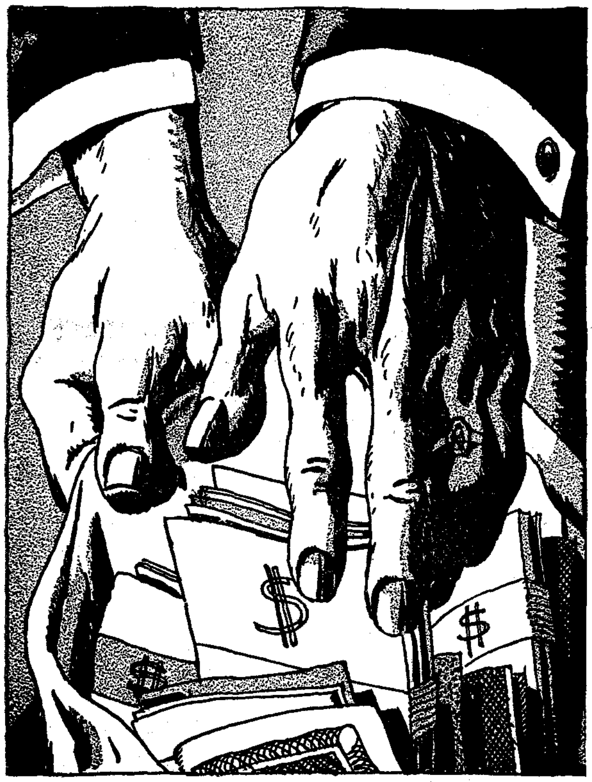
Is the Investor Helpless?

by **BERNARD J. REIS**



I AM THE KIND of fellow who can't see why stockholders shouldn't get the same kind of fair treatment they would get if they were big partners instead of little partners in industry."

These words of William O. Douglas, new chairman of the Securities and Exchange Commission, bespeak the plight of the American investor. Ways have yet to be devised to give the investor a minimum of protection. Today — quoting Mr. Douglas again — investors are "by and large orphans of our financial economy."

Big business derives much of its bigness from the savings and confidence of 10,000,000 little partners, a number that is constantly growing. The last decade has proved that these scattered, unorganized, credulous, and thrifty citizens are unable to protect themselves.

II

THE AVERAGE investor is unquestionably overwhelmed by the abstract nature of investments. He has been made to feel that wiser heads and fatter purses than his must rule the corporations to which he has entrusted his money. Consequently he has been accustomed to assume that boards of directors are the major partners in a business in which he holds only a few shares. What he has not realized is that the Joneses, the Browns, the Smiths, and the Davises are also small stockholders and that together they constitute the real owners of the large industries. Failure of this multitude of little partners to pool their interests proves that the investors' impotence is largely self-imposed. Boards of directors, though retaining the power of feudal barons, often own less than five per cent of the corporations they control.

The machinery used by the inside minority to hold its grip is simple. Management, bankers, and security dealers co-operate to induce the security holders to surrender their power by proxies. And the effectiveness of the proxy machine depends on the small investors' lack of organization.

The real owners of a large business are numerous, scattered, and preoccupied with their other affairs. It is easy to persuade them to delegate their power to someone else. To do so, insiders form a proxy committee and, at company expense, solicit the small investor to mail in his proxy. When, rarely, opposition appears, squads of personal solicitors are set loose at the company's expense, a maneuver that usually succeeds. Where the issue is close, brokers and bankers who are the record owners (but who rarely have anything at stake) side with the insiders.

What is the result? The insiders obtain enough votes to approve the actions and policies of officers and directors and to re-elect themselves. Independent scrutiny of the management is foreclosed. Year after year the process is repeated, and officers who jointly own ridiculously small fractions of the outstanding securities remain masters of the public's money.

Occasionally, a stray stockholder attends an annual meeting. He finds himself alone among the directors and bewildered in procedure railroaded by the best corporation talent in the country. Finding the meeting only a series of legal resolutions, he does not go a second time. In fact, many of these meetings are held in inaccessible places, thereby ensuring nonattendance of stockholders. F. W. Woolworth Company meets annually in Watertown, New York; International Paper Company convenes in Corinth, New York; and Southern Pacific Company invites its 55,788 stockholders to journey to Spring Station, Kentucky, where the total population is normally 34. Being among friends and free from public scrutiny, boards of directors have been known to vote themselves fabulous salaries, often despite a record of deficits.

But the treacherous proxy machine is not the only danger. Investors must also abandon a naïve faith in the integrity of other self-appointed guardians: the bankers, underwriters, dealers, or brokers who originally advised the purchase of securities. Whenever the selected enterprise gets into heavy seas, substantially the same group appears to give advice. At this stage the original promoters are known as protective committees or reorganization managers or underwriters of new securities.

In any event, the investors' bitter experience of the past few years shows that all these advisers and protectors are primarily interested in mending their own fences. Whether they call themselves by one euphonious name or another, they are merchants: salesmen of securities or services. At the beginning of an enterprise or when reorganization or refinancing becomes necessary, the bankers and underwriters are aligned with the insiders. Their job is to sell, convert, or exchange securities — for profit. And, like other merchants, they look for jobs. When business does not seek them, they try to create it.

When foreign bonds were selling so fast that there weren't enough to supply the demand, many of the nation's outstanding investment bankers begged foreign governments to take loans for no matter what fanciful purpose, so that more bonds could be sold to the public at a substantial profit. When investors became fewer in number and far more exacting, the bankers were compelled to offer high-grade securities. Today, with a vast and inexperienced buying public, bankers can sell any security represented as conservative and safe.

Although a security is an intangible and mysterious thing, it is nevertheless a commodity like any other, and the investor must find a method of judging its real quality. Unfortunately, high price and low yield are not necessarily the test of soundness. The security buyer must beware. Indeed, there is more security for the buyer of ordinary commodities than for the purchaser of investments. Such terms as *14-carat gold*, *sterling silver*, and *free from benzoate of soda* are construed at law to mean exactly what they say, whereas *conservative*, *ultraconservative*, *first mortgage*, and *equivalent to United States Liberty Bonds* have no definite meaning. They can be applied to any sort of security without any protection to the buyer or the slightest risk to the seller.

Another reality must be faced courageously by the investor. The appointment of one of the very large trust companies or banks as "trustee" does not give the protection which the investor innocently expects. This has been dramatically proved through investigation by the Senate and other federal and State agencies. But let us turn to some schemes not yet exposed to general view.

Once more the market is being flooded with bait for a newly emerging class of small investors. For as little as $10 a month, the customer is promised that in ten years he can enjoy all the good things of life — his own home, a college education for his children, and a trip to Europe. The sellers give no tangible guarantees of safety but mystify the purchaser by emphasizing the name of the trustee, invariably a banking firm of long and reputable standing. Actually, the trustee rarely has any responsibility in the affairs of these companies.

Judge Rosenman of the New York State Supreme Court recently stated in the case of Hazzard v. The Chase National Bank:

> The cruel fact is that not only is the trustee not required to exercise that greater skill and watchfulness and prudence which it has but it is even absolved from exercising merely the ordinary care which a single individual should exercise as to his own affairs.

This, however, does not deter these companies from printing the name of the trustee in large bold-faced type on the front of a prospectus and from using the financial standing of the *trustee* as a major selling point. They know that the untrained investor will assume that the great financial institution named as trustee will supply the skill and watchfulness and the experience which he himself lacks. *Nothing could be further from the truth.* The Securities and Exchange Commission has recently made an investigation of the dangers to the investor which such misleading use of the trustee's name involves and recommended legislation to Congress to stop it. But such legislation was not passed.

III

It would be natural to expect the investor to receive primary protection from certified public accountants. Although employed to do private work, the members of this profession are licensed by the various States as "certified public accountants." Only recently has it become sharply evident that the small investor should place little faith in financial statements "certified" by public accountants. An underlying difficulty is the ordinary person's lack of the technical training and habits of thought necessary to understand even a thoroughly candid financial statement.

Nor can it be said that the accountants have done their utmost to simplify financial statements. It is regrettably true that many accountants ingeniously contrive subtle headings, artful qualifications, and innocent-looking conditions — at the command of the companies who pay the bills — so that there may be a minimum of compliance with the law and a maximum of protection for the accountant and his clients.

The average person would be startled to know that the law has seemingly clothed the public accountant with immunity, even where a false financial statement has brought loss and even ruin on those who accepted it as accurate. Nevertheless accountants do enjoy virtual immunity, even in the rare instances when innocent losers go to the great expense of establishing the true connection between their loss and the accountants' false report.

Some years ago the Court of Appeals, the highest appellate court of New York State, fashioned a satisfactory yardstick for measuring the responsibility of the public accountant. The Court said:

> Where a party represents a material fact to be true to his personal knowledge, as distinguished from belief or opinion, when he does not know whether it is true or not and it is actually untrue, he is guilty of falsehood, even if he believes it to be true, and if the statement is thus made with the intention that it shall be acted upon by another, who does so act upon it to his injury, the result is actionable fraud.

In a later case, the United States Circuit Court of Appeals for the Second Circuit passed on the same question, involving a suit by preferred stockholders against a prominent firm of accountants. But the federal court radically altered the yardstick. The question of a false statement was subordinated to the point "whether the omission to state certain matters was deliberate and intended to conceal." In other words, the investor injured through a false report has no remedy even if he proves that the accountants either knew or could have learned the facts — *unless* he also proves that the falsehood was deliberate.

Hence, the ordinary investor cannot depend on the reports of public accountants as substantial protection. And, if he blindly does so, it is futile to imagine that he can obtain redress in the courts. The apparent need for establishing intent to conceal deprives the theoretical court remedy of any practical value. It may be incidentally observed that the Circuit Court's yardstick runs contrary to the philosophy of the securities act and seems to raise a serious obstacle to effective administration.

Generally speaking, the legion of investors cannot safely depend on the courts for protection. Based on the record of suits, this assertion is unassailable. Suits by investors are infrequent; successful suits are exceptionally rare. The reasons are not far to seek. Even assuming the plaintiff's case of wrongdoing, of mismanagement, of dissipation of assets, the investor is not regarded as having a right to personal redress. He does have the right, under certain conditions, to bring what is known as a derivative suit. This means he can sue only in the name of the corporation. He can sue for the benefit of the corporation on his own behalf and on behalf of others who are similarly situated. Such suits are inhibited by practical consideration. Assistance from competent accountants and lawyers is seldom obtainable, and it is hard to obtain access to the essential records of the insiders. More often than not, investors' suits end in settlements that usually fail to right the wrong but may aggravate the situation by piling additional expense on the corporation.

Because these inherent difficulties are fertile soil for abuse, the courts have become suspicious of attempts of minorities to seek legal satisfaction. And this judicial predilection is tantamount to an invitation to the accused insiders to indulge in pious denunciation of all such lawsuits as strike suits or holdup suits, producing an atmosphere of recrimination and vituperation. This vicious circle almost excludes effective court action by investors. Let us turn now to litigation of a public or quasi-public character.

IV

HAS THE GREAT volume of so-called blue-sky legislation passed in recent years by most of our State legislatures given protection to security holders? The insignificant success of these laws was illustrated in 1933 when a Senate investigation showed the need of regulation by the federal government to curb abuses.

We come now to an appraisal of the protection offered by the Securities and Exchange Commission and by the legislation which the Commission is entrusted to enforce.

When President Roosevelt came into office, the New Deal recognized that something had to be done to protect the investor. Under the securities act of 1933, all new issues to be sold in interstate commerce must be registered with the Securities and Exchange Commission. Every registration statement must contain complete data as specified in some 32 requirements, plus a copy of the prospectus to be issued to the public. There are some exempted issues, notably securities issued by a financial institution subject to authority of a State banking commisioner. Supervision of State banking commissioners, however, has in most cases proved ineffectual. This exemption permits millions of dollars of securities to be sold to small investors in the form of guaranteed certificate plans and investment savings plans, without passing under surveillance of the S.E.C.

The act requires registration only, and registration does not mean the Commission's approval. Although there are penalties for anyone who willfully makes an untrue statement of a material fact or omits essential facts, the Commission *does not and cannot* under the law indicate whether it considers the registered issues *safe* or speculative; whether the capital position of the issuing company is a sound one; or whether the provisions of remuneration are fair to the stockholders. The Commission's sole effective power is the issuance of a stop order for the sale of the securities only in those cases where the facts are not disclosed in the registration statement. In fact, the Supreme Court of the United States, in one of its famous six-to-three decisions, held in the Jones case that, where a person files a registration statement and the S.E.C. wishes to examine him on it, he may withdraw the statement and thus avoid examination. Thus he is not penalized for trying to get by with something.

The major value of the securities act is that it does make available — to anyone who has the ability to read the facts realistically — complete information on every new registered issue of securities. That is all. It must be clearly understood that the commission does not and cannot pass on the desirability of an issue. In fact it causes to be printed on the face of each prospectus this warning:

> IT IS A CRIMINAL OFFENSE TO REPRESENT THAT THE COMMISSION HAS APPROVED THESE SECURITIES OR HAS MADE ANY FINDING THAT THE STATEMENTS IN THIS PROSPECTUS OR IN THE REGISTRATION STATEMENT ARE CORRECT.

Nevertheless, the average investor assumes that registration signifies governmental approval, and securities salesmen make no effort to dispel the illusion.

This misapprehension arises from the inherent faith that citizens of a democracy have in their government. They assume that the government, so wise in its dispensations, will investigate the complicated transactions of any given corporation before allowing innocent taxpayers to invest their money. Indeed, this should be the case. Of what value to the investor is an act which rightly requires full information from a corporation but merely creates an archive of complicated financial documents, many of them 100 pages or more of finely printed matter? Though such essential knowledge is available to the ordinary investor, what good can it do him if it resembles so much

Sanskrit? Lacking the training and ability to understand these documents, the investor must engage expert legal counsel and financial advisers to tell him whether or not the issue is safe. That he can scarcely afford to do.

V

HERE IS a case which illustrates the limited powers of the Securities and Exchange Commission. The facts quoted were presented in the company's registration statement. Since all the facts are given, the Commission has no choice but to permit registration, although any expert would find it a most precarious financial setup.

The X Steel Corporation had a capital and surplus of $752,000 on May 31, 1937. Its principal assets were real estate, buildings, and equipment of $566,000 net worth and inventories of $427,000. Mortgages of $243,000 must be met before November 1, 1942. None of the officers or directors owns any securities of the Company. But Mr. A, a resident of New York City, owned 72 per cent of the stock on May 15, 1937. The prospectus fails to show when he purchased the stock or what he paid for it. Between May 15 and May 31, Mr. A purchased another 22 per cent of the stock for an unstated price, giving him control of 94 per cent of the shares. Although the registration statement is signed by the officers and directors, the signature of the principal stockholder is missing.

In May, 1937, agreements were made with a New York banking firm, whose officers were former executives of S. W. Straus & Company. Under these contracts $660,275 of stock is to be sold to the public; but the Company is to receive only $127,706.25, *less* expenses for issue and sale estimated at $27,989. Thus the Company gets only $99,717.25 from the sale of $660,275 in shares. The discounts or commissions to the underwriters amount to $165,068.75. Now where do the remaining $367,500 go? Believe it or not, the prospectus unblushingly shows that they go in cash to Mr. A, the principal stockholder. No doubt this sum more than reimburses him for the cost of his 94 per cent of shares, and still he retains 25 per cent — which amounts to virtual control.

Only the rare person, however, is competent to ferret out the truth behind the scene. Many intelligent professional men are unable to interpret an involved prospectus. Instead, they rely on the word of an investment banker, and a large sale is often consummated merely by a friendly letter.

For example, this note was written by a member of the firm that handled the X Steel Corporation issue:

> Dear Jack:
>
> I am enclosing a prospectus on X Steel Company stock which we will offer publicly next Tuesday.
>
> After living with this situation for the past several weeks, it looks mighty good to us and I think it is the type of business that should become very interesting. Indications now are that the stock will be well taken.
>
> If after looking over the prospectus you'd like to pick up some of the stock at the offering price of $7 just tell me and I'll try to take care of you when allotments are made Tuesday noon.
>
> Sincerely,
>
> BOB

In the case of securities already issued, the Securities and Exchange Commission requires all companies listed on any exchange to file detailed annual financial reports, as well as all plans for mergers, consolidations, and recapitalization; management and bonus contracts; etc. Yet the commission can do no more than require a full and truthful report. Stockholders naturally — but wrongly — assume that registration implies federal supervision.

On the contrary, registration not only fails to curb the grabbing instincts of the insiders but often provides a legal window dressing, for compliance with the securities act eliminates the charge of shady dealings in secret. One result is that many officers are now being paid even higher salaries than in 1929.

Neither, as Chairman Douglas has said, does registration prevent corporations from presenting oppressive plans for mergers and consolidations; from depriving preferred stock of its accumulated dividends; from proposing inequitable plans for recapitalization; or from making management contracts and bonus arrangements. No matter how flagrant any of these plans may be, the Commission has no right to intervene. Theoretically, the Commission knows all; practically, the Commission does nothing. Meanwhile the facts lie buried in the Commission's files, unless a financial expert for some stockholder digs them out. The law has not gone very far in policing financial brigandage and, until stockholders learn how to use the available facts, the law serves no significant purpose.

The commission's files show, for example, that in December, 1936, Joseph Schenck, President of Loews, Inc., was voted a salary of \$2,500 a week, or \$130,000 a year, plus a bonus of 2.5 per cent of the net profits. In addition, the directors gave him the right to purchase 48,490 shares of stock, over a period of 5 years, at \$40 a share. When this privilege was granted, the stock was selling at \$65 a share. Mr. Schenck's compensation was thus enhanced on a single day by the tidy sum of more than \$1,000,000.

Stockholders were notified of this option contract, and a copy was filed with the Securities and Exchange Commission. But it is not the job of the Commission to question even such flagrant abuse of corporate funds. Distinctly it is the business of stockholders themselves to organize for the prevention of inside manipulations.

VI

To OFFSET this discouraging picture, another incident is offered. Early in 1937 a well-known chain-store system suddenly confronted its preferred stockholders with a plan for substituting a new issue of common stock. The invitation was accompanied by a letter showing the handiwork of skillful Wall Street counsel and by a financial statement that failed to prove any need for a drastic sacrifice by the preferred stockholders. The company had weathered the depression, and its business was good; although there were dividend arrears on the preferred stock, the amount was not large enough to demand recapitalization.

On the other hand, the equity of the common stockholders amounted to practically nothing. The common stockholders stood to gain everything that would be given up by the owners of preferred shares. Still more interesting, the preferred group had succeeded to their right of electing a majority of the board, because of the unpaid dividends. But, several months before the plan was announced, the insiders dominated by the common stock had won control of the board through the old device of the proxy machine. The result was that a board theoretically controlled by owners of preferred shares was trying to put across an unnecessary plan that would seriously injure the preferred stockholders.

Incensed by the proposal, a small group of preferred stockholders went to work almost at the eleventh hour and circularized all the other owners. Within a few days enough proxies were obtained to block the plan. At the stockholders' meeting the directors backed down and announced that the plan was being withdrawn. The moral of this story is that *investors possess the power to overcome through united action the disastrous consequence of an impotence which in reality is self-imposed.*

In a hundred ways it can be shown that the investor has a new and important role to play in modern financial life. But he needs an organization representing his interests exclusively, one that will safeguard his money by every available legal and financial means. His present inactivity serves only to perpetuate an anachronistic feudal system and to preserve a class of feudal barons.

An investors' protective organization offers the only hope for democratizing our financial system. It must be composed of a vast body of large and small investors, each of whom will pay a nominal fee; but because of its large membership it will be able to afford a highly competent financial staff. The investor-member, instead of falling into every financial trap baited for him, will be warned of the "phonies" among the many thousands of issues put out every year. The organization will serve as his watchdog at stockholders' meetings. It will kill the dictatorship created by the proxy system. Through its power in rousing public opinion, it will become a real force toward legislative protection.

Surely the history of corporation finance has provided abundant evidence of the injuries to investors through lack of an organization to match the devious cunning of the inventors of the proxy machine. Today plans are already under way to establish an organization of investors. It will be directed by men who are not only possessed of outstanding competence but also equipped with social consciousness that precludes any thought of personal gain.

Now that corporations are required to register full and true information with the Securities and Exchange Commission, investors have for the first time what is literally a golden opportunity to watch and control the affairs of the corporations they really own. The means are available. The question is, will investors use them?

Lost Horizon

by **GERALD HEARD**

Of all our problems today, the riddle of progress is the oddest. Before the World War, progressives believed in progress, reactionaries mocked at it. Now it is the progressives who dismiss it as only a vulgar faith held by backward people. It is common to hear someone say today, "Only an extravert believes in progress."

Yet advance has not stopped. It is increasing with constant acceleration. Our power over our environment — William James's definition of pragmatic truth — is as much beyond that of our parents as theirs was greater than the ancient Romans'. Nor are we overcoming mere physical difficulties. In the struggle for physiological soundness, for health, we also hold the initiative and are pressing our advantage. Tuberculosis is a failing disease, the venereal plagues are in retreat, diabetes and pernicious anemia are now held. These are triumphs of our generation. This is what civilization, with all its faults, can do for the body. Why then this despair among the educated, this wish to retreat away from the city to the savage? Is this cold fit only an attack of nerves, the fault of "excessive sensibility"?

Unfortunately this is not so. The intelligent have grounds for their misgivings. In spite of our increasing power and decreasing bodily disease, something is gravely wrong, something which may neutralize all our outward advances and credits, turning them into retreat and bankruptcy. This is no fancy. There is definite clinical evidence of it. In the United States, where people live free of the acute war anxiety which overshadows the lives of nearly every other industrialized people, even here this writing on the wall is unmistakable. The number of mental patients in this country has risen lately by 4.5 per cent. Further, compared with all other diseases, mental trouble accounts for 173,000,000 "hospital hours," while all the other plagues of mankind fill only 123,000,000.

What this means is clear. We are winning the victory on our front only to lose it at our rear. And what shall it profit a man if he gain the whole world and lose his wits, get everything into his hands but find himself driven out of his mind? Certainly, too, this is an unprecedented state of affairs, and that no doubt accounts for the fact that, in spite of the accuracy of the evidence, we find it hard to believe and even harder to think what we can do about it. The intelligent, it is true, no longer believe in progress; the psychiatrists provide proof of a serious and growing collapse. What is the alternative, how the retreat is to be stemmed, no one seems to suggest. Psychiatry tries to deal with individual cases, to restore outstandingly dislocated persons to a society from which they have become alienated. Revolutionaries try to change the society, leaving the character of the individuals who made that society unchanged. Most of us content ourselves with the dreary repetition of the cliché — "You cannot change human nature."

Nevertheless that is just the fact with which we are confronted. Human nature is changing. To put our problem quite crudely, if paradoxically: Human nature — and no cataclysm of outer nature — has suddenly altered human nature's conditions and human nature is refusing to stand the change. This is a problem which no other civilization has had to confront, and this accounts, no doubt, for our bewilderment. In all previous cultural collapses, such as the Helleno-Roman, economic decline mirrored mental decline. Invention failed as "men's hearts failed them," and social organization went to pieces as the character and nerve of individuals disintegrated. This fact, that past civilizations always showed signs of material breakdown when their hour had come, has of course blinded us to our peculiar crisis. We could not help assuming that physical progress must be a symptom of mental integration. It