

The proponent of a change in the law at any time has a peculiar responsibility. In ancient Greece there was a little republic, inhabited by a people called the Locrians who had a salutary rule. When a man stood up in the assembly to propose a new law, he did so with a noose around his neck. If the law was adopted, he was acclaimed. If it was rejected, he was promptly strangled. When a Locrian suggested a change, therefore, he had to have a pretty good reason for doing so.

There is a good analogy between that situation and the position of a man who suggests a change in corporation laws today. He, too, has a noose around his neck, at least economically, because the group most interested in corporation laws have had things pretty much their own way for some time, and they have about reached a position which satisfies them. Virtually, the corporation laws of today permit any promoter of average ability to do almost anything he chooses. I shall revert to this in a moment; but I would like to make that point perfectly clear as one of the two horns of the dilemma in which we are. On the other side, there is a growing feeling that the average citizen who has saved some money and invested it in good faith is entitled to a reasonable amount of safety in his savings. He knows very little about the complicated processes of finance; and is as much in the fog as all of us about the obscure processes of economics under which properties are tremendously valuable today and worth rather less than nothing tomorrow. All he knows is that he worked hard, lived frugally, acquired a competence, got the best advice he could, salted down his savings, and now winds up an object of charity.

Obviously, there is something wrong here; and in this tangled system of government of ours there must be some group whose business it is to solve the difficulty. I take it the National Association of Security Commissioners is that group, if ever there was one. Not only that, but

this group realizes its function and responsibility; it has taken a creditable part not only among the local constituencies, but nationally, in demanding that the problem receive adequate attention both by passing uniform laws, and by receiving respectable attention from the federal government. I come before you quite frankly to plead a cause; and I am glad to do so, because this is the place where the cause should be pleaded.

The object of laws supervising and regulating the sale of securities is threefold. It took us some time to realize this triple nature; but we know it now. First, it was designed to prevent the pure swindle. That, of course, is primarily a police job; because the man who is engaged in selling gold bricks, or operating a confidence game, is not bothered particularly by Blue Sky Commissions. His business is akin to larceny; his job is to find a guileless prospect; separate him from his bank roll, and get out of town before the sheriff arrives. I should like to leave that problem on one side. The function of the Blue Sky Commissions in handling it is, I think, thoroughly understood; and while the problem is a large and significant one, it is by no means the major problem.

The second problem has to do with the local enterprise which seeks to attract investors-- the real estate financing of the new hotel down the street, the local group which wishes to sell stock in a new factory, the kind of enterprise which peculiarly operates within a single state or a single community. That problem again, is important; but it is a problem peculiarly adapted to the habits of each locality; and it is almost impossible to lay down any uniform rules. A considerable amount of the country's savings is invested in this class of enterprise. But it is still, relatively speaking (at least in terms of dollars and cents invested) not the great question of today.

The third, and by far the greatest, avenue by which savings are invested, is the avenue of the corporation having an interstate, and often a national scope, making a country-wide plea for investment, operating through the national machinery of investment bankers, and quite commonly using the machinery of one of the stock markets in connection with its securities. It is, I think, with this last problem that this national conference is most vitally concerned. The swindler can be handled by close local attention. The proper safeguarding of investments in local enterprise can be handled by careful and sympathetic attention of each Blue Sky Commission within its own state. But nothing save a general agreement, or federal legislation, or both, can make possible the clean functioning of Blue Sky machinery with reference to the large securities issues.

I may as well state at once my conception as to the heart of the difficulty. We have framed our laws on two theories at once. Worse yet, the theories are inconsistent. We have arranged our corporation laws so that anything and everything, honest or dishonest, could be done by the promoter in control. At the same time we have been steadily endeavoring to arrange our Blue Sky laws so that we could prevent or correct fraud or undue manipulation in the sale of those securities. Which has produced about the same result as though you were to set the scrub lady to mopping the floor, leaving the spigot turned full on. In all humility I submit that something has to be done about this; and that the way to do it is to try to bring the two sets of legislation into something like approximate harmony.

I realize the extreme difficulty of tinkering with corporation laws. On one occasion I was invited to attend the meeting of the group which was revising the Delaware Corporation Law. A couple of proposals were made which, it seems to me, opened a wide door for manipulation or sheer dishonesty. One of them, for example, was the provision allowing the directors of a

corporation, without previous notice, without consulting their stockholders, and without supervision, to issue options to purchase their stock at any price that they might think fit, the options to run any time or forever. It was the simplest and easiest means for diluting the last ounce of substance out of the stock issue ever devised. I objected that this left no safeguard to the honest investor in the stocks of Delaware corporations whatever. The group--it was a New York group, because they make the Delaware corporation law in New York, representing such famous financial institutions as Insull Utilities, Goldman-Sachs Trading Company, Kreuger & Toll, and others--said at once: "You have to assume that the men running finance today are essentially honest, and that they are essentially using their judgments to protect their investors. You can never prevent the crook from taking advantage of laws; the laws must be devised on the theory that the financial community realizes its responsibilities." The argument lacked conviction to me, because I was aware that even assuming the honesty of everyone in that committee, there were plenty of people not there represented who would be likely to abuse the privileges which the Delaware Corporation Law might give them; and I asked leave to withdraw. Subsequently, it developed that even the financiers there represented, supposed at that time to be New York's finest, had a conception of responsibility sufficient to shock the country and ruin every investor who relied on it.

Accordingly, I make it my first point that we can not permit our corporation laws to be run on the theory that all financiers are responsible; and that the only person who might abuse them is the crook who is likely to wind up in a police station anyhow. It is pitiful to have to admit that in the struggle to determine whether the higher or the lower banking ethics would dominate, the lower prevailed; and it did not prove equal to the strain of directing the flow of the country's savings, and protecting the use of those savings. But in the face of the situations which

are being developed day by day, there is no point in denying that fact; we might as well reckon on it first as last and go on from there. The conclusion is obvious. Corporation laws must be so drawn as to include standards of business conduct.

The second great principle in this business, likewise developed out of the recent financial disasters, is that you cannot end your supervision of securities at the time when the issue is floated and the sale is complete. Heretofore we worked on the theory that the only time when a man was likely to be defrauded or irresponsibly parted from his savings, was at the day, hour and moment when a security was sold to him. We know now that that was a short-sighted view. It was very much as though a bank commissioner should say, "I will take every care that the bank when it opens shall be solvent, responsible and in the hands of honest men. No one shall deposit his money except in a bank which I approve. But after the bank gets the depositors' money I have no further interest in it; the honest management may sell its control to rascals; the management may play ducks and drakes with the depositors' money; it is no concern of mine. That is the risk which a depositor assumes when he puts his money in a bank." This would be simply absurd. Yet our corporation laws are so framed that an issue, perfectly straight when put out, can be converted into a mere fraud overnight.

If the system is to work at all, we not only have to see that the security is straight when sold, but that it stays straight thereafter.

How can we achieve these two results? As I see it, the time has come when we must regretfully abandon the policy of drawing up so-called "free" corporation laws. I still feel that there is a place for the corporation law which allows a group to do anything and everything they please, and to invent any kind of arrangement the English language will permit. But I do not think that this kind of corporation ought to be allowed to go out in the highways and by-ways

and bid for American savings. The initial change, then, ought to be dividing our corporation laws so that we have one law for the private group of gentlemen, say thirty or forty stockholders, who want to have a private business; and a second type of law for the corporation which is going to make a public bid for funds. This is the distinction made in England; and it is perfectly sound.

I think we are entitled to require certain things of a corporation bidding for public savings. First, its capital structure should be simple. By this I mean that it should not consist of a piled up tangle of weasel securities relating and interrelating so that nobody but an expert accountant can figure out the exact position of any share of stock in the picture. I can see a place for the corporation with common stock only. I can see a place for the corporation with standard preferred stock on top of that. I can see that that preferred stock might be either cumulative or non-cumulative, though the latter is not a type which any investor in his right mind ought to buy. I can see, also, that a corporation may need first preferred and second preferred. All these, if of standard types, can be comprehended by an investor. I do not, however, believe that we ought to go very much beyond this point. I think the investment bankers probably would welcome this; because even they and their clients are getting to feel that a complex corporate structure makes it extremely difficult to sell the security.

Now it is too much to expect that forty-eight states of the union will amend their corporation laws in any such respect as that. Nevada, for example, which buys few securities, but incorporates a good many companies, would have very little interest in limiting the freedom of action of her corporations, because by and large her business is not investing money but furnishing charters. Nevertheless this result, or something very like it, can be obtained and in fact is likely to be attained in one or perhaps both of two ways. We are about getting to the point where there will be federal legislation, and possibly even federal incorporation. It is not a

pleasant thing to contemplate; it ought never to have occurred. But the combination of a certain venality among the charter-mongering states, with an irresponsibility in the financial districts, has brought us to this pass.

A second method by which this can be brought about is the right in the various states, which means in substance you gentlemen, to protect investors by passing upon the fairness of the financial scheme involved. Many Blue Sky laws do not, of course, give this discretion. But a good many do; and the discretion there can be applied so that the "trick security", the tangled corporate pyramid, the triple super-holding company whose ramifications nobody can work out, is not allowed to sell securities. A short while ago there would have been a tremendous outcry against this proposal by the various states. Even investors would like to have their chance to buy any kind of security they like. Yet those same investors today shed bitter tears because in 1928 and 1929 somebody did not stop them from buying Kreuger & Toll and Middlewest utilities. The country at the moment is in a different mood.

Along with a simplified corporate structure, there should also be regular, continuous and supervised publicity of accounts. My friend, Professor Ripley, has advocated this for years; and a country which does not stay foolish all the time is at length realizing that the dear old professor knew what he was talking about. One of the major parties in this election has adopted it as a cardinal point in his financial program; Governor Roosevelt at Columbus the other day made a brilliant and forceful argument in that direction, to which not even his bitterest opponents have yet made any answer. The New York Stock Exchange is for it, in a somewhat modified sense; and I believe that we shall have publicity of accounts and supervised accounts before very long. It may surprise you to know that the United States is almost the only civilized country in which the books and accounts of a business enterprise are not open to inspection. Abroad, those same

books are part of the legal mechanism of the company; and the state has jurisdiction over them. In England, there is an officer of the company separately elected by the stockholders, whose business it is to maintain a running audit. Only in America can the corporation take the attitude that its stockholders ought not to know too much about its affairs; and at the same time insist on a continuous public market for its shares in the stock exchange. This is a job, I believe, for the securities commissions. If the federal government ever occupies that field, it will probably be unnecessary for state commissions to undertake the job of insisting on regular reports; but until that time, I think the Blue Sky Commissions in the various states can do a good deal. It is true that the Blue Sky Commission, say in Ohio, does not have jurisdiction over a Delaware corporation. But the Delaware corporation has no particular business to come into Ohio and sell securities, except on terms; and one of those terms can easily be that the corporation shall make an agreement with the securities commission looking towards publicity of accounts, properly audited. And if Ohio, which through the foresight of my friend Edwin Marshall of Toledo, has an extremely good corporation law, permits a Delaware corporation to come in, it can require that the Delaware people offer to Ohio citizens at least as much protection as Ohio requires of its own home corporations. We have, I think, become a little flabby in handling state jurisdiction. There is no reason why a state which wants to run its affairs carefully should necessarily permit the evasion of its own well thought out requirements simply because a group of men get a charter somewhere else, returning home to flourish that charter before the authorities of the state in which they expect to operate, or in which they expect to sell securities.

Third, we must, regretfully, repeal certain exemptions from the Blue Sky legislation. Many, perhaps most Blue Sky laws contain a clause by which securities listed on the New York Stock Exchange and certain other exchanges, either are definitely exempted, or may be exempted

at the discretion of the Commission. There was good reason for doing this. All the world knows that the New York Stock Exchange especially has been a pioneer in endeavoring to secure responsibility from corporate managements. Yet I think even the stock exchange governors themselves would concede that the going had been pretty rough. Specifically, the worst losses we have incurred have come from the stock exchanges, though the Boston and Chicago exchanges have a considerably worse record than New York. Even New York, however, cheerfully listed the stocks and bonds of the Kreuger & Toll companies; and it has a couple of other incidents to its credit, making it clear that there is some distance to travel. One of the most enlightened presidents the New York Stock Exchange ever had, Mr. E. H. Simmons, speaking of just this subject, in 1925, observed, “

“The typical American procedure has been to allow fraudulent corporations and fraudulent securities to be created wholesale, and then to pursue frantically the individuals who sell them to the public”;

and in pursuance of this view he, more than any other man, started the drive towards tightening the restrictions all along the line. It is no disgrace to a brave and far-seeing man, to note that the dance of the millions from 1926 to 1929 left the really essential remedial work of the stock exchange far behind. No, we cannot leave the protection of investors longer to the stock exchange committees. It means more work; but one Insull incident is enough for a lifetime.

Everything discussed so far has been structural. We have been talking first about simplifying corporation structure; and then about publicity of accounts; and just now, about subjecting all corporations to the supervision of the Blue Sky Commissions, quite irrespective of their financial sponsorship. But you realize that these are only the externals of the problem. We have to go farther than that.

Granted a reasonably simple corporate structure, with a clear set of accounts, and you have the foundation on which an intelligent policy of protecting the investor can be based. Presumably, in such case, he can look at the accounts and see what the company is doing; and he can look at his stock certificate or his corporate charter, and know what share in its fate belongs to him. I do not go along with my friends who insist that all you need do for the American investor is to give him information. That is true as far as it goes. But when the information you give him relates to a legal situation which only a battery of Philadelphia lawyers can untangle, and when the accounting and financial information you give him can only be unsnarled by a process of differential calculus, it is foolish to say that you are adequately protecting him by information alone. I remember one famous case in which the information, God knows, was accurate enough. It was a favorite of the New York and Boston stock exchanges. It sold stock among other things on the basis of a statement of earnings showing some \$12 or \$13 per share. At the bottom was a statement, "This does not include earnings of subsidiaries". The fact was that the subsidiaries of that corporation had been losing far more than the total income of the parent company; and a consolidated earnings statement would have shown them in the red. The information was diabolically accurate; but it was the kind of accuracy which leads you farther astray than a straight lie. You give accurate information to the stockholder of a Delaware corporation when you tell him that he has one share of common stock subject to all the provisions of the charter and the Delaware law. But neither he nor anyone else can tell what the implications of the Delaware law are; and only high priced counsel can tell him with any definiteness about the charter; and only God Almighty can tell him whether the charter will stay that way or the Delaware law will stay that way, in the next six months. No, we need something more than information.

There are only two ways yet known of protecting investors. One is flatly to prohibit certain kinds of corporate activity, trusting that you will catch in your net of prohibition the dodges through which investors' savings are usually lost or dissipated. That is not a good way; because the business processes of today are complex; conditions change overnight; honest corporate managements not only want but thrive under a wide freedom of action. The other method is to give your corporation pretty wide latitude in what it does, within reasonable limits; and then make your directors and officers personally liable for any abuse of the machinery. In substance, you can say to people, "Take all the power you want; but you, individually, are responsible for the use of the power". I think by a process of common law we are getting to this latter view; but whether we are or not, it is pretty clear that legislation will put us there before very long.

I therefore offer, as a fourth point in this program, legislation tending to place all directors under direct personal responsibility for corporate manipulations in which they are directly or indirectly interested. In part this would be declaratory of the common law; in part, it would carry the liability one step forward; but it would be salutary.

And as a fifth and last proposal, I have a radical suggestion to make. This is, that the enforcement of such liability on behalf of the stockholder be permitted to be exercised by the Blue Sky commissions of the various states in which the securities are sold where, in the discretion of that commission, that action seems necessary. In other words, I do not feel that a single small stockholder runs a fair chance when he is pitted against a corporation. He has not the corporate treasury with which to wage the battle; and they have the information. He can get together in a committee, of course; but you will generally find that the stockholders' committee when it finally works itself into the clearing, is composed of people whose interest is more in

protecting the Board of Directors and the corporate management than it is in protecting the stockholders. This is a legitimate function, it seems to me, for a Blue Sky commission to assume when absolutely necessary.

This discussion is already over-long; and I need pause only to summarize.

1) We should distinguish between corporations whose securities are to be sold to the public, and corporations for private use only. The former should be limited to simple capital structures more or less standard in type. Since the amendment of corporation laws in this sense is a long job, if not impossible, any state which agrees with this point of view can decline to permit the sale of securities within its borders, unless those securities are in a corporation whose structure is approximately simple and approximately standard in type.

2) The stockholder, and business in general, is entitled to standard, regular and public accounting. Pending the necessary federal legislation on the subject, I believe that securities should be permitted to be sold only where the state issuing such permission conditions it upon an agreement, properly guaranteed, that the corporation will issue to the securities commission regular accounts which shall be documents of public record.

3) The traditional viewpoint under which securities listed on the New York Stock Exchange and other similar exchanges may be exempted from the "Blue Sky" scrutiny must, regretfully, be abandoned.

4) To the extent that we allow managements wide power in corporation laws, we should strive for a legislative declaration of the personal responsibility of those directors for the result.

5) The securities commissions should exact by agreement a declaration of such responsibility; and should, likewise by appropriate agreement, accept the function of enforcing that liability where there is no other practicable way of doing so.

I have tried, in working out this program, not to do what I should like to see done, but merely to hit the limit of practicable reform at the moment. There is no use, however, in concealing the fact that really there is a much larger task in view. The job of investment banking and sale of securities is the job of directing the capital of the country. In theory, that job must be so handled that at all times the banker keeps in mind the economic balance of things; withdrawing credit when the field is over-crowded, supplying it when it is under-developed; and the like. American bankers not only did not assume this responsibility but took the view that their job was exactly the same as that of the peddler of neckties on the corner. It may be that the banking community will have another chance to redeem its reputation; but it is at least fairly possible that the difficulties in which we now are will go so far that no one will care to risk that second chance. In that case we shall find that the job of protecting the American investor from "fraud" has been expanded to protecting the investor against sales of securities or applications of capital which are economically unsound. For that reason, I would suggest that all of you watch out a little in the direction of economic information. The time may come when before you allow a security to be sold in your state, you will ask whether the particular steel company issuing that bond is needed in the world, whether there are not already more steel plants than the country can hold; and on some such basis as that you will disqualify the security. When that happens, as it well may, you gentleman will replace the elder Mr. Morgan and men of his type in determining how the country gets developed. In suggesting a far more conservative program than that, I have

the distinct hope that the larger responsibility may ultimately be avoided; and I have no wish to see either the federal government or a series of state governments undertaking to govern the flow of capital. I think, however, that the alternative is plain. Either the governments will assume that responsibility in the face of a tremendous popular demand; or else the situation will clean itself up by the adoption of remedial measures along the lines I have suggested. Their adoption is, in my view, the best insurance possible for the continuance of the system under which we now live.