CHAPTER I

THE FORCES OF DISORDER

This chapter consists almost entirely of an address delivered at the University of Chicago on October 27, 1936. A few paragraphs have been added from talks before the Economic Club of Chicago on February 1, 1938, and before the Bond Club of New York on March 24, 1937.

Investment in this country in the past twenty years has undergone a shift from a few but very rich private families and individuals to the masses. There have also been substantial changes in the complexion of institutional investments. The banks are considerably larger investors in corporate securities, particularly bonds, than they were, say, at the turn of the century. Life insurance companies are still the largest single factor in the bond market and have become more so in the last few years. The advent of the investment trust and investment company and the spread of stock ownership among life insurance companies have made the institutional buyer of stock a greater factor than it was twenty years ago. The most pronounced change, however, has been in the spread of ownership of corporate securities among people of small income. A list of some thirty large companies on the New York Stock Exchange shows that the total number of stockholders from 1900 to the present time has increased tenfold. It was not so long ago when dividend and interest income was an unknown quantity to the great majority of American families. The spread of ownership of bonds and stocks among the masses has had the result that more than one third of the dividend and interest income of the country is now being received by individuals or families making tax returns of $5,000 or less, while 50 per cent of the total dividend and interest income is being received by our large middle class, people whose total income is $10,000 or less.

This development has been accompanied by another shift— an increasing flow to New York of the local investment funds from many communities throughout the United States. Frequently, perhaps too often, these local savings have been attracted to the great national corporations at the expense of small local enterprises back home. It is true that, as New York became the national clearing house for investment funds, Wall Street supplied capital to the larger local enterprises all over the country. Still there were many instances where worthy local enterprises suffered from lack of financing. There was good reason for this. The small local investor, following the trends of the moment, poured his money into the industries and the companies which at the time were the most favored.

When airplane, motor, oil, or radio stocks are in the ascendancy on the New York exchanges, the less spectacular home industry has little chance to compete for the local investor's funds. A New York banking house, for obvious reasons, could scarcely be expected to service all of the needs of local enterprises. Wall Street, as a general rule, is not geared to small local issues. The local job cannot be done there. Yet the backbone of this country's progress has been the small companies, for the giants of today started under humble auspices and with small beginnings only a generation or so ago.

The Centralization of Industrial Control

Looking back over the past five years it is obvious that a reaction has set in against acute centralization of industrial control. The demand has been more and more insistent for greater democracy in industry and in finance. The voices of the investor and the worker (not to mention the consumer) have been heard with increasing persistence. The legislation of the past few years (the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935) has been a partial response to that demand. I feel that the solution of current industrial and financial problems is to be found in large measure through democratization of industry and finance. This question is one of the greater economic problems of today and tomorrow with which we in government have a deep concern and those in finance have a vital and abiding interest.

Destructive Forces in Finance

Of the many forces which breed insecurity, perhaps the most dangerous are the exploitation and dissipation of capital at the hands of what is known as "high finance." The reality of such waste and leakage comes forcibly home when one sees the tottering ruins of industry in bankruptcy or receivership. During two years in Washington we had occasion to examine into those ruins with some care. Under a mandate of Congress we made a study and investigation of dozens of protective and reorganization committees. Our examination of the files of companies, trustees, committees, and lawyers ranged from Los Angeles to Boston.

Through the window of reorganization most of the many varieties of capital exploitation and dissipation can be seen— certainly if a reorganization is studied, as it should be, in its financial and economic setting. Reorganization is frequently but the aftermath of such practices, for the result of the operations of high finance is to weaken the vitality of companies and to cause or to contribute to their failure.

In a competitive, capitalistic system business failures are inevitable. In any system of free enterprise investors will always be forced to pay the price of progress and competition. This is unavoidable. In a sense, capital is a thing to be lost, not saved, anomalous as that may seem. The silent and rotted water wheels of New England bear mute evidence to this. The onward rush of technology, the displacement of old devices by the new and more efficient, makes certain that this phenomenon will be constantly repeated. But dissipation and exploitation of capital are other matters. They relate not to progress but to tribute at the hands of those who may be accurately termed financial "termites."

The financial and industrial world has been afflicted with termites as insidious and destructive as the insect termites. Instead of feeding on wood they feed and thrive on other people's money. Enterprises ostensibly secure collapse as a consequence of their subtle operations. Their mysterious and destructive work has ruined many fine businesses. And at times the first warning which security holders have had that these termites were at work was the disastrous collapse of the company.

These financial termites are those who practice the art of predatory or high finance. They destroy the legitimate function of finance and become a common enemy of investors and business. While they are not seen in the antecedents of every business failure, they have been present with such frequency that the importance of dealing with them directly and forthrightly cannot be denied.

The wealth of many of our institutions—commercial banks, savings banks, insurance companies, public foundations and churches, and universities—is in the form of securities. In back of those securities are railroads, factories, public utilities, foreign credits, and the like. When the financial termites feed on the enterprises which underlie these securities, they breed insecurity and instability in values. When their operations are on a large scale, the whole national life becomes involved. It is estimated that there are twenty-five million persons who are direct owners of securities in this country. These persons are or should be definitely concerned with the destructive nature of high finance. Furthermore, every man who has a deposit in a bank, or has an insurance policy, or owns a home or a farm which is mortgaged, is affected and should be concerned. All of us are interested, whether we know it or not, in healthy conditions in our security markets, in the new issues that are floated, and in the outstanding issues that are dealt in in our public markets.

In the eyes of high finance, business becomes pieces of paper —mere conglomerations of stocks, bonds, notes, debentures. Transportation, manufacture, distribution, investment become not vital processes in economic society but channels of money which can be diverted and appropriated by those in control. The farmer with his raw materials, the laborer whose blood and sweat have gone into the steel and the cement, the investor and the consumer who are dependent on the enterprise, become either secondary or inconsequential rather than primary or paramount. Business becomes not service at a profit but a preserve for exploitation. The basic social and economic values in free enterprise disappear. For such reasons one of the chief characteristics of such finance has been its inhumanity, its disregard of social and human values.

High finance is interested solely in the immediate profit. Its organizations are not interested in whether our natural resources are wasted, whether we are overbuilding in one direction and underbuilding in another, whether our economic machinery is getting out of balance. Such groups are not concerned with whether our credit resources are being used up too rapidly. A larger demand for credit means high returns on money and these men are dealers in money and capital. They are in business only for immediate gain; a long-term view is of no profit and of no interest to them.

As one probes into the background of particular business failures, he.finds reflected in them practices and policies which have preceded the collapse of many enterprises. He finds practices designed to siphon the money both from investors and from business. He sees that high finance has piled holding companies on top of holding companies until investors whose money has been taken have no more than a piece of blue sky for their security. He sees market manipulations. Companies have been merged and consolidated for no sound business reason but only to create profits for high finance. The overhead and costs of finance have been placed on business merely to keep high finance prosperous. High finance has levied its toll by taking watered stock and by unloading that watered stock on the public. The promoters pocket the proceeds. The company gets nothing for the stock it has issued. The public holds the bag.

It would be an error to denounce all of finance in these terms. Finance occupies an important place in our society, whether its functions are performed by government or by private bankers. But finance moves into the zone of exploitation whenever it becomes the master rather than the faithful and loyal servant of investors and business. To make finance such a servant rather than a master becomes a central plank in any platform for reform.

When I speak of reform, I mean reform by business as well as by means of legislation. Government can and should help, by pointing the way. An economic democracy in action would be recalcitrant in its obligations if it did not do so. It has done so in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935. But the fact that there is at last a Securities and Exchange Commission in Washington should not lull investors and business into forgetfulness of the fact that the problem of what happens to their capital is still their concern. Nor should they forget that many ultimate victories over predatory finance must be won by investors and by business. The program by which investors and business can keep the national riches from exploitation cannot be realized overnight. Yet it is clear that the necessity to eliminate the elements of instability occasioned by predatory finance will not brook delay.

The struggle between investors and business on the one hand and high finance on the other is a strenuous one, for these predatory interests, working in compact groups with friendly alliances, wield an economic and financial power second to none. The danger of that concentration of power is that it is not accompanied by the assumption of social responsibility. These groups, collectively divorced from social responsibility, are the chief agents through which our economic and financial blunders accumulate until the next blood-letting process. This is called a crisis. But it is nothing more than the rhythmic breaking out of the pent-up forces of abuse, mismanagement, and maldistribution of economic effort and income. Academic economists have tried to endow cycles and crises thus created with natural attributes. In this way they have cleverly washed the hands of high finance and excused it from social responsibility. But the cycles and crises thus created are not inescapable. We may in years to come look at them as monuments to the folly of the human race.

Such a program of reform involves both the organization and the management of business and a resetting of the laws under which it operates. In such a program there is one central principle. These predatory interests must be prohibited from being on both sides of the transactions out of which their profits flow. This is a simple and obvious proposition. Yet as Mr. Justice Holmes, I believe, used to say, the most difficult task is to teach the obvious. If an investment banker did not have control over a company, he would not be able to load that company with the "cats and dogs" which he as an investment banker had acquired. If a banker-management group were not in control of the protective committees in a reorganization, they would not be able to improvise a plan of reorganization which restored them to power, giving them another feudal tenure in the company. If a market operator were not in control of a company, he would not be able to use the funds of that company so that he could acquire another company and sell it to the first company at a profit. If the current moral and legal standards governing transactions of these men who are on both sides of the bargain more nearly conformed to the notions of decency and ethics embodied in the ancient standards for fiduciaries, their operations would be substantially curtailed.

The transactions themselves are often involved, intricate, and mysterious. Their legal garb is often baffling. Frequently, only the analyst or the lawyer is able to fathom them. Actually, however, the fundamental problem is neither intricate nor involved. It is not one reserved for analysts, financiers, or lawyers. It is so simple that he who runs may read and understand. It is basically nothing more nor less than a man attempting to serve at least two masters—security holders on the one hand, himself on the other. I say it is nothing more nor less than a man serving at least two masters, because more often than not high finance has a plurality rather than a mere duality of interest. When a man has a plurality or duality of interest, history has it that one of his several self-interests will be served first.

It is not simply a question of policing and curtailing the activities of dishonest men. If the system is provided so that honest men may have their two or more masters, the dishonest will rush to take advantage of the opportunities afforded. Furthermore, it is not solely and simply a question of honesty on the one hand and dishonesty on the other. No man's judgment can be trusted to act in a sound and disinterested way in those situations where the issue is whether he shall make a turn in the market, or some other profit, if he can use only other people's money to finance it.

This duality or plurality of interest permeates the whole fabric of our financial system. One sees it wherever one turns. The whole mechanism has become so complicated and intricate that frequently it is hidden and concealed even from the deep probings of investigation. But it exists in a multitude of subtle and indirect ways. It has been accepted in practice. It has gone so far that frequently the very cornerstones of certain institutions seem bottomed on it. In fact, it is commonly said that one who seeks to tinker with that part of our financial mechanism is retarding prosperity, interfering with the American way, and stifling freedom and initiative. As one banker recently put it, if steps are made in that direction "you are going to crab the initiative of lots of financial concerns." Hence, when protest is made against practices which violate ancient standards for trustees and there is insistence that they be discontinued, wails and objections go up, even from responsible and socially minded individuals, who protest that business cannot be conducted without these practices. More often than not these are but the protestations of spokesmen for the predatory elements in finance, though they appear in the guise of the profound judgment of practical men of affairs.

Lax Corporation Laws

Restraints both on the complexities and on the size of business must be designed. Complexities are made possible by notoriously lax corporation laws—laws designed to suit the ingenuity of high finance and its lawyers, laws drafted in Wall Street for Wall Street's purposes. Holding companies can be piled on top of other companies without end until even an astute analyst cannot divine what real values lie underneath. Corporations can be affiliated in such devious ways that huge corporate structures become as intricate as the works of a Swiss watch. These complexities make it possible to hide assets and to move them about from company to company covertly. These complexities make it possible to conceal basic business facts from investors. They create the ideal stage setting for high finance. In these circumstances high financiers can with practical immunity maneuver and manipulate other people's money to their own preferment. In a simple conservative corporation setup such maneuvers would be as obvious as taking cash from the till. Amid corporate complexities these raids become disguised and concealed in intracompany transactions. Provisions in charters purport to give officers and directors immunity against liability for acts which shock the conscience. Protective provisions of stocks, bonds, and other securities, permitted by corporation laws, become loopholes for insiders. Drastic overhauling of lax corporation laws of the states becomes a primary requisite to any basic reform.

The "Curse of Bigness"

Complexity in corporate structures is usually an incidence of bigness. But bigness has other consequences which justify the expression, "the curse of bigness," uttered by Mr. Justice Brandeis years ago.

In the first place, bigness taxes the ability to manage intelligently. The energies and abilities of man are limited. No single man or group of men can intelligently conceive, promulgate, supervise, and execute from day to day intimate business details necessary for intelligent operation of big business. They cannot give management policies that painstaking and careful personal consideration necessary for responsible management. Those details must be assigned to others. So-called responsible management officials become removed from the active arena of their business affairs; they cannot give their businesses the personal care which they demand. They build themselves an elaborate bureaucracy to run the business. At the top they become so-called formulators of policy. But they are so removed from the actualities of their business—the laborers in their mills, their production problems, their intimate financial affairs—that they lose perspective and judgment. Opportunity for intelligent management decreases with the growth of business. The needs of a small Middle Western community are apt to be better served by a banker at the head of a small local bank than by the same banker at the head of the nation's biggest bank. It is not a question of ability but of capacity.

In the second place, bigness concentrates tremendous economic and financial power in the hands of a few. This may be used dishonestly; but an even greater risk is its unwise use from the national viewpoint. Enterprises or institutions which command tremendous resources, which hold the fate of whole communities of workers in their hands, which have a virtual or actual monopoly, which dominate markets and control vast resources tip the scales on the side of prosperity or on the side of depression, depending on the decisions of the men at the top. This is tremendous power, tremendous responsibility. Such men become virtual governments in the power at their disposal. In fact, if not in law, they become affected with a public interest. The impact between their stockholders' interest and the public interest at times becomes acute. Incompatibility is often in evidence. This does not necessarily mean that they are enemies of the democratic system. But it does increase the duties of government to police them, at times to break them up, to deter their further growth. And it also means that if their growth continues at the rate of the last few decades capitalism will be eclipsed. For the inherent characteristic of capitalism is competition, individual initiative, freedom of opportunity. If present tendencies continue, the only hope of economic order within the architecture of the present system will be government by cartels. That raises no hope in the breasts of those who love democracy.

In the third place, the growth of bigness has resulted in ruthless sacrifices of human values. The disappearance of free enterprise has submerged the individual in the impersonal corporation. And when a nation of shopkeepers is transformed into a nation of clerks enormous spiritual sacrifices are made. Communities everywhere lose men of stature and independence. Man loses opportunities to develop his personality and his capacities. He is denied a chance to stand on his own before man and God. He is subservient to others and his thinking is done for him from afar. His opportunities to become a leader, to grow in stature, to be independent in mind and spirit, are greatly reduced. Widespread submergence of the individual in a corporation has as insidious an effect on democracy as has his submergence in the state in other lands.

But the curse of bigness has other manifestations. In big business management tends to become impersonal. The huge aggregations of capital of big business mean that the number of public security holders is large. These investors are also widely scattered. Management acquires a sort of feudal tenure as a result of the utter dependence of the public security holders on them. That tends to give management a sense of a proprietary interest, though they may have absolutely no investment whatsoever in the enterprise. With their relationship to investors so remote and impersonal, they frequently take advantage of their own superior practical position to use the perquisites of management for their own preferment. There can be no question that the laxity in business morals has a direct relationship to the size of business. Empires so vast as to defy the intimate understanding of any one man tend to become the playthings for manipulation. The fact that railroads, or banks, or operating utilities lie somewhere deep underneath the corporate maze becomes incidental. Values become translated. Service to human beings becomes subordinate to profits to manipulators. The stage is set for moral decadence.

All of these facts challenge the *status quo* and demand concerted efforts to restore American business economy to a simpler stature.

So far as high finance is concerned, if its past practices were allowed to continue, their cancerous growth in our financial and industrial body would eventually consume it. It would be consumed because, when high finance thrives and flourishes, there are two consequences. First, there are dislocations in income and purchasing power which eventually upset the economic balance. Second, our faith in fair play and in equality, and hence our trust in democracy, is undermined. These two work for social disintegration.

America, including American finance, needs reeducation on these simple and obvious principles. Whatever the world of high finance may think, he who has not much meditated upon ethics, the human mind, and the *summum bonum* may possibly make a thriving termite, but he will most indubitably make a sorry fiduciary and a sorry economic statesman.