

THE EVOLUTION OF  
FINANCE CAPITALISM

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**RESPICE**

**ADSPICE**

**PROSPICE**

## PREFACE

THE title of this book, *finance capitalism*, is employed as a concession to popular usage, for this study is essentially an inquiry into the nature of the non-financial and the financial institutions of *security capitalism* which is a more accurate term. The study is based on the general theory that economic processes are determined not by laws which remain fixed but by institutions which change. The evolution of these institutions is therefore traced for the purpose of indicating the principles of private and public control which should be exercised in the future in order that the system may produce the highest results from the standpoint not only of individual wealth but also of social welfare. The non-financial institutions considered in this study include the political, social, economic, philosophic and legal forces which have moulded the evolution of the system. Analysis is made of such political institutions in the domestic field as the rise and decline of parliamentary government and in the international field as the coming and passing of world peace; of such social institutions as the rise and decline of the rate of population growth and the changes in the welfare of the various groups in society; of such economic institutions as the adjustment between production and consumption; of the schools of economic philosophy such as the rise of classicism and of such legal institutions, as the growth of corporate law. A survey is also made of the purely financial institutions such as the central bank, commercial and investment banks, and the stock exchange, as well as the force of investment and of saving in the capital market.

These institutions are treated historically, comparatively and statistically. The historical approach is used, for security capitalism should be studied in relation to the past. The dramatic financial events of recent years do not constitute an isolated episode which suddenly crashed upon an unsuspecting world in October, 1929, but rather they were the inevitable results of tendencies in operation for decades. Instead of viewing merely the recent day-to-day events of security capitalism, it is necessary to study the long-range trends which are the antecedents of the current movements. A comparative analysis is undertaken to contrast the growth of institutions in various countries. This study is also based on a statistical foundation, for the economic historian must make full use of the statistical technique developed in recent years. Particularly in the field of financial history is it necessary to apply the science of sta-

tistical analysis. In recent years considerable progress has been made in developing more exact measurements, and quantitative tests have been used effectively in applied finance in analyzing the position of a particular corporation or government. This study seeks to employ in the field of social finance for the public interest, the same measurements which were heretofore utilized purely for individual gain. As far as possible the text is kept free of the statistical data which are presented either in tables accompanying the text or in appendices in those instances where the data are the basis for conclusions in more than one chapter.

Throughout the book the same general order of presentation is followed in considering each country. The stages of the rise, the development and the crisis of security capitalism are studied. Consideration is given successively to the political, social, economic, philosophic and legal background of the system, to the growth of financial organization in the form of the central bank, the commercial and investment banks and the stock exchange, to the demand for capital as expressed in governmental and corporate security investment, to the supply of capital as reflected in saving, to the various problems arising from the operation of security capitalism, to the criticism of the system and finally to the efforts at public control.

The evolution of security capitalism in leading countries, as England, France and Germany, as well as the general trends in world security capitalism are first traced. These studies serve as a setting for the comparative analysis of the evolution and the problems of security capitalism in the United States which constitutes the major part of the book. The rise and the development of the system in the United States from approximately 1820 to 1914 is first traced; consideration is given to the relation of American security capitalism to the World War and the political, economic and social background of post-war security capitalism in the United States is then surveyed. The changing function of the financial organization is presented, and a study is made of the problems arising out of the demand for capital in the fields of corporate and governmental investment. There are next presented an analysis of investment policies and a financial statement of American security capitalism. Public control of the demand for and the supply of capital is critically analyzed. The final chapter presents the principles and policies which should form the basis for reconstructing security capitalism.

The system of security capitalism is highly technical, and in practical operation is as intricate as the most highly developed industry. However, in these days of rapid change, a study of technical

security practice is of little more than antiquarian interest, since the old methods are being largely discarded, and the new methods have not yet been formulated. Many parts of the financial machine have broken down, and the experts are still doubtfully experimenting with the repairs. The student of security capitalism, therefore, faces the danger of losing his way in the maze of an intricate and ever-changing financial machinery and of not arriving at an understanding of the basic forces which at first aided the development of the system and later checked it. In view of the technical and complicated nature of the subject it would be an error to oversimplify it. Persons who would hesitate to air their views on an intricate problem in physical science, think nothing of surveying the entire subject of security capitalism in a five-hundred word article or in a fifteen-minute radio broadcast. The presentation should not be brought down to the reader, but realizing the challenge to his intellectual power, the reader should rise to an understanding of the subject.

A further difficulty which obstructs an inquiry into security capitalism is that over all the years of its operation, little progress has been made in placing security capitalism on a scientific basis by developing a classified and verified body of knowledge about it. As a result of this lack of scientific progress, security capitalism is presented, and often taught, as an incoherent mass of fragmentary, unsubstantiated and confused statements. The student of the subject of security capitalism should, therefore, seek to produce a body of classified and verified facts which taken together has some coherence.

It should also be realized that security capitalism is an imperfect system which, at times, has not functioned satisfactorily from the standpoint either of the individual or of society. As a result, critics of security capitalism overemphasize the dramatic and sensational misdeeds of particular individuals. On the other hand apologists, unwilling to admit the limitations of security capitalism, seek to veil the failure of both public and private financial statesmanship by senseless propaganda. Critical iconoclasts and apologetic idolators have built up prejudices and myths which have found widespread acceptance not only among the general public but even unfortunately among professional economists. Security capitalism therefore needs understanding both from those who have little realization of the practical difficulties in finance and from those who have scant appreciation of the social consequences of their errors. Too often in recent years attack has come from those who cannot very well be considered deep students, from those who write sweepingly and condemn in broad generalization; too frequently defense

has come blindly from those who lack understanding, and from those who in self-interest tolerate no honest criticism. The limitations of security capitalism should be viewed with neither destructive assault nor uncritical defense, but rather with constructive criticism and objective detachment. To the radically inclined mind the following presentation of security capitalism will seem merely another useless disclosure of the known weaknesses of the system and a futile effort to bolster up a decadent institution. To the reactionarily inclined mind the presentation will appear as just another inquisitorial venture. It is the hope of the author that the book will attain the fundamental test of scholarship in being an honest search for truth, whether pleasant or unpleasant, and based on this truth in proposing a constructive program of controlling security capitalism which, despite its imperfections in the past, has served the interests of society.

We should therefore approach the subject for the purpose of understanding the underlying principles, of grasping the significance of its complicated organization, of assembling and co-ordinating a body of classified and verified facts concerning the system and of searching out its imperfections with a view toward reconstruction.

For the general method of treatment the author is indebted to Dr. Charles A. Beard under whom he studied at Columbia University a quarter of a century ago. Dr. Beard developed a technique of historical institutional research which had been sadly lacking in financial investigation.

The manuscript has been read by Professor James D. Magee of New York University, Professor Nelson P. Mead and other members of the History Department of the City College of the City of New York, Professor Joseph L. Tynan of the English Department and by Mr. Jerome B. Cohen of the Economics Department. Acknowledgment is due to Dr. Harold G. Moulton who gave the author the idea of an integrated study of the financial system. The initial compilation of the tables and appendices was undertaken by members of W. P. A. Project 165-97-6999 (6051) which I sponsored. I owe a debt to my students of the City College of the City of New York who over the years have constituted a critical though always a friendly and stimulating audience. My deepest obligation is to my wife not only for her painstaking research and careful preparation of the manuscript but particularly for her encouragement and inspiration which have made the writing of this book a joyful experience.

The later chapters dealing with American security capitalism are in a large measure based on the findings of the various governmental investigations of the system. The results of these findings

have been analyzed and an attempt has been made in this book to give a critical and orderly presentation of these data. The student of security capitalism is deeply indebted to Joseph Healy, Ferdinand Pecora and Max Lowenthal for the wealth of information which they have disclosed respectively in the hearings on public utility, banking and railroad finance. Liberal use has also been made of the findings of the munition industry inquiry and the reports of the Securities and Exchange Commission. In writing the chapters on the history of security capitalism on the Continent, the author was fortunate in having available the studies of Alfred Neymarck, the comments of Werner Sombart and the work of Jacob Rieser.

The source material for the early chapters was obtained over a period of years from libraries in this country and abroad, as the New York Public Library, the Congressional Library, the libraries of Harvard University, of the Federal Reserve Board, of the American Bankers' Association, of the British Museum, of the London School of Economics and of a number of French, German, Belgian, Austrian and Scandinavian banks. The general plan of this book was conceived in Germany in 1922 while undertaking a study of European financial organization and part of the data was gathered in subsequent visits to Europe. In the chapters on post-war tendencies the author has drawn upon his own direct observations in this country and abroad. He was fortunate in having had the opportunities for such direct observations through association with various departments of the federal government and also with private organizations such as in founding the Institute of International Finance for the Investment Bankers' Association of America and in working with the American Bankers' Association at various times in recent years.

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THE EVOLUTION OF  
FINANCE CAPITALISM

# THE EVOLUTION OF FINANCE CAPITALISM

## *Part I—Evolution of World Security Capitalism*

### CHAPTER 1

#### *FINANCIAL INSTITUTIONS OF SECURITY CAPITALISM*

THROUGHOUT its evolution, capitalism has taken various forms, and can be grouped according to its territorial extent as local, national or international capitalism; according to its relation to the state, as private or as public capitalism; according to the economic class which dominates the system as agrarian, mercantile, industrial or banking capitalism. A more important principle of classifying capitalism is according to the nature of the transfer of capital. Thus a distinction should be drawn between individual capitalism and security capitalism.<sup>1</sup>

Under individual capitalism the funds for financing economic activities are furnished by the entrepreneur operating as a single owner or in partnership with others. These funds may be applied either to private or to public undertakings. In the former case the funds are generally used by the entrepreneur in his own business where capital ownership and executive management are combined. In the latter the entrepreneur, singly or with a group, turns over his funds to the ruler as an individual. In private finance the single-ownership and the partnership have been gradually replaced by the corporation while in public finance the ruler, as the borrowing party, has been supplanted by a legislative body, and in both fields today the transfer of capital is largely evidenced by securities. Individual capitalism thus has given way to "stock-and-bond" or security capitalism.<sup>2</sup>

Individual capitalism and security capitalism differ in several essential respects. Individual capitalism depends largely on entrepreneur capital, it is personal in nature and the basis underlying

its capital consists largely of tangible assets as farms, factories or ships. Security capitalism rests on investor capital, it is essentially impersonal and the instruments evidencing claims to wealth are based on intangible as well as tangible assets.<sup>3</sup>

Under individual capitalism, the entrepreneur finances himself for short periods of time by commercial credit, while under security capitalism there is more reliance on investment credit. Under individual capitalism, labor and land are the important factors in production, but capital is dominant under security capitalism.

#### MEANING OF SECURITY CAPITALISM

Security capitalism may be defined as the economic system which is financed through the conversion of the saving of investors into security investment. Security capitalism is thus the system which brings together the forces of saving and of investment as far as they relate to securities.

Saving, on the one hand, results from the collective choice of individuals willing to restrict their expenditures in relation to their immediate income, while investment arises from the collective action of entrepreneurs or governments desiring to increase their expenditures beyond their current income. Saving refers to the accumulations of the consumers, whether individuals or corporations, while investment denotes the forms evidencing the transfer of the saving to entrepreneurs or governments. This investment may be evidenced in various forms such as commercial paper, mortgages and particularly securities. This study deals with the application of saving to security investment which today constitutes the greater part of total investment.

The relation between saving and investment can be studied from the standpoint of the individual saver and the individual entrepreneur. Such a treatment lies in the province of a treatise in the field of investment practice presented from the standpoint of individual profit. This book is concerned rather with the relation between saving and investment from the social viewpoint and deals with the operation of these two forces from the standpoint of public interest. Saving will therefore be considered as the excess of national income over expenditure. National income will be used in the sense of the money value of the goods and services received by the individuals composing the nation over a definite period of time such as a year.

#### PARTIES TO SECURITY CAPITALISM

There are three leading parties to the system of security capitalism namely the saving-investor, the saving-receiver and the saving-

dealer or the investment banker.<sup>4</sup> The first party, whom we will call for brevity the investor, retains the ownership of his saving, but transfers the executive management to the receiver who in exchange gives paper claims in the form of shares or of bonds. The incentive which induces the investor to part with the control of his saving is the expectation of income in the form of dividends on stock, interest on bonds, or of profit through the appreciation of the market value of these securities. The expectation of income by the investor is based on his confidence in the earning power of the corporation or in the fiscal power of the government.

The receiver of saving may be either a corporation which applies it to some private enterprise or a government which directs the saving to some public undertaking. It is important throughout this entire discussion to keep in mind that security capitalism facilitates the application of saving not only to private but also to public financial operations. The third party to the system is the investment banker. He is not an essential party, for saving can be converted into security investment through the sale of securities by a corporation or a government directly to the investor. However, such direct sales are relatively unimportant. The investment banker is primarily a dealer who purchases securities and sells them to the investor. The purchasing operation of the investment banker has become an important activity in the modern capitalist system. It is a power which has deep social and economic significance. Through the purchasing function the investment banker exercises a selective power by which he can either grant or withhold new capital so essential to financing the needs of corporations and of governments. By the exercise of this selective power the investment banker therefore controls the flow of new capital.

After purchasing an issue of securities, the investment banker sells them to the investor either directly or indirectly through other financial institutions, such as deposit banks, including both savings banks and commercial banks receiving savings deposits, investment trusts, or life insurance companies. Under the direct relationship between the investment banker and the investor, the latter exchanges his saving for the securities of the receiving corporation or government. Under the indirect system, the investor obtains a claim on a financial institution which in the case of the bank is a deposit account, in the case of the investment trust is a stock or a bond, and in the case of the life insurance company is a policy. These institutions in turn may place the funds of the investor in securities of corporations or governments.

Old capital, as represented in securities already outstanding, is bought and sold through brokers, who act as agents, and derive their

return from a commission on the purchase or the sale of securities. Such brokers are grouped in either fully organized stock exchanges which trade in listed securities or more loosely in over-the-counter markets for the purchase and sale of unlisted securities. The so-called commercial bank has also become an important party to the system of security capitalism. As mentioned before, it may serve as an institution of indirect investment. Another important function is to supply credit for carrying securities. Similarly the operation of the central bank, as the keystone of the commercial banking system, has been influenced by security capitalism. In practically every country the central bank grants advances collateralized by securities, and in certain countries it performs other security services.

#### RELATION BETWEEN MANAGEMENT AND BANKING

It is frequently held that the prominence of the investment banker in the financial system necessarily leads to his assuming the function of capital management. In American economic literature this extension of his function is generally described as domination by Wall Street and in European literature there is a similar criticism of the grip which the investment banker is supposed to hold over the industrial life of the nation. As will be indicated in later chapters describing the financial organization of various countries, there is not always a close relation between investment banking and industry, and banking domination is not necessarily an essential characteristic of security capitalism.

The evolution of the financial relation between capital management and investment banking generally passes through three stages. In the early history of a particular corporation or industry, or even economic system, the relation between capital management and investment banking is generally negligible. Industry finances itself internally through the reinvestment of its earnings and this policy is usually the result not of choice but of necessity, for the untried corporation or the young industry or the new system is unable to finance its growth by the sale of securities to the public. In the course of time the particular corporation or the industry or system, if operations are profitable, is in a stronger position to finance its growth by the sale of securities. At this point a close relationship between management and investment banking may develop. This tie is not a necessary result, for if the needs of the corporation are not pressing the management may readily retain control of its own business. Furthermore, the same result may follow if the supply of capital in the market is abundant, as was the case in England in the nineteenth century. If the expansion is so rapid that the

corporation must have a large and continuous supply of capital, and if the supply of available capital is limited, then the investment banker may very well obtain control over the management of the affairs of the corporation. Such conditions prevailed in Germany in the period of rapid industrial expansion in the last quarter of the nineteenth century.

In the course of time there comes a third stage in the relationship between industry and investment banking. As a nation attains economic maturity the supply of capital funds directly owned by corporations increases, and under these conditions they are less dependent upon investment banking. Similarly, the increase of profits enables the management to finance its expansion more and more from the reinvestment of earnings, and as a result the control of investment banking over industry is weakened. Such was the history of the relationship of investment banking to industrial management in the post-war period in the United States when banker control was lessened. The decline of control by the banker and the re-assertion of control by industry also occurred in Germany in the post-war years, but unfortunately was accompanied by sweeping political changes. The history of security capitalism indicates that control of the management of industry by banking capitalism is but a transitory stage.

#### CHARACTERISTICS OF SECURITY CAPITALISM

The underlying characteristics of security capitalism may next be noted. In the first place, while the investor retains the ownership of his capital, he generally loses control over its management. This divorce of management from ownership of capital is particularly true in indirect investment where the investor turns over the disposition of his funds to the deposit bank, to the investment trust or to the life insurance company. Even under direct investment in corporate finance, the investor has frequently been separated from control of his funds through the creation of such divorcing agencies as the voting trust, non-voting class A stock and the holding company. In public finance, the investor has practically no control of his capital. Furthermore, security capitalism has led to wide diffusion of the ownership of corporations. This tendency is frequently described as the "democratization" of capitalism. It is true that security capitalism has transferred corporate ownership from the few to the many, but because of the diffusion of securities among many holders, control still continues in the hands of the few who manage not only their own capital but also that of the multitude. Security capitalism thus effects democratization of the







































































































































































































































































































































































































































