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FINANCIAL DEMOCRACY

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THE brilliant public addresses which William O. Douglas made during his two years as Chairman of the Securities and Exchange Commission were all in the headlines of their time. Lawyers, investment bankers, and public utility executives consulted them eagerly to learn what course the commission intended to pursue in administering the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and other legislation within the SEC's scope. Collected in book form under the title *Democracy and Finance*,[1] the Douglas speeches are even more important reading than they originally were, now that their author has become an Associate Justice of the Supreme Court and now that the administration which appointed him, and which named four other members of the Supreme Court as well, has been returned to office for a third term.

In their present arrangement by subjects, the speeches give a more complete picture than was possible when they were being delivered, one at a time, of the relation which must obtain between government and business in order to insure the existence of economic democracy in the United States. Skillful editing and annotating by James Allen, formerly of the SEC staff and now in the Department of Justice, have helped to produce a volume which will take its place with Brandeis' *Other People's Money* in the important literature of American finance.

The books of both Douglas and Brandeis deal largely with the dominance of finance over industry and the concentration of control of finance in a few hands in a single spot. Douglas, however, has had several advantages over his distinguished predecessor, who wrote his great work some twenty-five years ago. Where Brandeis was the prophet, far ahead of his time, Douglas is the voice of today. Where Brandeis spoke as a

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[1] Democracy and Finance. By William O. Douglas. New Haven: Yale University Press, 1940. Pp. xiv, 301. $3.00.

private citizen who, at the time his book appeared, was without his later influential following and whose public service up to that time had been as counsel to governmental investigating committees, Douglas speaks as member of the Supreme Court, as former chairman of an important governmental agency, and as authoritative exponent of the economic philosophy which now dominates all three of the Federal Government's great departments, the executive, the legislative, and the judicial.

FINANCE MUST BE THE SERVANT

The doctrine that finance must be the servant rather than the master has been proclaimed before, although it has been increasingly neglected in practice in the United States. Brandeis voiced it before Douglas. John D. Rockefeller, who had the most profound understanding of the process of creating wealth of any man in history, was saying it before Brandeis. One of my earliest business recollections is an occasion when the elder Rockefeller said to me of the financial giant of that time, "He is a mere banker." Those five words constitute the most succinct expression I have ever heard of the incontrovertible fact that the United States owes its unparalleled economic progress to its creative geniuses and not to its money lenders. The record has invariably shown indeed that, when bankers subordinate their useful function of money lending to the more alluring, but completely unnecessary, pastime of trying to run every phase of business, economic progress is sacrificed.

It is in examination of the record and in concrete suggestions for reform that Douglas is at his best. Recalling Brandeis' phrase, "the curse of bigness" in business, Douglas points out that the result of bigness is the concentration of tremendous economic and financial power in the hands of the few. And regardless of ability, no individual or small group of individuals has the capacity for responsible management of our present-day corporate colossi. Moreover, the trend to bigness and to the resultant centralization of control, he emphasizes, threatens to eclipse those inherent characteristics of capitalism—competition, individual initiative, and freedom of opportunity. No mere viewer-with-alarm, however, he is ready with constructive recommendations for the democratization of industry and finance. Two of them which have recently been receiving increasing attention are the greater development of regional finance and the adoption of competitive bidding among investment bankers for new issues of securities.

REGIONAL FINANCE

The development of a number of strong regional financial centers is urged by Douglas as a workable method of eliminating some of the more grievous economic dislocations which now exist. When the securities underwriting business comes home from New York, where most of it is at present concentrated, to the regions in which the issuing corporations operate, ownership and management, trusteeships, registrar and transfer agencies, legal work, auditing, engineering, printing, advertising and all the other business that belongs at home will follow. Furthermore, these measurable economic gains will be accompanied by incalculable social benefits.

The need for greater development of financial machinery outside of New York is brought home forcefully by the extent to which the Federal Government has found it necessary to take over the task of supplying the financial needs of its citizens and corporations throughout the country. Government lending agencies, about thirty in number, are currently employing in the neighborhood of fourteen billion dollars for this purpose. The securities underwriting record of the past year shows how private bankers have abdicated their money lending function. Securities issues handled through ordinary investment banking channels in 1940 totalled somewhat more than two and a half billion dollars, of which amount only a little over a third was for new money. The other two-thirds consisted of refundings which, in view not only of their routine character but also of the unprecedented volume of idle funds available for investment, required small skill or resourcefulness of the investment banking fraternity. The bulk of this underwriting was monopolized by a handful of New York banking houses; they went even further and saw to it that other financing which they did not choose to undertake was accommodated by private placements or government loans rather than by underwritings managed by rival bankers. Barring immediate democratization and revitalization, the investment banking business is in danger of sharing the fate of the New York Stock Exchange. The Exchange has never recovered from the loss of prestige it suffered from allowing itself to be used as a convenience by the same small group of New York bankers who are now making an appurtenance of the whole banking business.

Douglas points out that talking and writing will not be sufficient to bring about the development of regional capital markets. He calls upon local bankers and local businessmen to tackle the problem, which is largely in their hands, but reminds them that the Securities and Exchange Commission will help, inasmuch as regional philosophy runs throughout the statutes which are administered by the commission. Since 1938, when the regional finance speeches were made, there have been signs that local businessmen and bankers are beginning to assert the rights of their communities. There are many who predict that the Federal Reserve System, with its twelve regions, will be the model followed in building strong investment banking centers throughout the country. The latest evidence of SEC cooperation is the greater authority about to be given to regional offices of the commission; the experiment will begin with the Cleveland and San Francisco offices early in 1941. Similar decentralization of other administrative agencies, like the ICC which is now housed in a remote and forbidding colosseum in Washington, would make them more accessible to the whole nation and more responsive to regional needs. It would also keep the commissions free of the "internal decay and institutional paralysis"[2] which, Douglas says, is always threatening them.

COMPETITIVE BIDDING IN THEORY AND PRACTICE

Competitive bidding, like regional finance, is advocated as a means of ending grave abuses. In Douglas' own words, ". . . . where bankers are dispensing to themselves the patronage of a monopoly—whether by reason of directorships, voting trusteeships, strategic investment positions, or otherwise—a private sale of securities by the issuer to those bankers should not be made. Bona fide competitive bidding should be had in such cases in absence of affirmative proof that it would be impracticable."[3] With characteristic courage, Douglas chose an address at the New York Bond Club in March, 1937, as the occasion to make this and other related statements on the abuses arising from monopoly in finance. In view of the tenor of his speech, it is not surprising perhaps that the *New York Times* found it necessary to record that "when the speaker was introduced, the members rose and gave a round of applause. When he concluded his remarks the spattering of hand-clapping was far from cordial."

The results of the Bond Club speech have been considerably more than "talking and writing," although it is true that since 1937 the art of pamphleteering has enjoyed increased popularity among those opposed to competitive bidding as a threat to the monopolistic practices of which they are the chief beneficiaries. Their arguments have been based to a large extent on the contentions that the investment banker's relation to the issuing company is that of a professional man whose advice is indispensable to his client and that any disturbance of traditional banker-borrower relationships is fraught with peril. As Brandeis pointed out in 1914, however, the investment banker is first and foremost a merchant, who buys securities at wholesale for resale at a profit. Douglas effectively dismisses the second point with the statement that "the economic utility of continuity of banking relationships is of unestablished value to anyone

[2] P. 247. [3] P. 37.

except the banker."[4] To date none of the anti-bidding pamphleteers has been able to explain why, in a democracy, there should not be the same competition in the furnishing of money as in the supplying of any other commodity. Nor has anyone tried to explain why, in a democracy, the financing of some of our largest corporations should be a prerogative of favored bankers, to be handed down from generation to generation, so that no other banking house, not even one which stands ready to pay a higher price than the traditional bankers for the securities being sold, can ever hope to be eligible to participate in the underwritings of these companies.

More significant than the outpouring of writings on the subject in the last two or three years, however, have been the instances in which competitive bidding has been successfully applied. These include $30,000,000 Chesapeake and Ohio Railway Company bonds, $12,000,000 Cincinnati Union Terminal bonds, $7,000,000 Terminal Railroad Association of St. Louis bonds, and 46,292 shares of Pennsylvania Telephone Corporation preferred stock. These examples are all over and above the countless sales at competitive bidding of municipal bonds, railroad equipment trust certificates and Massachusetts public utility company bonds, including the recent $53,000,000 Boston Edison bonds; it should be noted that bidding has been legally required for these three classes of securities for many years, and that among banking groups seeking to buy issues of such securities are regularly found some of the most ardent opponents of further extension of the bidding practice.

The success of competitive bidding has been strikingly demonstrated so often that its practicability is no longer a subject for mere wordy speculation. Indeed the SEC is reported ready to adopt a bidding requirement in the near future for all issues over which it has the requisite authority, and such SEC action may well be followed by similar moves on the part of the Interstate Commerce Commission and the various state public utility commissions.

Anti-bidding bankers are basing their last desperate opposition on the thesis that competition will force securities prices so high that the investor will suffer. Aside from the fact that there has been small evidence of overpricing in the competitive bidding record, which, it must be remembered, includes extensive experience in the municipal and equipment trust fields, the sheer sophistry of this argument is obvious. The banker has no means of compelling his customers to pay excessive prices. If his judgment is so poor that he overprices the securities he is trying to sell, he, and not the investor, will be the sufferer.

[4] Ibid.

EQUITY VERSUS BOND FINANCING

In the section of his book which discusses the Public Utility Holding Company Act of 1935, Douglas cites the delay with which provisions of the bill have been brought into effect and notes that many operating utility managers have been paralyzed into inaction "under the whiphand of New York finance."[5] "Perplexing to me," he says, "is the failure of the so-called financial leaders to appreciate the force of public opinion which brought about this law."[6] If the SEC is still moving slowly in the enforcement of geographic integration of holding company systems, it has displayed somewhat greater vigor in preventing further weakening of holding company systems through unsound financing. Douglas points out that utility operating companies, in order to fulfil their obligations to the public, must be able to obtain relatively large amounts of money through the sale of new securities, a considerable part of which should be raised through the sale of additional preferred and common stock. In a number of recent cases, beginning with the *Consumers Power* decision in December, 1939, the SEC, recognizing the dangers inherent in excessive debt, has called for a better balance between debt and equity.

An adequate equity, with a maximum of around fifty per cent of debt, is sound financial doctrine for utilities and for other corporations, such as railroads and telephone companies, which are monopolies or quasi-monopolies. For confirmation, one need only look at the financial condition of the railroads, which are the glaring example of overbonding, accomplished on the advice of the traditional bankers who found bonds the easiest type of security to sell. If strong capital structures are desirable for such companies, they are doubly desirable for industrial companies, especially those subject to the greatest competition. Against the day of depression, of unusually severe competition, of unexpected obsolescence by reason of technological improvements, corporations should keep themselves as free of bonded debt as possible. The ideal company, which has only common stock outstanding, is, of course, never faced at an awkward time with the problem of meeting interest and sinking fund charges or having bonds come due, and is always ready to meet advances in the industry requiring new capital expenditures.

LAWYERS, BUSINESSMEN, AND FINANCE

Douglas has some very enlightening comments to make on the reform of corporate reorganizations. Particularly interesting to the legal profession should be his remarks on "Lawyers and Conflicts of Interest." He

[5] P. 131. [6] P. 132.

warns lawyers against the dangers of serving as professional tutors to those who seek to dominate finance and concludes that "not only finance, but the bar needs re-education on the simple principle that no man can well serve, directly or indirectly, two or more masters."[7]

The big law firms may try to resist re-education, however, for the size of their overhead makes it desirable for them to represent as many sides of a question as possible. Quite common, consequently, are cases like a recent one in which the same lawyers represented a railroad issuing some new securities, the trust company acting as trustee of the issue, and the investment bankers who underwrote the securities; in addition, one partner of the law firm sits on the board of the railroad and another on that of the trust company. It is not too much to say that the biggest law firms have already gone far beyond their professional capacity of giving advice and are big businesses in the fullest sense of the word. This is particularly true of the half-dozen firms which, with a handful of banks and banking houses, are inextricably interconnected and intertwined in the domination of the country's largest corporations in every field of business and finance.

Other portions of the book, which there is no space to examine here, take up the subject of stock exchanges, administrative government, and education in government and law.

Democracy and Finance should be read by everyone who is taking a leading part in American business and with especial care by those who have occasion to make speeches about "our system of free enterprise" and "the American way." Executives who are too busy to do their own reading should at least assign their public relations men to a searching study of the Douglas book, the most straightforward and intelligent exposition that has been written of the views on business of the Federal Government which a majority of the voters has seen fit to elect three times in a row. The majority will continue to support that view, moreover, as long as there is someone of intelligence and force to proclaim the doctrine and to rally the people.

[7] P. 240.