for the effectuation of self-interest.

Broadly speaking, such an issue, frames in economic terms, was presented by the nature of our advancing corporate civilization. Either of the two answers was possible. Believing that the return of control to ownership was no longer practically possible, legislation might well have proceeded upon the theory of rejecting the re-establishment of the principle of democratic control and subjected management to the direct supervision of government. The federal securities legislation of the past two years chose to reject that answer. Instead, it sought to return to and revitalize the original theory of the corporation.

Because these statutes based themselves upon the belief that ownership could and should accept responsibility for the direction of corporate enterprise rather than upon the belief that such direction should be the immediate concern of government, wise men have characterized them as non-progressive in their tendencies and distinctly nineteenth century in their tenor. The answers that these men would make to the problems of corporate finance are in terms of government supervision over the economic desirability of financing a particular enterprise, with government assuming much the same sort of obligations that now rest upon the underwriting groups. The soundness of the investment as well as its ability to promote the general welfare should, according to them, be the direct concern of government.

It may be that there are wise men, and that they are better prophets of the future of government control over corporate enterprises than you and I. Certainly, the hope and aim of our recent securities legislation is utterly different. I say hope, for though we may already count many gains, the time is still too short to know definitely whether the effort to make intelligible the nature of the corporation will withstand the insistent pressure of the contrary forces at play.

It is admittedly a bold hope upon which the Securities Act rests,-- the hope, first, that it is possible to present within a limited compass the facts necessary to intelligent investment, and, second, that the normal investing public will understand and therefore seek to judge for themselves from these investment facts, rather than succumb to the persuasive chit-chat of some salesman. It is an even bolder hope that underlies the Exchange Act,-- a hope, that through the dissemination of information buying and selling of our securities will become intelligent rather than being simply responsive to vague rumors, the confidential suggestions of customers' men, and the speculative fever engendered by the ticker tape.

To illustrate in detail how these broad principles underlie the mechanism of this legislation, has been done before and need not now be repeated. True, both Acts involve certain policing features, designed to eliminate fraud, dishonest market practices, and the tendency to pervert exchange markets from their true function. These policing features are those that, perhaps, excite more public interest than the aspects of the Acts which I have mentioned. But from the standpoint of keeping our corporate life true to its pretensions and thus insuring the continuance of the basic character of our business life, those features of this legislation which direct themselves toward making investment, trading and management intelligible to the general public seem to me of the utmost importance to American life.

As I scan the results of the months of operation of these Acts, I think I am not alone in that belief. The evidence indicates that an appreciation of the importance of realizing these objectives is shared by the vast majority of our listed corporations. It is difficult otherwise to explain the ready acceptance by these corporations of the obligations that the statutes imposed upon them. When it came, for example, to compliance with the requirements for registering securities on exchanges, some corporations, it is true, chose to refuse and to lose for their security holders the benefits of an exchange market. Unfortunately in this process the smaller exchanges suffered more heavily than the great exchanges. But the corporations who chose this path, viewed broadly, were so negligible in number and in public interest, so as to give one pride in this wholesale exhibition by American management of its responsibility to its stockholders. Here was no wholesale rush to the assumed protection of the courts, in disregard of the wider public detriment that such a ganging-up process necessarily implies, but a sober recognition by public corporations of their public responsibilities.

Unfortunately there are still areas where the recognition of these obligations is not to be found. Numerous corporations, whose securities have been admitted to exchanges upon an unlisted basis, have consistently maintained much the same attitude as that exhibited by the Delaware, Lackawanna & Western Railroad in 1866. In a recent report to the Congress, we have acknowledged the practical exigencies of this situation and recommended measures which we hope will gradually eliminate the disparity and unfairness that exists now between listed and unlisted trading.

Furthermore, there are a series of corporations in this country, whose securities are widely distributed, that have not sought and do not require an exchange market. Disclosure and reporting by the management of these corporations is again often haphazard and uncertain. Not only does such conduct present a continuing threat to the breakdown of the theory of our corporate life, but it presents a serious element of unfairness as against those corporations who have willingly accepted the obligations that should attend management. The correction of this situation was recognized by our Commission as a matter of pressing national moment upon the solution of which depended much of the effectiveness of present methods of control.

Apart from such legislative solutions as we recently presented to the Congress for consideration in connection with these questions, substantial progress in that connection could be made without resort to law. At my post, I have had the opportunity to gain some knowledge of the nature and operation of our smaller exchanges together with some insight into the functioning of our so-called over-the-counter markets. The smaller exchanges in some of our cities are and have been for some years declining in importance. The causes for this are not difficult to ascertain, though not always are they alike. Chief among these is the natural centripetal force exercised by such a financial center as New York. When one regards the highly developed mechanism of a large modern exchange, distribution in the vicinity of the exchange— a standard necessary for justification of

an exchange market---becomes meaningless because its vicinity is the nation. Concentration of securities which have a national distribution upon a great national exchange may thus, perhaps, be inevitable, and thus as the circle of distribution widens the shift to such an exchange occurs. Again, some of the local exchanges have been deserted by the richer financial institutions in that vicinity, institutions which prefer to rely upon the resources offered by an out-of-town exchange or which, preferring to act as dealers rather than brokers, build up local markets in competition with the exchange. Sadder instances are, of course, those local exchanges which have fallen into bad hands and lost the confidence of both local investors and local financial institutions.

The rehabilitation of these exchanges, so as to make them a dominant force in the financial life of their community, can in my judgment result only from a recognition by the community of certain needs. First, of course, is the willingness of the management of local enterprises to assume the duty of holding themselves openly responsible to their security holders, in the firm belief that such a course redounds to the benefit of all concerned. Second, is the education of the investing public to the benefit to them of buying on a brokerage basis under appropriate conditions as against the net price basis that characterizes most over-the-counter transactions. And third is the determined insistence of the exchange to maintain fair practices and to reduce the costs of operation. In the revitalizing of these exchanges, it seems to me that a community as a whole has a deep interest. Its business life is enriched by any such institution when the exchange can be made to serve not only as a clearing house of values but also as a source for a thorough understanding of the corporate life of the community.

I have intimated, that American business has generally accepted the principles of the Securities Acts. By this I do not mean to imply that differences of opinion do not exist, but they relate primarily to matters of detail rather than principle. The extent to which disclosure is demanded is frequently challenged upon two grounds, that of utility when weighed against burden, and that of infringement upon matters of justifiable corporate or personal privacy.

The grounds of difference between the Commission and some portions of management as to the utility of making certain facts public spring from a general failure to appreciate the significance of two factors. The first is the function of the expert in investment. That his judgments permeate the entire field, is obvious from an examination of the channels through which the corporate appeal for funds is made. Consequently adequately supplying his needs means stimulating the effectiveness of the galvanic current that flows from him outward to the many only average investors. The second factor is the failure to recognize the very great need in our economic society to educate as best we can the growing public that participate in American enterprise. A public that only a few years ago paid no attention to the possibilities of returns from its investments, but cared only for gains from quick appreciation, is only now beginning to realize that earning statements have a significance. The next years must be spent in inducing it to read and grasp the record that management makes, a record that must gradually become plainer. But obviously, if the public is to be educated, the present capacity of the public to absorb and understand data is no just standard for determining the type of detail that should be supplied.

The objection to disclosure that springs from ideas as to rights of privacy, is important to analyze. True, there are legitimate areas of privacy even as against the scattered but true owners of the business. But in the years past, which might be characterized as the hey-day of corporate irresponsibility, certain conceptions as to the right of management when contrasted with ownership gained an undue weight. To illustrate this point, Congress and the Commission's attitude on the disclosure of the compensation paid to executives is a case in point. Privacy as to individual income is an understandable concept. But in a public corporation, and our large corporations are truly public in character, privacy as to compensation for work done stands upon a different footing. That compensation is frequently uncontrolled and is always payable from profits accruable to the business as a whole. Whatever argument can justly be made against such devices as pink-slip laws has no place here. If the sources of a man's income are my pocket as a taxpayer or a stockholder, some knowledge of what he is being permitted to take is my concern. True, there can be little question that the novelty of this type of disclosure has for the time being made it a matter of public comment by the curious and the idle. But little harm, if any, has resulted and the abuses that were once held up as a national scandal will hardly recur. As the novelty wears off, a fairly safe prediction would be that the objections to the disclosure of this information will look as obsolete to future Americans as those raised by corporations in 1833 to the disclosure of any financial information.

Thus far I have not dealt with the implications of the third statute whose administration lies with our Commission, the Public Utility Holding Company Act of 1935. Indeed, the Act is the subject of so much discussion and so much controversy that, like the scriptures, almost everything said about it has been twisted to suit some other purpose. But a candid examination of the Act will reveal its close relationship to the features which characterize the corporate legislation of the day. Naturally it introduces elements of direct governmental regulation, unknown to the

Securities Act, but familiar to the systems of state utility regulation that the last two decades produced. The privilege of being or controlling a public utility carries with it certain obligations to submit management to the direct supervision of governmental authority, along lines that thus far still recognize an essential distinction between instrumentalities such as railroads, banks, and public utilities and the ordinary industrial enterprise. In addition to the familiar scheme of regulation based upon these lines, the Act dnawa also upon the general principles of disclosure, continuing the persistent effort to restore the responsibility of management to ownership.

In one aspect, however, it recognizes that the holding company relationship may well have so complicated the problems of intelligent control over management as to make the principle of disclosure an impotent means for accomplishing its objective. That the complication has existed and still does exist is, of course, beyond question. One remembers only too well the testimony of one of our great industrialists, who had been responsible for the lending of money to the Insull system. He said that the complications of its corporate structure were beyond his grasp. Under circumstances such as these, the retention of complexity necessarily means that the democratic theory of corporate control has not a chance to come into being. The pitiful effort made in the last Congress, through a flood of spurious telegrams, to prove that managements' opposition was dictated by its stockholders, need not here be rehearsed.

Under circumstances such as these, Congress determined that in this field simplification was warranted. There are those who think Congress did not go far enough. They criticize as too conservative attempts to place limitations upon the holding company and would go further to a complete return to the old common law doctrine that one corporation may not own another.

It is not my purpose here to argue the merits or demerits of these solutions - the solution of simplification or the solution by disclosure. It is the application of the principle to a particular field that is of interest. It is not a principle that we as far-sighted citizens may lightly pass over. To dismiss by an empty characterization as novel and revolutionary an attempt to return to the original theory of American corporate life is to have no insight into the source of recent history. To reject it without some substitute solution for the pressing issue of making corporate enterprise both intelligible and responsible to the public whose savings give it being, is, in my judgment, not the perception of true conservatism but a stubbornness that refuses to concern itself with the destinies of our nation.

Perhaps it is too early to say whether our attempts to deal with this problem will ultimately prove successful. One thing, however, is certain. We have begun to define the problem, to examine it, and we have made a start at solving it. The principle of disclosure has come to be recognized and accepted both by management and by the financial community. The effects of these statutes have not only made themselves felt in the corporations directly affected by them, but have had repercussions in companies that have not had the occasion to assume obligations under them. With this spirit dominant, we need fear neither for ourselves nor for the future of our common enterprise.