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BIG BUSINESS, WHAT NOW?

by
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EVER since the election, this query has arisen on all sides, especially among businessmen and financiers: "What will the President do with the tremendous new power at his command?"

This question is the result of a political phenomenon -- a popular and national verdict, almost unanimous as to states; a President beholden to no class or group for his re-election; an opposition reduced to legislative impotence.

It is not surprising that leaders of finance and business are bewildered, sensing their misunderstanding of public opinion with respect to the policies of the President and their own.

This query has often been addressed to me, among others by the editor of THE SATURDAY EVENING POST. In my opinion, there is another query which needs to be answered first, and I venture to propound it in return. It is: "What will the leaders of finance and industry do, in the light of the recent election?"

If these leaders continue to display an unrelenting disposition to hold fast to what they too long considered their prerogatives, and thus ignore the implications of the election of November 3, 1936, I feel sure that the powers of the Federal Government will perforce be extended. The dear days so happy in retrospect for the few are departed, never to return. The people of the United States will not soon again elect a government of the old Republican type, regarding itself as an agency of the privileged. Not soon again, if ever, will we establish in office the philosophy that the welfare of the nation is advanced if we guarantee prosperity for the few. An English friend of mine puts the situation best: "There cannot simultaneously and successfully exist in the same nation a political democracy and an economic oligarchy."

The Burning Question

But the immediate signs are propitious among the leaders of business and finance. The day after the election, the sign "Business as usual" was hung out. There were, to be sure, some disappointed faces, but, generally, the verdict was accepted in sportsmanlike spirit.

The will of the majority has prevailed. The question is: How long will this feeling endure? That is for the leaders of business and finance to answer, and upon their answer, I think, depends the immediate future of legitimate business management in the United States.

It may be recalled that about two days after the election there was published an exchange of letters between John D. Rockefeller, Jr., and the Democratic National Chairman, James A. Farley. Mr. Rockefeller congratulated Mr. Farley for his statement of election midnight in which he promised that "there would be no reprisals." Take Mr. Rockefeller's letter as symptomatic -- good as far as it goes. But if it were followed by a thousand other such letters, it would be of value only if fortified by an attitude in consonance with the sentiment therein uttered. This sentiment would amount to a pledge that business will co-operate with the President in his labors for a permanent recovery.

An Eight-Point Treaty of Peace

But in what spirit and on what terms is that partnership to be based? During the last campaign, the spokesmen of important business and finance were, so far as could be ascertained from public appearance, overwhelmingly opposed to the re-election of the President. Rare, indeed, it was to find an important executive who took the other position. In some instances, when an officer of a large company showed a disposition to foresee the popular determination better than his fellows, he was bullied or cajoled into lining up with the rest. One result of this has been, in my opinion, unfortunate. It was not unfortunate in its effect on the result, for a popular majority of eleven million votes and an electoral success in forty-six of the forty-eight states demonstrated the futility of individual positions. But the misfortune lies in the fact that many men who, by their experience and patriotism, are best qualified to advise the Congress must bring their advice into a hostile atmosphere of their own creating.

Possibly because I was not one of those who responded to the pressure or emotionalism of my natural business friends and associates, I have been asked, as in this instance, to offer an opinion as to what the future relations of Government and business should be. Accepting that role, though protesting my inadequacy for it, I venture to make certain proposals to those sections of American business and finance which have at last become aware of the direction in which the sovereign people have ordered the American Government to go.

There are, of course, a great many program items that space will not permit me to enumerate at this time, but I should like to mention eight points to which business should give careful consideration:

FIRST. Industry should lead the way in reviving the good aspects of the NRA, with the ultimate object of providing more employment in the United States and the elimination of unfair trade practices. This revival need not include government by executive order and

remote control by Washington of the smallest concerns of village life. Those mistakes, natural to a hasty formulation, were swept away by the unanimous Supreme Court decision, and I do not understand that anyone in authority at Washington wants to revive them.

SECOND. A great many objections have been levied against the Social Security Act -- objections relating primarily to method, and not to objective. We should remember that it has taken England more than twenty-five years to arrive at a workable plan of social security. But there are a great many points in the current act that must be studied in order to make it practical. Industry, instead of offering all the objections to the plan that can be thought of, should, out of its experience, offer ways and means to make it workable.

THIRD. Industry surely recognizes the attempt of the President and the State Department to generate more business in the United States through the reciprocal-tariff treaties. It, therefore, should become the object of finance and industry to assist in perfecting these treaties to their stated end of recapturing some of the lost foreign trade.

FOURTH. The financial community should address itself to a plan whereby corporations held by the public shall more generally be run for the benefit of stockholders instead of that of the management. Up to date, management has proceeded as if in ownership of these corporations.

FIFTH. Federal legislation to reform investment trusts should be welcomed by the financial community.

SIXTH. Federal legislation to reform reorganization committees formed for the benefit of security holders should be welcomed by the financial community.

SEVENTH. Business leaders should give cordial consideration to Federal incorporation for the purpose of acquiring a uniform law under which all corporations can work.

EIGHTH. Private bankers should be eliminated from control and management of corporations.

Heeding the Voice of the People

In these suggestions I have discussed attitudes for both the business and financial community, but, space not permitting amplification of the items affecting both groups, I shall confine explanatory details to the field in which I have had most experience -- the financial. I venture these suggestions in the hope that business and fiscal leaders have accepted the 1936 election as a most decisive factor in our economic history and in that spirit will read the President's second inaugural, about to be delivered.

That election has properly been described as a triumph of the democratic process. While interpretations have differed here and there, these conclusions were virtually unanimous: That an overwhelming majority of the American people told the President to go forward with social and economic reforms and said they wanted business and finance to co-operate in carrying out his general ideas; that no group or party can claim credit for the President's victory and thus demand a controlling part in the Government.

In accepting these interpretations, which, indeed, must appear logical to any thinking man, the leaders of business and finance must perforce accept the new day and labor in its light. The dictates of successful private management are firm that they should so proceed. They can, it is true, point to the seventeen millions who, for one reason or another, and on arguments real or spurious, voted against the President. But in this country we abide by rule of the majority, and this is the third time the President has submitted his cause to the people. It is notable that on each submission the mandate grew -- especially in the congressional election of 1934 and in the presidential election of 1936. On both occasions the sole issue was: "Shall the President proceed as he thinks best?"

I am assuming that business and finance will accept this condition with a certain amount of thankfulness -- thankful that many irresponsible elements in our political life opposed the President; thankful that, because these extremists did not support the President, they cannot now rush forward with claims for recognition. The position of business and finance would now be far more difficult if these temporary associates of theirs had been on the winning side.

I am assuming, also, that business and finance now realize that the great weaknesses of their Republican political allies were: Their failure to repudiate the old order; their blindness to the need of change; their failure to recognize that the American people are permanently disillusioned with the leaders of 1929; their failure to conceive that such generalities as "The American Way" are not sufficient to erase the memory of the people. It is a fact that only a handful of the leaders of business and finance have, since partisan politics succeeded the emergency spirit of 1933, shown a real spirit of co-operation. The financial community reassumed its view of the Government as an alien thing, to be resisted or controlled. Through the press and otherwise, by radical vituperation and through mass resort to the courts to enjoin the process of government, the Administration was pictured as an enemy of honest enterprise. "Finis" should be written to all that.

A Basis for Co-operation

Hardly a thought was given, from 1934 to 1937, to the gradual evolution in this country from less to more government regulation in order to meet the baffling problems of a modern complex society. But assuming this neglect is now relegated to the past, I have ventured to outline my ideas as to how business could cooperate under the new order.

Since the President has been established by the vote of the people in 1934 and 1936 as the national leader in economic as well as social affairs, I revert to what he said in transmitting the Securities Act of 1933: "What we seek is a return to a clearer understanding of the ancient truth -- that those who manage banks, corporations and other agencies handling or using other people's money, are trustees acting for others." This is the basis for any financial corrections that must come. In the same fashion, the President at that time gave life and renewed meaning to the simple code of fair dealing as applied to the stock exchanges and the monetary markets through the enactment of the Securities Exchange Act of 1934. An investigation by the Senate had revealed the shocking disregard of elementary honesty and the unwillingness or inability of those known as leaders to assure the American people that markets would be free of unfair practices.

In this spirit, American finance should itself begin really to deliver the control of business corporations to their stockholders, proceeding to do these things:

Corporation boards of directors should be purged of persons who serve as officers of banks, trust companies, investment-banking houses or similar financial organizations. Banks and bankers should not be permitted to control the affairs of corporations in which they own little or no stock.

Here are some examples of the workings of the present system:

A leading private banking firm has for many years held a dominant position in our largest utility company. This position has been held not through ownership of a large percentage of the stock, for the stock is scattered among half a million stockholders, but presumably through personal contacts and control of the proxy machinery by the management.

During the past year, this company has been refunding many of the bond issues of the system. The syndicate for each issue has been headed by the private bankers referred to and the spread has been, uniformly, two points. The issues have been of the highest grade and could have been sold many times over with no effort on the part of the bankers. A one-point spread would have given them a good profit. A number of issues of smaller New England utility companies have been offered for public bidding during the past year or two. In almost every case, the issues brought a higher price than was expected and were sold to the public with only a small spread. Within the past few weeks, a power-company issue of 3 1/4's was purchased through competitive bidding by a syndicate at about 102 1/2 and resold to the public at about 103 3/4. These are good bonds, but not comparable in quality to most of the bonds of the larger system.

During 1935, a leading New York banking house handled two large industrial-debenture issues for a fraction of a point. It is understood that the firm made a good profit on the issues and was planning to handle several more on the same basis. The deals were very good for the industrial companies, as they cost very little and resulted in large savings in fixed charges. Presumably, many more industrial companies would have done similar

financing. However, it is understood that most of the large investment bankers commenced to boycott the house which worked for such a small profit, and, as a result, that firm bad to discontinue the type of business mentioned above.

When Bankers Step In

A large utility concern has for many years been directed in its financial affairs by a fiscal agent for the company in New York. A few years ago, the latter suffered reverses. At the time, it owed the utility, as a deposit item in the capacity of fiscal agent, about $2,000,000. The deposit liability was settled by the giving of a note secured by residence real estate. This note has been carried by the utility for a number of years as a cash item. Banking control made such a predicament possible.

A leading New York bank has for many years been in close contact with a leading power and industrial concern, presumably due to former personal relations between bank officers and corporation officials. Now the bank owns about 17 per cent of stock, most of which, presumably, came from a loan defaulted by an official of the corporation. The bank now controls this giant enterprise.

In 1929, a group of New York investment bankers acquired at a high price a large interest in a leading utility. In 1930, they formed a corporation to hold this interest. About $25,000,000 had been borrowed from banks to make the acquisition. With the depression, earnings of the system declined. However, in order to get funds to pay interest on the bank loan and to reduce it, these investment bankers forced the utility to continue to pay dividends, even though not earned and even though the company had a $25,000,000 maturity in 1935 and no means in sight of meeting it. As a result of this dividend policy, the company was unable to meet the maturity in 1935.

High and Low Finance

The indications are very strong that the principal reason for the acquisition, in 1929, by the New York investment bankers was to enable them to get in on the financing of this large system. In 1935, the utility probably could have got holders of the $25,000,000 debentures to extend the issue for five years. If no commissions were paid to get bondholders to extend, no registration under the Securities Act of 1933 would have been required. Many companies obtained extensions in this manner. This utility, however, chose to register under the Securities Act and pay investment bankers -- who controlled the company -- two points to get the bonds extended. The original agreement with the bankers even provided that on bonds held by the bankers themselves, and extended, the bankers should be paid the two points for getting themselves to extend.

As a result of the plan to give the bankers two points, the company had to register. It filed a registration statement so complicated that only by great skill and great patience did the SEC learn the real story. It required six months of effort before the registration statement

could become effective. Incidentally, in the process the SEC required a complete recasting of the financial statements in order to reveal what had been concealed -- to wit, that for a number of years dividends paid had exceeded net earnings. The bankers were not able to secure the consents of a sufficiently large number of the bondholders and late in 1935 the utility took steps to reorganize under the Federal Bankruptcy Law.

This affair cost the company several hundred thousand dollars in accounting, legal and other expenses as well as several hundred thousand in bankers' commissions, all futilely expended. It probably cost the company a million dollars of unnecessary expense and resulted in great loss of value of holdings to security holders. The investment bankers, however, got their commissions.

Recently, the SEC made a study at the request of Congress. This study showed serious shortcomings in our institution called the corporate trustee and in the protective-committee device which was supposed to be a method of protecting the holders of defaulted securities.

Basically, the problem arises because of the helplessness of the individual security holder. The poorer he is the more insecure his position. Let us consider the case of Mr. A, who owns a bond of the X Company, which has defaulted in its interest. The Y Trust Company is trustee under the mortgage. It alone can institute proceedings to foreclose and to take the steps necessary to protect the security holder. The researches of the SEC have disclosed that this company which calls itself a trustee is in effect a mere stakeholder. Although the sale of the bonds has been aided by the prestige of the Y Trust Company, it gives the individual security holder practically no protection and has assumed numerous relationships which make it almost impossible for it to concern itself with the rights of the bondholders. Mr. A has no one who acts in his interest either to prevent abuses by the issuer or to protect him when loss is threatened.

A Misleading Word

There never was a more misleading term than the word "trustee" as applied to this situation. For years and years, the ingenuity of the Wall Street lawyers has been devoted to devising language which would immunize these trustees, so-called, from any sort of liability, with the result that for all practical purposes the elaborate indenture is mainly concerned with what the trustee need not do, what it is not responsible for, and how much it is to be paid for the elusive benefit conferred. The term "trustee," as applied to the present system, must be abolished and some method devised to assure the small investor that he will receive from the agent who represents him a reasonable amount of protection against the wrongs of the issuer, even if the agent is to receive a larger compensation.

Protection That Doesn't Protect

The activities of protective committees constitute one of the most dismal chapters in the annals of American finance. The theory of a protective committee is very simple. A company gets in financial difficulties. A single security holder cannot act effectively for himself. Hence a committee seeks to secure authority to act for the security holders. But in practice it has resulted in the most vicious kind of imposition, double-dealing and downright fraud. The investigation by the SEC has revealed two general types of protective committees, and in their practices there is little to choose between them. The first, and by far the more common, is the investment banker committee, and the second is what might be called the entrepreneur type, which is sponsored, usually, by a lawyer and is seldom but a racket for fees.

The investment banker who sponsors a protective committee usually justifies his conduct on the ground that he is protecting the investor to whom he sold securities. This is seldom, if ever, true. The investment banker, except in rare cases, organizes these committees for selfish purposes, and the interests of the security holders are a secondary consideration at best. The record of the commission's investigation teems with instances where there existed major conflict of interest. In many cases, the investment bankers organized committees to act for one class of security holders when they themselves held large blocks of a different class of securities. There was bound to be a conflict, to the detriment of the hapless and helpless investor. In the field of foreign defaults, the investment bankers were frequently found to be negotiating for the holders of long-term debt while at the same time they were owed by the issuer on short-term notes. Well, who won second prize? You guessed it. The bankers did not.

In many instances, the bankers organized a committee for the express purpose of taking command of the reorganization and, by covering up the evidence of their past wrongdoings, insulating themselves against liability. In practically every case, the bankers were motivated by a greedy desire to preserve or secure control, so that they might enjoy the perquisites thereof. This is the equivalent of what we call "graft" in public life.

In addition to all these factors, the legal fraternity have distorted, by the most ingenious phraseology, a simple relation of principal and agent into a status where the agent lays down all the conditions and the principal who owns the security and does the hiring has nothing to say.

After signing on the dotted line, the principal finds himself bound hand and foot by his protective committee. The immediate query is: "Who is being protected?"

As for the entrepreneur legal racket, a measure of discretion in the Securities and Exchange Commission could easily outlaw the type of racketeer and still leave room for honest and vigorous minority committees to watch the reorganization.

I will hazard the guess that the Congress will abolish the institution of the investment-banker committee as it now exists. The record reveals that they have betrayed their trust.

The SEC is now conducting, at the request of Congress, an investigation into the history and practices of investment trusts. For months the press has reported results of this investigation, and the record is a disgraceful one. Every type of corporate evil that one could imagine has been shown in this study.

Investment Trusts

It is really a paradox that our banks should have been the subject of such legislative concern almost from the beginnings of the country while investment trusts have avoided practically all Government supervision since they first developed in this country after the war.

As a matter of fact, in one respect the investment trust needs greater supervision, since the security holder is unable to demand his money, as can a bank depositor. Consequently, the very threat of deposit liability is a veritable sword of Damocles over the banker's head -- a threat, unfortunately, not present in the case of an investment trust.

Our old friend, duality of interest, is found most frequently in this form of institution.

The investment banker in this field has played a major part as sponsor, with the usual result. The record is replete with instances where these bankers have served their selfish interest over that of those for whom they were trustees. There is no more justification for an investment-banking house sponsoring and controlling an investment trust than for a commercial bank to do so. The potentiality of evil is present and the choice of masters is inevitable. The relation itself should be outlawed by statute. In this way, the dealings as principal, the brokerage fees, and such perquisites as the insurance business of controlled companies, will be eliminated.

Strangely enough, there was hardly a witness at the commission hearing who did not espouse the cause of Federal regulation of investment trusts. It is to be hoped that Congress will act in a thoroughgoing manner to give renewed meaning to the fiduciary concept so ably championed by the President. Today we see on all sides the evils of investment bankers serving on industrial corporations. If our premise be valid, this practice must end, and I venture to predict that it will be outlawed.

I could fill many pages with recitals of how this relationship has been prostituted in favor of the banker and against the best interests of the issuer. Excessive financing, excessive underwriting charges, excessive bonuses, improper loans and a host of other evils -- which, if they occurred in public life, would be unequivocally condemned as graft -- are of frequent occurrence where this relationship persists.

Multiple Directors

Quite apart from the morality of the situation, the economic arguments seem to favor the abolition of this conflict of interest. The investment banker, if he is conscientious, has a full day's task attending to the job of being an investment banker. The law should not ignore how little can be done by one man, no matter what may be his reputation.

When one takes into account the strict obligation which is supposed to be assumed by a director, the high standard of care and good faith, the case of one gentleman, a director in fifty-eight corporations, looks a little ridiculous. It is utterly impossible for him to serve adequately on the boards of one-tenth of these companies. Yet in mere numbers there is not only financial prestige but the inevitable perquisites.

Of course, the forms of polite society are observed. Thus: At a meeting of the directors of a New York transportation company, the subject of issuing bonds was up for discussion, and the minute book records that this director left the room. Then the issue was voted and his firm was named as principal underwriter. The minute book then records that the multiple director came back, but fails to tell us how surprised and pleased he must have been at this little evidence of his fellow directors' confidence.

The fact is that an investment banker should act as a financial adviser to a corporation and should not act as part of the management. In the first place, the relationship is morally wrong; in the second place, it is not efficient, and, in the third place, the reason advanced for the practice -- that the investment banker must watch the issuer, in the interest of the security holder -- is not a valid one. The time to watch the issuer and form a judgment about the trustworthiness of the management is before the money of the public has been taken.

To these details of present imperfections in the private fiscal system, and to these suggestions of reform, the response of American business ought, in my opinion, to be candid recognition of the evils, admission of the need for reform, and constructive and fair-minded countersuggestions.

These are some of the outstanding evils in the conduct of capital and finance that need correction. But there are two suggestions I am taking the liberty of making herein for real consideration by Government authorities. These suggestions have two purposes: The establishment of the safe-and-sane economic conditions to effect which President Roosevelt has pledged himself; and real and substantial aid to business.

I propose:

FIRST. Real modification of the capital gains tax.
(s) To accelerate money.
(b) To soften sharp breaks in the stock-exchange prices.

(c) To eliminate the real handicap to American investors as against foreign speculators.

SECOND. A revamping of the economic features of the new corporation tax.
(a) To benefit new corporations, which must be encouraged.
(b) To permit corporations to maintain surpluses to take care of times of depression.

Taxation Dangers

In considering modification of the capital-gains tax, I think the Government should allow increment growing out of sound investment to a man while he lives, and not take it away from him in wholly disproportionate taxes. England has found it salutary to encourage initiative by permitting a man to enjoy the fruits of his earnings from investments while alive, and has been satisfied to take its proportionate share of those earnings from the beneficiaries -- recipients of wealth unearned by themselves -- after the death of the man whose labors purchased the wealth.

The argument for the repeal of the present tax should not only be a traditional one; it should also be based upon the fact that while American citizens are taxed on their security appreciation, other countries impose no such tax upon their nationals; the foreigner can trade to tremendous advantage in our security market, sell at the appropriate time and avoid assessment on his profits, whereas the American citizen is prevented, by the taxation laws of his country, from exercising even ordinary prudent judgment. Incidentally, of course, the effects are also harmful. If Americans in large numbers are prevented from selling the securities and capturing profits, then stock inflation is accentuated, because there is a premium put on holding stocks off the market. An artificial scarcity is thereby created that will make effective unwarranted price levels which inevitably and ultimately must collapse.

Without spelling the matter out in detail, I can also see a benefit to the general economy of the country by the free exercise of judgment of practically all security holders.

Corporation Surpluses

The profits in security appreciation in recent years have been very great in the aggregate. If these profits were taken and used, then, on the mere principle of velocity of money circulation, business would be stimulated by the increased purchasing power thereby created. As it is, an inert and frozen, mass of purchasing power remain idle.

My reasons are several for hoping that the Administration will take steps to undo the harm it has done to shrewd corporate management by the oncoming undistributed-profit tax on corporations. It is not enough to point out that the act has accomplished its purpose; that the $650,000,000 additional revenue needed by the Administration is assured by the flood of taxable dividends currently being made by American business corporations. The larger consideration, to my way of thinking, should prevail. The larger

consideration calls for our restoring as a virtue in American business life the corporate practice of providing a reserve against the inevitable rainy day.

We have all had experience with corporations which, no longer than three or four years ago, had substantial operating deficits and would have been plunged into bankruptcy had they not accumulated surpluses in former prosperous years. It is a terrible thing to contemplate another period of business recession with large American corporations inadequately equipped to ride through the storm.

In recent years, an economic revolution has occurred in this country, in the sense that millions of people have become investors in securities and count upon continuity of their dividend returns in budgeting their living expenses. Anything that would interrupt the continuous flow of dividends will rob the thrifty American investor of part of his livelihood, and any law which makes such a state of things possible is inherently a bad law. I admit that the law has some substance. I admit that the hoarding of resources beyond the needs of potential crises by some of our corporations cannot be justified. I know that during the period of wanton extravagance and bad judgment within the past ten years corporations spent money on plants and expansions for which they have never since had a need, and it would have been far better to have distributed those funds to stockholders.

But these few instances do not offer justification of a tax which weakens the structure of a typical American business corporation and which actually penalizes the small and younger concern that has never been able, in the course of its development, to accumulate a treasury surplus.

I hope and confidently believe that these inequalities and shortcomings in the present law taxing corporation surplus earnings will receive the prompt attention of the Senate Finance Committee.

I feel, in general, that we are merely suffering social growing pains similar to those Great Britain experienced a generation ago. This sudden development of our economic life into the corporate form, the rise of giant business, the separation of ownership and control, the evolution of management as an interest separate and distinct from, and often antagonistic to, the owners of a business, have reared a thousand difficulties. Gradually we are solving them under the leadership of the President, who is sponsoring the revival of standards of democracy to be applied to corporations of the present day. The very decisiveness of the recent election ought to make us thankful that at least we know how the vast majority of the American people feel; make us thankful that the President's mandate to continue his policy of government comes to him not from witch burners, crackpots and visionary reformers, who have, in my judgment, been greatly overestimated, but from a people grateful to a man who rescued the country from despair. The President has given life and reality to the hopes of millions that the Government can be a conscious protector against

vicissitudes of life and that it can, by the exercise of intelligence and courage, extirpate evils which had brought the country to its knees.

The captain of industry and the financier can no longer hope to combat progressive government by means of sweeping assaults on statutes written in good faith, or by launching phrases such as "More business in Government, less Government in business"; "Communism" or "The American Way." These phrases have lost their magic and their popularity.

Participation in the fruits of economic progress has been established as a fixed reality. The United States has come of age. Business and finance henceforth must deal with it and its people as partners, not as minor wards.