ADDRESS

of

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Administrative Control over Corporate Finance

A librarian of one of the western states was recently telling of her difficulties in keeping intact a 1000 volume library which she had installed in the state prison. She had designated as prison librarian one of the inmates - an ex-minister. On one of her trips of inspection she discovered that 500 of the 1000 volumes had disappeared. She remonstrated to the prison librarian and told him frankly of her disgust at his negligent supervision of the library. He apologized profusely and then stated, "Madam, whenever you get several hundred men together you are bound to find among them a couple of crooks."

It was not precisely on that theory that Congress, in pursuance of its considered and informed judgment, enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. Those, whom your own memory associates with the feverish days of the late twenties, would probably fall in a different class. You probably would not designate many of them as crooks. In community circles they would be respected; in clubs they would be admired; in society they would be honored. Some were servants or victims, others were masters, of the system which brought corporation finance into such great disrepute.

Had the problem been one of dealing solely with those whom you and I would call crooks, it would have been a simpler problem. But the tast was not merely to catch crooks. In dealing with the fundamental problems of corporation finance the technique required was to establish in financial practices higher standards of ethics and morality to the end that investors might be protected and the public interest served. It had become clear to all attentive observers of finance, including the better element of business, that those higher standards of conduct were essential if the capitalistic system were to survive. Those engaged in manipulation were using other people's money; those managing corporations were managing other people's money; those seeking new capital were seeking other people's money. The demand was insistent that the activities of such persons be conditioned by the standards of fiduciaries or trustees. To that end the Securities Act and the Securities Exchange Act make measurable progress. They supply for the first time standards of conduct, welcomed by those who never desired or who certainly no longer desire to sacrifice ethics for expediency, but who in the competition and pressure of high finance drifted into the loose habits of the market place.

The Securities Act of 1933, as you know, calls for the full disclosure of material and relevant facts concerning the issuer before securities are sold. The Securities Exchange Act of 1934 sets up administrative machinery over stock exchanges, (and to a lesser extent over the over-the-counter markets) with a view of supplying reliable and current information concerning securities traded in on the exchanges and also with the view of preventing manipulative practices in such securities. It also requires adequate and truthful disclosure in regard to the solicitation of proxies and transactions by officers, directors and large stockholders in the stock of their corporation. Through the disclosure requirements of these statutes and of the rules and regulations thereunder the Commission has started on the task of policing the securities markets and of establishing standards for officers, directors, bankers, accountants and other experts who make or contribute to the representations which are made about securities.

As I have stated, the new codes of conduct which we are seeking to establish are not exclusively or essentially for crooks but for the run of the professions of banking, management, accountancy and the law. Successful administration will be measured not by the number of crooks who are incarcerated but by the number of leaders of the professions who either through compulsion or conversion respond to the insistent demand that those who have the powers of fiduciaries likewise assume the responsibilities. As a matter of fact, it is not too much to expect that if the first 100 of each of these professions seriously undertook to make permanent the fundamental changes in codes of conduct which this legislation envisages, the most difficult of the problems of administrative control over finance would be solved. For it must be remembered that they are the ones who not only handle the bulk of the most important financing but also set the fashion which those of lesser lights follow. Until that transformation takes place, administrative control over finance will not have been successful. And until such transformation takes place, one of the greatest hazards to any administrative agency in this field is that it will expend its energies and resources in pursuing the lesser lights whose importance is chiefly in the fact that they, like the poor, will be ever with us.

The factors that impede such transformation are numerous. Only two need be mentioned. In the first place morals in the field of finance have been too frequently determined by what actually prevails in practice. Once the tradition becomes established, lawyers, bankers, accountants tend to bow to it without question or hesitancy. It becomes the proper thing to do because it has always been done or because every one else is doing it. The conventions of the various professions are too often accepted without inquiry as to their social or economic consequences. The accepted way of doing things becomes the proper way of doing them. The ethics of the situation are subtly adjusted to conform to the requirements of the tradition. These traditions are chains which bind fast these professions to the ancient order of finance. They constitute one of the most potent imponderables which promises to delay the advent of any new era either in practices or in ethics.

In the second place concessions to any new order which are made will tend to be made solely in the interest of expediency. It is idle to say that the requirements of business are constantly going to be determined in light of the requirements of the public interest. The history of business reveals no such paramount importance of the public interest. Concessions to the public interest are frequently made. But the immediate requirements of management will tend to bow to the larger public interest only when necessary and to the extent that is necessary. It would be against all experience with psychological facts to expect sudden and permanent conversion. This in turn means that the bare minimam required by the recent legislation may be the maximum to be expected. This in turn means that once those bare minima are established they will tend to become a routine and hence a mere formality. They will serve as the offering at the alter of the public interest. Thus, once professional scriveners are developed it would be no great step to be able to make disclosure of material facts so blurred and so obtuse as to carve the heart out of the Securities Act.

That is to say, when disclosure of truth becomes an art and when avoidance of disclosure becomes a game, the essence and spirit of the new legislation will have become subverted although the formalities may have been fully satisfied. The immediate requirements of business will frequently make that objective seem to be a desirable one. For that reason no sudden transformation to any new era of finance can be confidently expected.

These matters are of importance in any administration of these acts. They mean that since social change is slow, an administrative agency would be innocuous rather than effective should it succumb to reduction of its requirements to mere routine and formality. Nowhere as in the field of finance is the requirement of flexibility of administrative action more clear. There are several phases of this problem.

In the first place, financial practices are not standard. They are varied and complex. They change constantly. They cannot be reduced to simple formulae. The requirements of business prevent it. The ingenuity of man forestalls it. It will be only the aggressive administrative agency which can keep pace with these developments. When it comes to disclosure of the truth about securities, forms get outmoded. What was adequate for investors under the original situation becomes inadequate as a result of evolution of financial practices. Somewhat the same thing is true of practices involved in the distribution of securities. New and different types of manipulation appear, more subtle in influence, more effective in result than older and grosser forms which we are quick to denounce. Alertness and vigilance supply the essential ingredients of thoroughgoing administration at this point.

In the second place, effective control calls not for the slower and heavier method of judicial decision but for the subtler and more sensitive control of daily administrative direction. This is not to say that studied efforts should be made to prevent parties from having their rights established by the courts of the land. Rather it means that adequate and effective methods of administration have never been and can never be fashioned through the judicial process. The residual group of cases susceptible of control by that process is insignificant. The battle will be lost through the fearfully cumbersome and indirect processes of the courts even assuming judicial approval or indulgence. Pools are run in weeks or months. Quick and immediate action is necessary. The most effective procedure will commonly be immediate investigation and disclosure with all the pressure which pitiless publicity entails, before the public is mulcted. That is to say, the battle will be won only by constantly progressive administrative standards quickly and surely applied and delicately adjusted to requirements of particular cases. Law suits and prosecutions will supply the final chapter to the story. In the interim preventive administrative action will reduce the losses to a minimum. The judicial process can thus be reserved to mark those significant milestones of achievement or those crossroads that indicate the direction in which constitutional control may be found. Thus it is that the most significant victories which will be won for investors will be found in those unheralded and perhaps unknown administrative sorties which prevent the happening of events which prove to be so disastrous to investors.

In the third place, this slowness of social change calls for administrative control which is constantly testing the validity of the fundamental hypotheses upon which our financial practices and our financial organization rest. All of us are prone to accept the validity of the normal and traditional manner of effecting financial transactions. The institutional method becomes the proper method. We are slow to question its adequacy or propriety.

The administrative task involves, at least in part, constant inquiry into the validity of these underlying assumptions. This is necessary (1) so that we may be certain that the traditional methods are not harboring a host of evils and abuses which an uncritical eye would fail to see; (2) so that we may be constantly ahead in the program of progressive reform to the end not only that we may be prepared for further change but also that we may anticipate change and pave the way for it by easy but direct steps. Such an approach not only gives vitality to our whole enforcement machinery, but also prepares us for the exigencies of the years which lie immediately ahead.

I need not multiply examples of the things I have in mind for you are all familiar with them. Margin trading is one. A thoughtful student of the subject cannot fail to be impressed with the naivete in the common assumption that margin trading is as essential to our welfare as is the Constitution. It may be. But it is an open rather than a closed question. The ramifications of that subject have never been adequately studied. I am confident that any administrative agency will be face to face with that problem ere it goes far in advancement of the solution to the problem of security speculation and security manipulation. Constant and attentive consideration of the incidences of abolition of margin trading becomes essential for the immediate and long range program of control in this field.

Another instance is the problem of the corporate trustee. We are prone to accept the validity and adequacy of the trust indentures under which bonds, debentures and notes are issued and pursuant to which the duties and obligations of the trustee are defined. The customary habit of thought precludes any serious questioning of the adequacy of that instrument from the point of view of investors. Such instruments are manufactured in law offices out of the traditional legal boiler plate which generations of lawyers have made standard. They are drawn with neatness and precision. They are administratively effective. Corporate trustees can do business under them. In other words, the system seems to work. But trustees acting thereunder can hardly be called trustees. They are stakeholders with immunity clause after immunity clause insulating them from liability and divesting them of responsibility. Yet the tradition that this is the proper way of doing it is so strong that the question, Why should not a corporate trustee be a trustee? is stilled, and the question, Can we not devise a system where the investors under such instruments will have a real guardian and protector of their interests? is seldom asked. Such questions are not asked because the traditional manner of doing things tends to foreclose critical analysis.

One further instance is the conventions of accountants. These tend to become fixed and ritualistic. They are likely to degenerate into shibboleths. Instead of being descriptive tags, accounting terms too often become vague and indefinite words of art, not pungent with meaning, not

vital with significance. Instead of accurately reflecting the true state of the financial condition and of the accounting practices of the company, they too often result in devitalizing the facts by forcing them into a mould which only traditional and conventional practices can justify. Accountancy at times may seem to be faced with a choice of two equally undesirable alternatives. The one is to standardize practices into a fixed and inflexible formula. The other is to forsake all conventions and make the formula fit the facts. Neither of these is the desirable alternative. Put up to date, little attention has been given by accountants to the problem of determining what the minimum or maximum acceptable accounting principles really are and what guides should be left for the residual cases which cannot be forced into any fixed mould. In this connection, certificates of accountants have tended to be accumulations of weasel words - evasive, general and meaningless. The true function of the public accountant - to subject to an impartial mind the accounting practices and policies of issuers - has too often been lost sight of. The consequence has been that protection to investors which might be afforded by the certificate has been sadly lacking. To be sure, some improvement has been made since the advent of these statutes. But the easy course is to succumb to the insistent demands for certainty and simplicity and to reduce the accountants' conventions to ready made and fixed formulae. It is this course which an administrative agency must resist. Effective resistance must take the form of constantly reappraising and testing the soundness and propriety of those conventions which tradition and practice have fashioned but which experience in the protection of investors shows to be frequently not only meaningless but misleading.

These are the general requirements of effective administrative action under the Securities Act of 1933 and the Securities Exchange Act of 1934. The problems of administration under the Public Utility Holding Company Act call for somewhat different techniques.

These utility problems are in some respects entirely different from those arising with respect to the securities legislation. Congress has consequently chosen a different method of administrative control more suited to the situation at hand. 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 draws 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. Under circumstances such as these, Congress determined that in this field simplification was warranted.

Similarly, it gives the Commission administrative powers which are broader than the requirements of disclosure. The Commission is vested with some control over fairness of terms and conditions of issuance of certain securities. It likewise may set certain criteria for management, certain standards for accountants. As the Commission moves into this larger area of activity perhaps it may be possible for it to fashion new precedents which will grow and flourish in other domains of finance. At least the opportunity exists to move directly towards such objectives.

These opportunities afforded the Commission in the use of a variety of administrative techniques are great. There are those who feel that there can never be effective social control over finance. They can cite in support agencies which started with promise but which became innocuous or ineffective either as a result of ineptness or as a consequence of being captured and controlled, by those whom they were supposed to control. But with the growing public and professional recognition of the permanent importance of these programs of reform and with the measurable progress already made, effective social control over finance becomes more than a possibility. If it ends in failure, I am confident of one thing - that it will not be due to lack of persistent, honest and aggressive efforts.