

*Strictly Tentative*

# INVESTMENT BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE PRESIDENT  
BUHL BUILDING  
DETROIT

January 16, 1941.

HONORABLE JEROME N. FRANK, *Chairman*,  
Securities and Exchange Commission,  
Washington, D. C.

Dear Mr. Frank:

It is desired to acknowledge the Commission's letter of December 20, 1940, with which was enclosed a copy of a report of the Staff of the Public Utilities Division of the Commission entitled: "The Problem of Maintaining Arm's-Length Bargaining and Competitive Conditions in the Sale and Distribution of Securities of Registered Public Utility Holding Companies and Their Subsidiaries." In this report, the P.U.D. Staff has recommended the adoption of a rule which would require generally that competitive bidding be resorted to in the sale and distribution of securities of registered public utility holding companies and their subsidiaries.

It is noted that before taking decisive action in this matter, the Commission desires to receive comments and suggestions from all of those interested and that at the request of any person concerned it will be prepared to arrange for a round table discussion of the subject.

We are glad to respond to the Commission's request. In doing so, we wish clearly to place ourselves on record as being of the opinion that any rule or regulation of the Commission requiring that, in the sale of securities of a public utility company, or other issuer subject to the jurisdiction of the Commission, corporate management must resort to competitive bidding, would, in operation, be detrimental to the best interests of issuers, of security holders, of consumers and of the investing public. We summarize our principal reasons as follows:

- (1) While compulsory competitive bidding may, under certain circumstances, procure higher prices for public utility issuers, it would do so at the expense of investors, whose interests the Commission has a statutory duty to guard, the damage to investors arising, among other things, from the over-pricing of issues which is a consequence of compulsory competitive bidding.

(2) If the increased price to the issuer in periods of rising markets would be of sufficient importance to warrant making a drastic change in the organization which has been evolved for the distribution of securities, then the decreased yield to investors should be correspondingly great. If it is argued that this is not necessarily so but that the difference would come from the underwriter's spread, then the underwriter making the least investigation, producing the shoddiest goods and contemplating the cheapest distribution methods, could afford to pay the highest price. The investor and the issuer would then suffer in several ways:

(a) The investor would more frequently than not pay a higher price;

(b) Skimpier and cheaper investigations by underwriters would increase the investor's danger of losing money and thereby affect the liabilities of issuers;

(c) The purchase of securities at the highest possible price through compulsory competitive bidding would tend to bring about high-pressure salesmanship, which reputable investment bankers seek to avoid;

(d) Issuers would be compelled to sell securities at a price higher than they might think proper, without regard to the manner in which the securities were to be distributed by the purchasing underwriters ~~\_\_\_\_\_~~ ①

(3) The underwriting of corporate securities by investment bankers is, in fact, competitive; and the competition of the market by which every issue must be judged assures fair prices to the issuer and to investors.

(4) Compulsory competitive bidding would force the concentration of distribution into the hands of relatively few underwriters and dealers. This would be greatly to the detriment of the smaller investor who must largely rely on broad facilities of distribution to provide him with opportunities to participate in purchases of new issues of securities.

(5) Compulsory competitive bidding is not the best available means for judging the reasonableness of prices and spreads.

(6) The requirement of compulsory competitive bidding would not remove the Commission's difficulties in satisfying its duties under Sections 6 and 7 of the Public Utility Holding Company Act; to meet its statutory responsibilities the Commission would still find it necessary to examine the reasonableness of the price and spread after the bids had been received.

(7) The sale of issues through compulsory competitive bidding could not be carried out consistently with the practice envisaged by the sponsors of the Securities Act of 1933 which requires that a thorough and searching investigation be made by a responsible underwriter.

(8) There is no feasible substitute for the professional work of the investment banker in the setting up of an issue, including the development of substantive provisions of indentures and of the securities.

There are a number of other factors which indicate the undesirability of compulsory competitive bidding; and in the accompanying document we discuss certain of these factors, as well as the more important ones outlined above.

In support of our opinion we are prepared to submit proof at any hearing of the Commission or of any committee of the Congress before which the matter may come for consideration.

We have long sought to cooperate with the Commission and its Staff in an effort to remove the causes of needless friction in the operation of the channels through which savings normally flow into productive enterprise.

When a public hearing on proposals for amending the Securities Act of 1933 was scheduled last May to be held before the Committee on Interstate and Foreign Commerce of the House of Representatives, we readily agreed to join in a request for the postponement of such a hearing so that the Commission might have until January 1941 to study such proposals and to consult with representatives of underwriters and dealers and of other interested elements before submitting a report to Congress. Our representatives have lately joined in a request of the Commission asking that the time for submitting to Congress the report on changes in the Securities Act be extended further to the latter part of February.

In an endeavor to work on a cooperative basis with the Commission and to solve our problems in a manner approved by the public and the Congress, during the past several months our representatives and those of other interested elements have, from time to time, been engaged in discussions with members of the Commission's Legal Staff and of its Trading & Exchange and Registration Divisions. While these discussions did not specifically encompass the Public Utility Act of 1935, it was our understanding that the conferences would deal with all prob-

lems arising under the 1933 and 1934 Acts or having to do with the regulation of the exchanges or the regulation of underwriters and dealers. The Commission itself and all other parties to these conferences have found, and have stated that, despite such differences of opinion as have existed, the conferences have resulted in a candid, objective and helpful examination of the problems there discussed.

The Staff of your Public Utilities Division, in a report, which seems to be more of an attack on investment banking than a discussion of the economics of compulsory competitive bidding has, however, recommended to the Commission a proposal which would be disruptive of present investment banking organizations engaged in purchasing and distributing securities. The organizations by which public utility securities are distributed are inseparably interwoven with the problems of regulation under the 1933 and 1934 Acts. The proposal put forward by the P.U.D. Staff, if adopted by the Commission, would, in our opinion, introduce procedures necessitating changes in the regulations under, and in the statutory provisions of, the 1933 Act. It would have been most helpful, therefore, if this proposal had been introduced for discussion in the conferences on changes in the Securities Acts and the regulations thereunder, which have been proceeding over the past several months.

The Commission's letter of December 20 transmitting to us the Report of the P.U.D. Staff asked that written comment be submitted prior to January 6, 1941. But, subsequently, pursuant to requests for an extension of the time for submitting replies, made by the Investment Bankers Association of America and the National Association of Securities Dealers, Inc., the Commission extended that date to January 20, 1941.

This extension of time has been helpful. Yet it has not provided sufficient opportunity to study in all its aspects the very detailed and lengthy report compiled by the P.U.D. Staff which consists of some one hundred and twenty-five pages of typewritten matter and statistical tables. The proper study of this material and the preparation of a comprehensive reply thereto necessitates the examination of many publications, reports, and other documents from which quotations have been taken or to which direct reference has been made in the report. There has not been time to do this. Indeed, some of these publications have not yet become available to the public.

For example, at pages 9, 10, 11 and 12 of the report a dozen or more references are made to the official report of the hearings before the

Temporary National Economic Committee, particularly to Parts 22, 23 and 24 of the said reports. We find, however, on endeavoring to obtain copies of these publications, quoted in the P.U.D. Staff report, that Part 22 of the T.N.E.C. Record was not published until December 23, 1940, and that Part 23 had not been published at the end of December and was received by us only on January 11. Part 24 of the T.N.E.C. record was not available to us up to January 16.

Apparently the P.U.D. Staff (having been directed by the Commission, in March 1940, to begin the studies which have resulted in the present report) was engaged for some nine months or more in the development of its proposals.

In comparison with the length of time taken by the P.U.D. Staff to prepare its report, the time permitted to industry, investors, state regulatory bodies, underwriters and dealers to study the report and to submit written comment thereon, has not, in our opinion, been adequate. We therefore made a further request to the Commission that the time for submitting written comment be extended for several weeks. We have particularly pointed out in this connection that, while the report of your Staff did become available to a few people in industry, and in the investment banking business, on December 21 (the Saturday before Christmas), for the most part those interested received their copies only on the eve of the Christmas season, when it is difficult to get members of an industry located all over the United States to leave their homes for meetings.

We have been informed by the Commission, however, that it has determined to adhere to January 20th as the "deadline" for submitting written comment. Therefore, we now present to you the accompanying paper in which an examination has been made of certain aspects of the Staff's proposal for a compulsory competitive bidding rule and of the considerations on which it has based this proposal.

We shall be glad to discuss the subject with the Commission in an informal round table conference as suggested in your letter and we ask that such a conference be arranged. We know it would be of help to us and we think that a full and frank discussion would greatly aid the Commission in its consideration of this matter.

Before any decisive action is taken by the Commission in the matter of compulsory competitive bidding, all who may be affected by the proposed rule including particularly investors and the smaller dealers, should, we believe, be given every opportunity, to make a thorough study of the Staff report on which the Commission has been asked by

the Public Utilities Division, to determine this important question. We also believe that such interested parties should be given a reasonable opportunity to study the views of our Association as reflected in the accompanying document.

We therefore urge on the Commission that no definite action on the rule proposed by the Public Utilities Staff be taken until these problems have been so considered by those affected and by the Committees of Congress. We also urge the Commission to join with us in a request to have the broad questions of public policy involved in the proposed rule thoroughly explored at public hearings before the House Committee on Interstate and Foreign Commerce.

We are sending you ten copies of the enclosed examination of the P.U.D. Staff proposal. Copies are also being sent to all of our members, to state commissions, investing institutions, members of the Congress and other interested parties. We shall be glad to furnish you with as many additional copies as you may wish.

Yours very truly,

(Signed) EMMETT F. CONNELLY,  
President

**AN EXAMINATION**

*of the proposal of the S. E. C. Staff for compulsory  
competitive bidding in the sale of certain  
public utility securities.*

**By**

**THE SECURITIES ACT COMMITTEE**

**of the**

**INVESTMENT BANKERS ASSOCIATION OF AMERICA**

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## I

### On "the main case for competitive bidding"

"The main case for competitive bidding rests" on "the element of concentration in and the non-competitive aspects of the security underwriting business," according to the statement of the P.U.D. Staff (i. e., the Staff of the Public Utilities Division of the S. E. C.), which appears at pages 23 and 24 of the report which it submitted to the Commission on December 18, 1940.

Here, the Staff has taken the view that the Public Utility Holding Company Act of 1935 should be administered as an instrument for regulating the investment banking business.

Let us examine the facts on which the Staff rests its main case.

The P.U.D. Staff report states (page 9) that "evidence" was presented to the Temporary National Economic Committee concerning the dollar amount of securities issues *managed* by "certain investment bankers," and that during the five and one-half year period, January 1934 until June 1939, six leading New York bankers *managed* 62% of all registered, *managed* bond issues and 57% of all registered, *managed* bond, preferred stock and common stock issues. The Staff then goes on to say (page 10) that "six New York firms, therefore, appear to exercise a virtual monopoly over the origination of desirable, quality bond issues. . . ."

It is apparently on these statistics that the Staff has based its main argument suggesting that there is an improper "element of concentration" in the investment banking business.

The statistics compiled by Dr. Oscar L. Altman and presented by him to the Temporary National Economic Committee on January 12, 1940, as a witness appearing for the Securities and Exchange Commission, seem to have been designed to create an appearance of great concentration. Investment bankers were not permitted to combat these figures at the hearings. These statistics attribute the entire amount of each issue of securities to the managers and do not show the individual underwriting *participations* of the several underwriters concerned.

According to Dr. Altman's method, an underwriter who may have had only a \$3,000,000 participation, in a \$60,000,000 issue, is credited, if he happened to be the syndicate manager, with having handled the whole \$60,000,000 issue, despite the fact that thirty or more other

underwriters may have underwritten \$57,000,000 of the \$60,000,000 issue. On a similar basis all the hits of a baseball team would be "concentrated" in the Captain.

While syndicate management is an important function the public would have been more fairly and accurately informed as to the actual manner in which the underwriting and sale of "registered" securities has been distributed amongst underwriters and dealers throughout the country, if the statistics submitted to the Temporary National Economic Committee, under the direction of the Commission, and employed by the P.U.D. Staff in its report, had been based on the actual underwriting *participation* of each underwriter. They would have been even better informed if the report had also shown the proportionate amount of bonds and stock of each issue turned over by the underwriters to hundreds of "selling group" dealers to be sold by the latter to the investing public.

In view of the fact that Dr. Altman's statistics as presented to the Temporary National Economic Committee are now being employed to support the arguments of the P.U.D. Staff, it is necessary again to point out that despite repeated requests for a hearing before the Temporary National Economic Committee, in which investment banking would have a full and free opportunity publicly to present the facts derived from its experience, in its own words and through witnesses of its own choosing, no such opportunity was ever afforded to us.

It is unsound to rest a "case for competitive bidding" largely on "evidence" consisting of ex parte statements by selected witnesses presented in hearings before which those directly concerned are afforded no opportunity for rebuttal or cross examination. It will be recalled that when, on December 19, 1939, an effort was made to have the Temporary National Economic Committee consider the problem of compulsory competitive bidding, the Committee decided against doing so and the Chairman of the Committee said: "Mr. Henderson pointed out earlier this morning that the S.E.C. is apparently preparing a complete study on that very question." Later on, Commissioner Henderson, one of the members of the Committee, strongly objected to the submission to the T.N.E.C. of any testimony relating to competitive bidding and no opportunity for the presentation of such testimony was ever accorded to investment bankers. Commissioner Henderson stated at the beginning of the hearing on December 12, 1939, that "Technical problems arising from the administration of the several Acts which the Securities and Exchange Commission administers will not be covered in the present hearings."

In contrast with the statistics compiled by Dr. Altman, for the T.N.E.C., statistics compiled by the Research and Statistical Staff of the Commission itself show that 515 underwriters and dealers participated in the underwriting of 745 security issues of \$1,000,000, or more, principal amount, "registered" with the Commission between January 1, 1934 and June 30, 1938. The total gross proceeds of these issues amounted to \$7,584,000,000. Information at our disposal indicates that the number of dealers who participated in this business as distributors was substantially greater than the number shown by the Commission's statistics as having participated in the underwriting of the business.

In recent practice approximately one-half of the principal amount of corporate bonds underwritten has ordinarily been made available for distribution to the investing public through a large number of selling group dealers in all sections of the country. The remainder has been sold directly at retail by numerous underwriters. Making allowance for the fact that the smaller dealers more frequently act as selling group members than as underwriters, it is estimated that the retail distribution of approximately 60% of all corporate new issues offered to the public is carried out by about some five hundred dealers who on some occasions act as underwriters but who more frequently participate in selling groups only and by approximately one thousand dealers who participate in selling groups but who do not act as underwriters.

By following Dr. Altman's formula for measuring concentration it may be determined from the data (pages C-31 to 37 inclusive) prepared by the P.U.D. Staff that four leading underwriters *managed* 94% of all public utility bond issues sold in compulsory competitive bidding and reoffered publicly since 1934. This compares with six leading underwriters *managing* 62% of all registered, *managed* bond issues. Granted that the P.U.D. data are inconclusive, there is still no reason to expect less concentration of leadership in underwriting under compulsory competitive bidding than in negotiated underwritings; the concentration being no greater than that which exists in any other calling where leadership is required.

It is in fact clearly demonstrable from experience that there is no greater concentration in the underwriting of corporate securities through direct negotiations than in the purchase of municipal securities in compulsory competitive bidding. In fact, when consideration is given to the relative size and number of issues in the two fields, it would appear that there is greater concentration with respect to underwriting in

the municipal field where compulsory competitive bidding is generally a statutory requirement. When distribution is taken into the equation it becomes clear that the handling of corporate issues is much less concentrated and embraces a great many more dealers than the number who participate in the handling of municipal issues. As to this, we refer particularly to the comparison of municipal and corporate financing contained in the monograph "*Competitive Bidding for New Issues of Securities*", by Franklin T. McClintock of Harriman Ripley & Co., Incorporated, 1939.

## II

### **On the competitive character of investment banking**

At one point (page 16) the P.U.D. Staff report declares that "the investment banking mechanism has become a concentrated financial power largely exempt from the safeguards of free competition." At another point (page 41) the P.U.D. Staff report asserts that "the investment banking business is characterized... by a definite absence of free market competition." Again (at page 42) the P.U.D. Staff refers to "the problems of banker... domination."

Yet, despite this talk of absence of free market competition and of investment banker "domination" and "control" over the financing of public utility issuers, the Staff of the Public Utilities Division has itself presented in its report evidence disclosing the unsoundness of these allegations. In Appendix E to its report, the P.U.D. Staff has presented a tabulation showing that 166 issues of securities of electric and gas utility companies, amounting in the aggregate to \$1,018,425,788, were sold in the six year period 1934 to 1939 directly by the issuers to insurance companies and other purchasers in so-called "private placements," without underwriting. Loans from commercial banks, the Reconstruction Finance Corporation or other agencies of government are not included.

It is surely not to be believed that, had there been an "absence of competition" for these issues or had there, in fact, existed any "domination" or "control" by investment bankers over the issuance and sale of these securities, the investment bankers having such power to "dominate" or "control" these issuers would, in view of their well-known opposition to "private placement," have failed to obtain for themselves the business of underwriting, or, at least, of participating in the underwriting of, the issuance and sale of these securities.

All told, the records covering so-called "private placements" indicate that in the period from 1933 to the end of 1940 more than four billion dollars, in amount, of corporate securities of all kinds, including industrial, public utility and other issues, has been sold directly by the issuers to investing institutions and others. There has been no underwriting of this business; and, in the great majority of cases, investment bankers have not participated in it in any way.

In view of these well-established facts, it is difficult to see what basis exists for the claim of the P.U.D. Staff that absence of competition for new issues of public utility securities makes necessary the imposition of a competitive bidding rule.

It seems, however, that the Staff has given little consideration to these facts. The significance of the statistics of so-called "private placement" and of long-term commercial bank loans or loans from governmental agencies is not discussed in the Staff report. Even though these statistics are not helpful to the case which the P.U.D. Staff has been endeavoring to establish it would seem essential that they be examined at some length in any objective presentation of the factors relating to competitive conditions in the sale of securities of registered public utility holding companies and their subsidiaries.

In the past six years or so some five hundred issuers have taken their business entirely out of the hands of underwriters and have sold their securities directly in what is called "private placement."

But it is certainly not necessary to rely on the statistics of so-called "private placement" to establish that there is "free and independent competition" in investment banking. The fact of competition persists despite the arbitrary decision of the P.U.D. Staff (page 24) that sales of security issues to underwriters transacted in accordance with usual practice are to be characterized as "non-competitive sales."

We have said before and repeat again, that competition is the life blood of our business. Investment bankers are engaged in keen competition for new clients. They likewise compete actively with each other for positions in underwriting and selling syndicates.

When a corporation enters the capital market, it chooses its underwriters from amongst those seeking to be selected and upon the basis of their past performances. When a relationship is established, assuming it to be satisfactory, it is likely to be a continuing one, based on mutual trust, as are most satisfactory relationships in human affairs. But the pressure of competition is always present and each investment

banker, in common with every accountant, doctor or lawyer, knows that others are ready and anxious to serve the clients who have customarily done business with him. If an underwriter fails in any respect to handle satisfactorily the business of issuers, they may go elsewhere. There are numerous examples of issuers changing from one underwriter to another.

The records of recent periods alone provide important illustrations of issuers who, for one reason or another, have terminated underwriting relationships and taken their financing elsewhere. Among these are Bethlehem Steel Corporation, Shell Union Oil Corporation and Republic Steel Corporation. Among public utilities, Pacific Gas & Electric Company, Commonwealth Edison Company, Public Service Company of Northern Illinois, and various subsidiaries of Middle West Corporation, have made important changes in their underwriting relationships during recent years.

In view of this situation, the P.U.D. Staff's assertion (pages 10 and 11) that there are such things as underwriters' "proprietary rights" to certain accounts, is incorrect on its face. It is wholly inaccurate to say, as the Staff has done, at pages 10, 11, 12, 13 and elsewhere in the report, that investment bankers claim "proprietary rights" to financing. We doubt if any such claim exists. As evidence supporting its declaration, the Staff mentions written agreements "giving the underwriter an option on all future financing of the issuing corporation." The Staff refers directly to "abstracts of twenty-nine such contracts, nineteen of which are apparently still in full force," which are to be "found in the T.N.E.C. record."

In the paragraphs preceding mention of these twenty-nine "contracts," reference is made to "six New York firms" which, says the Staff, "appear to exercise a virtual monopoly" over the origination of high grade financing. In the paragraphs preceding and following this, specific mention is made of several underwriters, namely, Kidder, Peabody & Co., The First Boston Corporation, Lehman Brothers, Goldman, Sachs & Co., Kuhn, Loeb & Co., Lee Higginson Corporation and Morgan Stanley & Co.

Because of this arrangement of matter in the Staff report, it is not to be doubted that the result has been to create, in the minds of readers who have lacked facilities for referring to the original documents, the idea that the contracts mentioned in the report were entered into by the investment bankers whose names the Staff has introduced directly into the records.

But, in fact, no one of these contracts was made by, or in any way, directly or indirectly, concerned, any of those so named. The record shows that eight of the twenty-nine contracts were contracts made by Halsey, Stuart & Co., Chicago, (and that all of these were cancelled in 1939) that four were contracts of Federal Securities Corporation, Chicago (which according to the report of the T.N.E.C. is now inactive, and which in fact went out of business in 1927), and that others were contracts of smaller dealers in Cleveland, Los Angeles and other centers about the country. Far from establishing or suggesting the existence of "proprietary rights," several of these latter "contracts," generally relating to promotional issues, represent nothing more than agreements to permit the dealer with whom the agreement was originally made "to purchase securities upon at least as favorable terms as proposed by others." So far as can be ascertained none of those now in force relate to public holding company or public utility operating company securities. The report is also wholly inaccurate in stating that Goldman, Sachs & Co., and Lehman Brothers "claimed proprietary rights"; they expressly disclaimed the existence of any such rights at the T.N.E.C. hearings, and the agreement between them dealt solely with their relations with each other and was not an agreement with any issuer.

But as the records of the Temporary National Economic Committee itself clearly show, the practice indicated by these twenty-nine exhibits was not, and is not, a general practice and is definitely not the practice of the underwriting houses mentioned as "leading...investment houses" in the P.U.D. Staff report; and it is not the practice of any of those mentioned specifically.

The fact that Counsel for the Securities and Exchange Commission before the Temporary National Economic Committee asked a question in which he implied that investment bankers "are, in effect, partners in a community business" is certainly not evidence of the existence of any such relationship or condition. And despite the fact that investment bankers were given before the T.N.E.C., no opportunity for the cross-examination of witnesses or the rebuttal of hostile "evidence," there is nothing in the records of the T.N.E.C. warranting the opinions and conclusions as to such relationships expressed by the P.U.D. Staff in its report.

Evidence of the keen competition which exists in the purchase and underwriting of new issues of securities is everywhere at hand.

Practically every investment banker worth his salt is constantly calling the attention of issuers to the merits of his services and to what

he has done and is doing in the way of underwriting and distributing securities. While every potential issuer of securities may not, in fact, be importuned specifically by a multitude of investment bankers seeking to persuade him to use their services in the issuance and sale of securities, the issuer is constantly made aware that numbers of investment bankers are anxiously willing to serve him at any time and issuers do not hesitate to brandish this sword over the heads of their customary underwriters.

It is not necessary that competition be an affair of noise and clamor in the streets. Competition manifests itself in various ways. It was once the practice of clothing merchants in some sections to employ men to go into the streets in front of their premises, seize potential customers and drag them by physical force into the stores. That was one form of competition. Other merchants, however, competed successfully with their rivals by the quieter method of improving the quality of their goods and of having an open door past which possible customers might freely go their several ways, or through which they might freely enter and make purchases whenever they so desired.

But, the P.U.D. Staff has arbitrarily decided (page 16) to set aside what economists describe as the "competition of the market." Despite the view of the Staff, this competition cannot be so dismissed from consideration. It is real. It exists and will continue to do so.

The competition of the market is relentless. Full, unsparing and "pitiless" publicity accompanies every step in the underwriting of securities; the public offering price, the coupon or dividend rate, the proceeds to the issuer, the expenses, the "spread" between the public offering price and the price realized by the issuer, the concessions available to dealers, and subsequent markets are published far and wide. The underpricing or overpricing of an issue becomes immediately a matter of public knowledge available to every issuer and financial officer and to every underwriter and dealer, as well as to all interested members of the public. Every document which is used in the business of underwriting an issue—the registration statement and the prospectus, the agreements between underwriters, the agreements between dealers, and other such papers—are available to all. The offering price and the terms of the "spread" are established in the light of the competition of the market for comparable securities, not only by that of the public market for securities, but also by that of the market for commercial loans, "private placements" and by the rates quoted by government agencies. The competition of the market represents the combined judgment of every buyer and every seller of securities in the



country. The success or failure of the offering of every issue becomes at once a matter of public knowledge and comes to the attention of issuers of comparable securities, of the Commission, of every underwriter and dealer in securities, and of the market. Nothing is hidden.

We particularly point out to you that the Commission's present responsibility is to deal with conditions as they exist today and not with conditions as they may have been alleged to exist in past history.

The Securities Act of 1933 and Public Utility Act of 1935 and related laws have brought about a different situation. They have added great force to the competition of the market. Present day problems must be considered in the light of these present day facts. Isolated "discussions" which may have taken place twenty or more years ago or unrepresentative arrangements which may once have existed (page 11), despite the interest they may have as a matter of history, have no bearing on the situation as it exists today.

### III

#### **On competitive bidding as a mechanism for judging the reasonableness of price and spread**

One of the conclusions of the P.U.D. Staff is (page 23) that: "Competitive bidding should produce reasonable prices and fees. We agree that effective competition is the only valid yardstick by which the reasonableness of price and spread may be measured. Such a valid yardstick is especially important in judging the reasonableness of fees and prices for security issues other than those of the highest grade since it is in these issues that the greater difference of opinion as to reasonableness may be expected to exist. The yardstick of value is, we think, best provided by the effective competition of the market."

Actually, the statistics assembled by the Staff of the Public Utilities Division (Appendix C) indicate clearly, if properly analyzed, that competitive bidding does not provide a dependable "mechanism" for judging the reasonableness of price and spread.

As to price, the facts set forth by the Staff at page C-13 indicate that there was an upward composite price variation of 1.87%, in the case of negotiated public utility issues as compared with the composite prices of public utility issues sold through compulsory competitive bidding, in the sixteenth week after issuance. The Staff apparently (pages

29 and 30) assumes from this that there is a tendency to *under-price* negotiated issues and that any *over-pricing* of issues sold in compulsory competitive bidding is so slight that it does not appreciably affect the investor's rate of return. It is our opinion that the conclusions of the Staff, in this respect, are not supported by the facts.

The P.U.D. Staff assumes (page C-4) that over-pricing or under-pricing of new issues exists only when the trend of subsequent quotations is above or below that of seasoned comparable issues. The Staff report shows that elaborate market records were compiled for eight public utility issues sold in compulsory competitive bidding and the trends established by the Staff's statistics were compared, *from the date of offering*, with Standard Statistics' averages and with 115 negotiated utility issues brought out at about the same time. The statistical methods employed by the Staff necessitate involved mathematical calculations for adjustment to general market trends which introduce elements of error.

The "market" for a large new issue of securities cannot be measured precisely by the quotations for small blocks of outstanding issues of comparable quality. The "market" for a new issue is almost invariably somewhat below the market for outstanding issues, the amount of the difference depending on the size of the new offering in relation to the then existing demand. It is a problem in supply and demand for the particular offering. New issues must, therefore, rise in value in secondary trading (on the average over a long period) in relation to the market. The P.U.D. Staff ignores this fundamental truth in its statistics, assuming that a rise is an indication of under-pricing. But, as we have already pointed out, the United States Government recognizes the principle that large new issues are not "worth" the quoted price for small blocks of comparable issues and, proceeding in accordance with wise policy, offers new issues of government bonds at prices somewhat below the "market."

The Staff assigns other reasons for the practice of pricing negotiated issues at levels which will, on the average, show a slight rise in secondary trading, saying: "Apparently the theory is that, if a new issue is so priced that it will be quoted slightly above the issue price, *shortly* after the public offering, this will leave the purchasers with a feeling of satisfaction, or at least with the feeling that they have not been over-charged. This in turn is regarded as helpful to the issuer's credit in connection with future issues. It is feared that competitive bidding would drive the price closer to, or even slightly above, the market."

There are two critical dates in connection with the distribution of any issue of securities. First there is the date on which price restrictions on transactions in an issue are removed. This is the date (rather than the offering date) from which a record of market movements expressed in relatives should start. It may be six weeks or more after the offering date but usually is only a few days thereafter. Second, there is the date on which stabilizing (or covering over-allotments, if any) ceases. A process of averaging will show that these two dates fall, on the average, well within a six-weeks' period after initial offering.

If the P.U.D. Staff had ascertained these two dates for each of the eight issues sold in compulsory competitive bidding on which market information was available, and if the Staff had arrived at weighted average intervals for the distribution period, a true picture of the market movement could have been developed in relatives, weighted by size of issue to reflect the economic importance of the various issues. By doing the same thing for negotiated issues, a direct comparison would have been possible. Each of the eight issues sold in compulsory competitive bidding and used in the Staff's comparison was sold in 1935 or 1936, a period of steadily rising bond prices, and a comparison with long-term government prices, properly adjusted, might provide a satisfactory measure of over-pricing, or under-pricing, using only a six-weeks' market record for issues sold in each way.

A regulatory body such as the Securities and Exchange Commission is in position to obtain the facts necessary to make a precise statistical analysis such as that outlined above. Persons other than those who represent government are not in this position.

In measuring the trend of quotations, the P.U.D. Staff averaged daily high "bid" and low "asked" quotations, remarking that "The use of bid quotations when compared with the offering price gives a slight downward bias. In general, actual prices run between the asked and the bid quotation." This is not in accord with the realities of the market. To the seller, the bid price represents the value of his holdings so long as the bid is for a block equal to the size of his holding. To the buyer, the offered side of the market will represent his cost so long as the size of the block offered is equal to or greater than his demand. It is, therefore, entirely proper to compare subsequent bid quotations with an initial offering price since both are values for "offerings." Bid quotations are the closest available approximation to trends in value. Actual sales prices are usually the prices at which odd-lots of securities change hands either at the then current "bid" or "asked" price, whereas over-the-counter bids are generally good for round

blocks. The methods used by the Staff in this respect (averaging daily high "bid" and low "asked" quotations) tend to overstate a general rise and to understate a general decline in relative values.

An analysis, using "bid" quotations, covering the market movement of all public utility bond issues sold through negotiated underwriting and brought out from January 1, 1938 to December 31, 1940, on which market information was available, shows the following weighted average deviations from original public offering price in dollars per \$100 bond (deviations weighted by dollar volume) :

	Deviation in Points from Original Public Offering Price
Day following removal of price restrictions	+0.5
One week later.....	+0.2
Two weeks later.....	+0.4
Three weeks later.....	+0.3
Four weeks later.....	+0.4
Five weeks later.....	+0.5
Six weeks later.....	+0.5

Due to the large size of the sample used in compiling these statistics, the short period covered for each issue, and the fact that inspection showed the influence of rising markets to be in large measure cancelled by the influence of sharply falling markets at intervals during the three year period 1938-1940 inclusive, no adjustment for general market fluctuation was considered desirable in making this analysis.

The results produced by this analysis, as stated above, show no evidence of general under-pricing in respect of negotiated issues. A rise of one-half point at the time of removal of price restrictions was followed, on the average, by market strain during the period of seasoning; but the issues again sold at a premium of about one-half point by the time distribution had been, on the average, completed. Market records indicate that a rise of about one-half point is considered desirable by the United States Treasury in effecting its new financing.

In contrast with the results for negotiated issues as indicated above the eight issues, sold in compulsory competitive bidding, used as a basis for comparison by the P.U.D. Staff (of which all but one were issued in periods of rising markets), declined in price a total of 1.12 points, on the average, (weighted) in the sixth week after issuance.

So, not only on the basis of the figures as to negotiated issues here presented, but also from the data prepared by the P.U.D. Staff, there

is, on the average, no true under-pricing of utility bonds sold through negotiation but, on the contrary, experience establishes that over-pricing of issues sold in compulsory competitive bidding has been general. In a period of declining markets, the reverse could be expected to result from competitive bidding.

Common sense tells us that dealers engaging in competitive bidding are apt to underbid for securities when market conditions are not good and that they are equally apt, when market conditions are strong, to submit bids based upon a contemplated offering above the proper market price, in the hope that a rise in the general level of prices may enable the issues to be sold successfully at prices which would not otherwise be justified. Competitive bidding is much less likely than direct negotiation to operate under all conditions in a manner which will produce prices in the best interests of all. When applied to corporate securities, competitive bidding seems to operate either to the disadvantage of issuers or investors and seldom functions in the interest of both.

Investors who are considering the purchase of an issue sold in compulsory competitive bidding not only give consideration to the "high" or winning bid as a measure of the reasonableness of price, they also give important attention to the consensus of opinion as to market values indicated by the next highest and other competitive bids. Since many investors take this attitude, the P.U.D. Staff is, we think, mistaken in assuming (page 23) that competitive bidding can provide an "automatic mechanism" to determine the reasonableness of prices. Consistent over-pricing to the extent of a point or more through compulsory competitive bidding cannot be dismissed as of no practical consequence.

A method of sale which may be satisfactory for cattle on the hoof, or for other articles of comparable value, may be unsatisfactory when large sums are dependent upon a single transaction. The weight of the evidence shows that the P.U.D. Staff is mistaken in its belief (page 22) that competitive bidding in the sale of utility securities of the character visualized by the Staff "has been successfully utilized over a period of years in Massachusetts, New Hampshire, and the District of Columbia."

As to "spread," the statistics at page C-23 of the Staff report show a median gross underwriting spread of 1.28 points for fourteen issues sold in compulsory competitive bidding as against 2.00 points for one hundred and fifteen grade "A" or better issues sold through negotiated underwriting, a difference of 0.72 points. This is not a true difference

since the cost to the issuer was increased by "other expenses" incurred by the issuer in the case of issues sold in compulsory competitive bidding. As Commissioners Healy and Mathews pointed out in their separate opinion in the Consumers Power case, underwriting "spread is a function of price" and "the net cost of money to the company is the most important feature of consideration in any issue of securities." The P.U.D. Staff itself says in this connection that "The evidence in these respects is inconclusive because of the small number of issues sold competitively. A comparison of the issues on the basis of size and quality supports the tentative conclusion that underwriting spreads are narrower for competitive issues."

With respect to fixed income securities, underwriting risk is definitely related to the "yield" on the security. Yield—the real annual rate of return to the investor over the life of the investment—takes into account all of the factors which have a bearing on underwriting risk such as the quality of the security, size of issue, maturity, tax exemptions and the relative demand in the market for similar securities. Accordingly, that portion of the underwriters' spread which represents compensation for the assumption of risk (as distinguished from cost of examination, preparation and distribution) is, under most circumstances, related to the yield on fixed income securities. Underwriters' spreads are, as a matter of fact, usually set at levels which recognize this principle. In the present period of easy money conditions, gross spreads, both in municipal finance and in corporate finance, have tended to decrease.

Although the P.U.D. Staff insists that "the two point" spread is characterized by "rigidity" and "universality" (page D-22) the facts are not in accordance with its views. Spreads vary with the conditions of the market. There is no rigid or universal practice which fixes spreads at "two points" or at any other set figure. In several recent issues the spread has been below two points and as Commissioners Healy and Mathews indicate in Public Utility Act Release 1834 in a number of issues the spread has been above two points.

In the negotiation of corporate new issues, underwriting spreads are agreed upon by issuers and underwriters after careful appraisal. Issuers know the spreads on all comparable issues, the cost of commercial bank loans, "private" placements, etc. If the issue is part of a series of financing transactions consideration is given to the success of the issue in such plans. The underwriting spread on a corporate issue is generally established after giving consideration

not only to the underwriting risk and to the estimated cost of setting up and distributing the issue, but, also, to the overhead costs of maintaining an organization competent to engage efficiently in the business of underwriting and distributing securities and readily available to issuers at all times. Although it is not possible to estimate these overhead costs in terms of percentage on the amount of a given issue, since the costs are relatively constant and their percentage relationship varies with the total volume of business transacted over a period, these costs are necessarily an element in the spread on each corporate issue. Consequently, in cases where the underwriting risk and direct costs are approximately the same, spreads for corporate issues generally do not show much variation over short periods. Such spreads are nevertheless variable in line with changing money conditions, since spreads are, as has been pointed out, a function of price.

The P.U.D. Staff statistics show (page C-5) that the spreads on utility issues sold through compulsory competitive bidding have varied between 0.73 and 2.16 points with a median spread (page C-23) of 1.28 points.

Distribution of corporate securities is frequently a difficult matter. Many issues of corporate bonds and most issues of preferred stocks could not be properly distributed without the assistance of a nation-wide selling group. The help of a large number of dealers, each with customers not reached by other dealers, is necessary to the success of a substantial proportion of these offerings. The objection has sometimes been put forward, however, that the selling group is used in the distribution of issues which can in fact be sold with little or no effort. This idea requires examination.

There are about 350 legal reserve life insurance companies in the United States, and about 15,000 commercial banks, to say nothing of the large number of fire insurance companies, casualty companies, charitable institutions, endowment funds and private investors. The banks are not only much more numerous than the insurance companies but their buying power is less concentrated. Moreover, the larger insurance companies buy for permanent investment, expecting to hold to maturity, while the banks generally buy in the expectation that they will sell whenever their position requires them to do so or whenever they feel that a more profitable investment is available in another security. Several of the largest insurance companies confine most of their purchases to new issues and do relatively little business in the corporate trading market (possibly because substantial pur-

chases of outstanding securities would exert great pressure on money rates) while banks frequently buy and sell outstanding securities.

If new corporate issues of a grade attractive to insurance companies were to be sold by underwriters in the same manner as municipal securities are sold it is likely that the more attractive issues would be taken up by the larger institutions, before the banks and other investors throughout the country had any opportunity to make purchases. Investors generally would be able to buy only what the larger institutions did not want. The situation might well be considered unfair and discriminatory with respect to the smaller institutional investors. The selling group is employed by underwriters to give all investors a fair opportunity to acquire attractive new issues. Selling group dealers in every community throughout the country sell bonds to their regular customers.

Corporations issuing bonds have additional reasons for desiring to obtain a wide distribution of their issues. It is in their interest not to have too substantial a portion of their issues locked up in the hands of a few insurance companies or other institutions. Subsequent sales of large blocks of securities might have a disastrous effect on future financing plans of an issuer. Moreover, wide initial distribution makes for a good technical position in the market for the issue after listing on an exchange. Of much greater importance, however, is the fact that corporations receive valuable advertising and create goodwill by having a large group of security holders throughout the country.

These considerations are not applicable to most of the issues sold in compulsory competitive bidding analyzed by the Staff in Appendix C, since these issues were relatively unattractive as to price to the larger institutions; but it is, nevertheless, significant that selling groups were formed for only three issues of public utility bonds among the fourteen issues which have been bought under the requirement of compulsory competitive bidding, by various dealers, and reoffered to the public, since 1935.

Without a selling group, wide distribution is virtually impossible in respect of both the "attractive" issues and those which require definite sales effort. Moreover, it costs the issuing corporation very little to obtain the services of a selling group. When the total spread is 2% on an issue maturing in twenty years, out of which selling group dealers receive, say,  $\frac{3}{4}\%$  on that portion of the issue (approximately one-half) which they sell, the aggregate amount paid to the selling group is less than one-quarter of the total dollar spread, and the cost of the



selling group, to the issuer, is less than 1/40 of 1% per year during the life of the issue. The total cost of underwriting and distributing such an issue, that is the cost to the issuer of the total "spread," amounts to 1/10 of 1% per year.

The Staff of the Public Utilities Division denies that the small dealer will be injured by compulsory competitive bidding; but the Staff has not answered the arguments previously advanced by underwriters in this respect except to say the problem of the small dealer is not within the province of its study.

The following data of the P.U.D. Staff, taken from Appendix C of the report, are of interest in that they illustrate the extent to which spreads may vary under compulsory competitive bidding:

Name of Company:	Cape & Vineyard Electric Co.	Fall River Electric Light Co.
Bond Issue .....	4%, 1968	3 1/8%, 1968
Size of Issue .....	\$1,000,000	\$2,000,000
Approx. Date of Public Offering	4/15/38	5/16/38
Moody's Rating .....	Aa	Aaa
Price to Company .....	102.20	102.10
Interest Cost to Company .....	3.887%	3.019%
Price to Public .....	103.50	104.00
Spread .....	1.30	1.90

According to the statistics of the P.U.D. Staff these small issues were offered within about one month of each other and each had been given a "high grade" rating. Yet curiously enough there was a difference in interest cost of 0.868%, or about 28% in favor of the bond with the lower rating. Did both companies receive reasonable prices? The issue which involved a high interest cost to the issuer was sold directly by the purchasing underwriters to a single insurance company. More than 30% of the issue which was sold by the issuer at a low interest cost was sold by the purchasing underwriters to a single insurance company, thus giving the imprint of expert judgment to the price, and the remainder of the issue was quickly sold to a small group of institutions without substantial assistance from dealers other than the five members of the underwriting group. In this case, were the services rendered worth almost 50% more than in the first case?

Clearly these figures do not support the view of the P.U.D. Staff that competitive bidding produces an automatic mechanism for determining the reasonableness of price and spread.

Another case in point is the issue of \$53,000,000, Boston Edison Company, refunding bonds, due 1970, for which bids were submitted

and opened on December 2, 1940. The high bid for 2¾% bonds (103.-525, or an interest cost of 2.58%) was 1.415 points above the next highest bid and 2.140 points above the third and low bid for 2¾% bonds. The bonds were reoffered on December 4, 1940 at a public offering price of 105 to yield 2.51% to maturity and a determined effort was made to place the bonds with investors at that price. Thirty days later about 70% of the issue had been placed, but distribution had slowed up to a point where it seemed inadvisable to continue. Price restrictions were removed on January 3, 1941 on transactions by underwriters and selling group members. Thereupon the price dropped two points. The market apparently was of the opinion that the second bid submitted at the time of the sale of the issue, in compulsory competitive bidding, reflected the market value more accurately than the high bid then submitted. The terms of sale in this case, as established by competitive bidding, certainly did not work to the advantage of those investors who initially purchased about 70% of the issue.

#### IV

##### **On obtaining the highest possible price for issuers**

Taking a view which seems foreign to the intent of Congress, the Staff of the Public Utilities Division asserts (D-1) that "the objective of Commission regulation of price and spread should be to insist that the issuer receive the most favorable terms obtainable. . . ."

Is it thus the opinion of the Staff that, despite the plain language of the statute as to the interests of investors, the Commission is, in effect, an agent for the issuer with no concern whatever for the public interest and that the Commission need only see to it that the issuer shall receive the highest possible price? Investment bankers are concerned about a *fair* price to investors as well as issuers—a price that penalizes no one.

But, the Commission itself has, in the past, clearly recognized its responsibilities to investors and to the public generally. We cannot believe, therefore, that it will do otherwise in dealing with the proposals which have now been put forward by its P.U.D. Staff.

In a footnote to the opinion of Commissioners Henderson and Eicher, set forth at page B-5 of the Commission's release No. 1854, dated December 28, 1939, it is stated to be a duty of the Commission under Section 7 (d) (6) of the Public Utility Holding Company Act to prevent the sale of public utility securities to the public at an unduly

high price. And, as the Commission has shown in its order (Commission's Public Utility Act Release 2009 of April 9, 1940) relating to the sale of West Penn Power Company Stock to the public, it gave much consideration to the price at which that offering was made. However, the P.U.D. Staff apparently does not agree with the views of the Commissioners since it states in its report (page D-1) that "the objective of Commission regulation...should be to insist that the issuer receive the most favorable terms obtainable, rather than the...avoidance of 'over-pricing'."

Consideration should also be given to the fact that should a compulsory competitive bidding rule be adopted as proposed by the P.U.D. Staff, such a rule will not solve the question of "price" and "spread." For, unless the Commission is prepared to ignore its responsibilities under Section 7 (d) (6) of the Public Utility Holding Company Act of 1935, or to disregard "under" or "over" pricing, it will still be necessary to determine, following receipt of information as to bids, etc. whether "the terms and conditions of the issue or sale of the securities are detrimental to the public interest or to the interest of investors or consumers."

The prices and terms of sale of an issue, arrived at by means of direct negotiation between an issuer and underwriters of its own choosing are, in our opinion, much more likely to represent fair and reasonable values to all concerned than are the prices and terms which would be arrived at through compulsory competitive bidding by means of sealed bids.

We observe with interest the comment of the Staff (page 9) indicating that the Commission's present Rule U-12F-2 has not proved to be an effective method of ensuring reasonableness of price and spread. No proof, however, has been put forward in the report of the P.U.D. Staff to establish that prices and spreads have been unreasonable. Whether it is dealing with a price arrived at in negotiation or one fixed by compulsory competitive bidding, the Commission, pursuant to its duties under Section 7 of the 1935 Act, is still confronted with the problem of ascertaining the norm of the market. The fact that there may have been recourse to competitive bidding by means of sealed bids would not, in our considered judgment, be in any sense determinative of the reasonableness of the terms and conditions of the issue or sale of the security.

We believe that the price of a new issue of securities should be considered from at least three points of view.

First is consideration of the public interest. It is of primary importance from the public point of view that the capital market operate fairly and efficiently, and that the flow of capital into industry should take place without destroying the mechanism of the market. The building up of over-priced inventories of securities in the hands of dealers through excessive competition tends to upset market conditions and to hinder and delay new financing. Those who have purchased are resentful. Others withhold their purchases waiting for the market to break and thus accentuate the disturbance of the market.

Second, it is important that the issuer should receive a *fair* price for his securities. It is improbable that, in practice, the excessive pressure of compulsory competitive bidding would produce consistently fair prices. Indeed, the P.U.D. Staff, in recommending the imposition of a compulsory competitive bidding rule, seeks to provide a mechanism by means of which the highest possible price (without regard to over-pricing) can be extracted from the purchaser—and thus from the investing public—for the benefit of the issuer.

Third, and of greater importance still, the prices of new issues should be fair to investors. In some way, the belief seems to have gained wide acceptance that when an issue is initially over-priced, the loss will fall wholly on underwriters and dealers. In almost every instance, however, at least part of the issue, and in other cases, substantially all of the issue, is sold to investors at the initial offering price. Thus, the loss, if any, resulting from a subsequent break in price due to the initial over-pricing, has, more often than not, been suffered by the investor. Investors are deeply interested in the avoidance of initial over-pricing which particularly in the case of lower grade bonds, and of preferred stocks and equity securities may be of very serious consequence. Over-pricing has a great additional disadvantage in that it tends to bring about high pressure salesmanship, which reputable investment bankers seek to avoid.

On reading Section 1 (a) of the Public Utility Holding Company Act of 1935, it will be found that Congress put first in the list of reasons establishing the necessity for the control of holding companies the fact that such companies “are affected with a national public interest, in that, among other things (1) their securities are widely marketed and distributed . . . and are sold to a large number of investors in different states. . . .”

The primary concern of Congress in enacting the 1935 Act was for investors and the public generally. The primary duty of the Commis-

sion in administering the Act is to hold the scales of justice even and not to exert the great force of its authority for the purpose of extracting from the public the highest price which can be obtained for the benefit of the issuer.

It is noteworthy that after trying the "competitive bidding" method of issuing long term securities the United States Treasury found it undesirable and abandoned it. The specific instances of record relate to five issues of United States Treasury Bonds offered for competitive bids in 1935. The practice brought wide variations in price, one of these issues having declined more than  $\frac{3}{4}$  of a point on the day when allotments were made to bidders. Moreover, a wide difference of opinion as to the value of the credit of the United States was indicated by the bids submitted to the Treasury. In one case the "spread" amounted to 0.78125 and in another case it equaled 0.59375. After these experiences the Treasury does not appear ever again to have resorted to the competitive bidding or auction block method of selling government securities.

While most states and municipalities are required by law to obtain competitive bids on issues of new securities, the Reconstruction Finance Corporation, which has in recent years acquired large amounts of securities of municipalities and of other governmental agencies, has the power to sell such securities in any way which in its judgment best meets the market situation existing at the time. It has been the general practice of the Reconstruction Finance Corporation to sell small municipal issues by inviting competitive bids. However, in several instances, the Reconstruction Finance Corporation has sold bonds through direct negotiation with one or another group of underwriters and dealers. Such sales during the past few years have included \$28,000,000 bonds of the Triborough Bridge Authority, \$147,000,000 bonds of the Metropolitan Water District of Southern California (sold in three blocks of \$60,000,000, \$13,556,000 and \$73,444,000), and \$71,000,000 San Francisco-Oakland Bay Toll Bridge Revenue Bonds, which were sold by the Reconstruction Finance Corporation through direct negotiation at substantial premiums.

These sales were made to large groups of underwriters, there being 134 underwriters in the group which purchased \$73,444,000 of Metropolitan Water District of Southern California Bonds in March, 1939, and 100 underwriters in the group which purchased the \$71,000,000 of San Francisco-Oakland Bay Toll Bridge Revenue Bonds in June, 1939. Of the issues sold through direct negotiation, large dollar amounts were usually involved and in several instances the bonds were

secured solely by revenues or by a combination of revenues and taxing power, making it desirable that the underwriters and dealers participate in the establishment of changes in certain of the terms of the issue so as to evolve a security which would meet the requirements of the investing public. Because of the special characteristics of these issues and of the fact that they were in general unknown to investors, distribution involved substantial costs to underwriters and dealers and in some cases was made possible only by months of effort spent in acquainting prospective purchasers with the terms of the security.

It appears that in the instances where the Reconstruction Finance Corporation elected to carry on direct negotiations with a group of underwriters, the securities were sold on bases more favorable to the seller than would have been possible through competitive bidding.

On the basis of the record, direct negotiation appears from the point of view of the issuer to be a better method of handling transactions involving many millions of dollars than competitive bidding which requires virtually immediate acceptance of the best bid or rejection of all bids. Under such circumstances, competitive bidding may operate to the disadvantage of the issuer. Prices arrived at in negotiation with underwriters who consider all aspects of the problem will be found, in the great majority of cases to be fair both to the issuers and, more importantly, to the investors.

## V

### **On the Commission's duties as to the maintenance of competitive conditions, etc.**

In the letter of the Director of the Public Utilities Division, set out in Appendix B-1 of the Staff report, it is stated that:

“By *express provisions* of the Public Utility Holding Company Act of 1935 the Securities and Exchange Commission is charged with the ‘maintenance of competitive condition’ and directed to construe that Act so as to assure the ‘elimination of the evils which result from an absence of arm’s length bargaining or from restraint of free and independent competition’ in the distribution of securities of registered public utility holding companies and their public utility company subsidiaries.” (italics supplied)

While careful reading of the statute fails to reveal any such “express provisions” even such express provisions would not warrant

revolutionary action on the part of the Commission where the "evils" mentioned do not exist.

Again, the P.U.D. Staff, at page 1 of its report, says that:

"Section 1 of the Public Utility Holding Company Act enumerates various abuses which gave rise to the need for control of holding companies and their subsidiaries. Section 1 (c) specifically provides that 'it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section.' Among the evils expressly enumerated in Section 1 are those which exist when securities are issued without state approval on the basis of unsound values or 'when subsidiary public utility companies . . . enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition' (Section 1 (b) (2) ) and 'when in any other respect there is lack of economy of management and operation of public utility companies . . . or lack of economies in the raising of capital.' (Section 1 (b) (5).)"

The excerpts from Section 1 as quoted above from the report of the P.U.D. Staff create, in our opinion, a distinctly misleading impression of the contents and intent of the statute. As we have already stated, Section 1 of the 1935 Act outlines the special purposes sought to be realized by Congress for the establishment of regulatory control over the activities of holding companies. This section is of great importance and we, therefore, quote its *full* text below. The italics have been supplied:—

## "TITLE 1—CONTROL OF PUBLIC UTILITY HOLDING COMPANIES

### "NECESSITY FOR CONTROL OF HOLDING COMPANIES

"Section 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; (2) their service, sales, construction, and other contracts and arrangements are often made and performed by means of the mails and instrumentalities of interstate commerce; (3) their subsidiary public-utility companies often sell and transport gas and electric energy by the use of

means and instrumentalities of interstate commerce; (4) their practices in respect of and control over subsidiary companies often materially affect the interstate commerce in which those companies engage; (5) their activities extending over many States are not susceptible of effective control by any State and make difficult, if not impossible, effective State regulation of public-utility companies.

“Section 1. (b) Upon the basis of facts disclosed by the reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session), the reports of the Committee on Interstate and Foreign Commerce, House of Representatives, made pursuant to H. Res. 59 (Seventy-second Congress, first session) and H. J. Res. 572 (Seventy-second Congress, second session) and otherwise disclosed and ascertained, it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

“(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such *securities* are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such *securities* are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from *intercompany* transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such *securities* are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an over-capitalized structure and tend to prevent voluntary rate reductions;

“(2) when subsidiary public-utility companies are subjected to excessive charges for services, construction work, equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States;

“(3) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such com-



panies, or when control of such companies is exerted through disproportionately small investment;

“(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties; or

“(5) when in any other respect there is lack of economy of management and operation of public-utility companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.

“Section 1. (c) When *abuses* of the character above enumerated become *persistent* and *wide-spread* the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, *in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies* which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.”

Except for the fact that the italics have been supplied, the foregoing is the exact text of Section 1 as enacted by Congress. The section does not once mention investment bankers and, obviously, is limited in purpose to situations in which there are evils.

The report of the P.U.D. Staff states (page 2) that the sections in the Act relating to the issuance and the sale of securities must be construed in accordance with the objectives set forth in Section 1. Accordingly, it is important to note that in Section 1 (b) (1) Congress was concerned exclusively with transactions involving *securities*, while in Section 1 (b) (2) it dealt with *inter-company* relationships, that is, with the relationships between holding companies, their subsidiary public utility companies and other companies in the same holding company system. In this Section 1 (b) (2) Congress did not make any reference to transactions involved in the sale of public utility securities to investment bankers or others in the general market, but referred to transactions involving excessive charges for “services, construction work,

equipment and materials” or to “transactions in which evils result from an absence of arm’s-length bargaining or restraint of free and independent competition” to which subsidiary companies might be subjected by the affiliated or controlling holding company. This construction is supported by the remainder of Section 1 (b) (2) which relates to the allocation of charges among subsidiary companies in different states.

Section 1 (b) (2) must be read in conjunction with Section 1 (c). When this is done, it becomes clear that Section 1 (b) (2) was intended by Congress to apply only to certain special classes of relationships and transactions between holding companies, their public utility subsidiaries and other companies in the same holding company system and that Section 1 (c) does not enjoin the Commission to read the provisions of Section 1 (b) (2) into Section 1 (b) (1) or into Sections 6 and 7, which deal specifically with the issuance and sale of securities.

Furthermore, the recital in Section 1 (b) (2), even when related to the transactions therein set forth, is concerned only with preventing “transactions in which *evils* (italics supplied) result from an absence of arm’s-length bargaining or from restraint of free and independent competition” in relations between holding companies and their public utility subsidiaries. It is thus a condition precedent to the application of Section 1 (b) (2) to the type of transactions therein described, that the existence of “*evils*” (italics supplied) be affirmatively shown.

The intention of Congress with respect to the regulation of public utility holding companies is made clearer still by reading the first phrase of Section 1 (c) in conjunction with the preceding sub-sections of Section 1 (b). Section 1 (c) begins with the statement—“When *abuses* of the character above enumerated become *persistent* and *wide-spread* . . .” (italics supplied). Congress plainly was not concerned with the mere suspicion of non-existent evils but sought to correct the real evils recited as resulting in persistent, and wide-spread abuses.

Nowhere in the one hundred and twenty-five page document comprising the report of the Public Utilities Division is it established that there have been any “*evils*” in the underwriting by investment bankers of securities of registered public utility holding companies and their subsidiaries, nor has there anywhere been produced any evidence to indicate the existence, in respect of such underwriting, of “*persistent*” and “*wide-spread*” abuses of the character which Congress sought to eliminate.

Indeed, we need turn only to the records of the Commission itself for evidence of the fair practices which have governed the underwriting and sale of public utility issues.

On the basis of statistics which, according to the P.U.D. Staff report (page C-2) do not permit a definite finding to be made because the number of public utility issues sold in compulsory competitive bidding, for which quotations are available, "is too small to make valid generalizations or conclusions," the P.U.D. Staff indicates (page C-23) that the difference in weighted average "cost of flotation" between issues sold in negotiation and issues sold in competitive bidding amounted only to 0.67% (the method of calculation employed by the staff has not been precisely defined). Applying this difference in "cost of flotation" to a 3½% bond issue maturing thirty years after the date of issue, the indicated difference in the cost of money to the issuer to maturity is only about 0.037%, annually. It is surely not to be believed that the Commission or any other body of reasonable men could regard so small a variation in the "cost of money," or such a minor fraction, as evidence of "evils" or of "persistent and wide-spread abuses" or as indicating an absence of competition.

In the absence of any affirmative showing of the existence of "abuses" and "evils" of the character mentioned by Congress in the statute, the Commission certainly has no *duty* to impose upon the management of industry a rule such as has been proposed by the Staff of the Public Utilities Division and in which management obviously does not believe. The rule so proposed would require the management of industry, against its best judgment, to sell its securities to the highest bidder without regard to the effect of the transaction on the issuer, its security holders, or the investing public and without regard to whether the securities are "over-priced" or the manner in which they are to be distributed to the public. As to the views of management, it is noted that according to the Staff report (page 41) corporate issuers who submitted replies to the Commission's letter of March 1940, were "almost unanimously" opposed to a competitive bidding requirement.

## VI

### On the position of the smaller dealers

Although the experience of underwriters and dealers leads wholly to the opposite conclusion, the P.U.D. Staff asserts (page 34) that its "consideration of the over-all situation" indicates that the rule which

it has recommended "is more likely to aid the small dealer, than the reverse."

However, the Staff says (page 33) that the "problem of the small dealer is not within the province of the present study." There is thus dismissed from consideration the whole question of the public interest in the maintenance in the smaller communities of the country of a sound and efficient organization of investment bankers and dealers in securities.

It may be, as Commissioners Henderson and Eicher declared in the Commission's Release 1854 (at page B-6), that there is no responsibility upon the administration "to underwrite" the investment banking business. We neither ask nor expect it to do so. But it is equally true that the Commission has no "mandate" to employ its powers under the Public Utility Holding Company Act of 1935 as a means to inflict serious injury on the hundreds of dealers in securities who, in current practice, are lawfully engaged in their respective communities in the business of distributing to their customers securities of corporate issues purchased pursuant to negotiated underwriting arrangements. If, under compulsory competitive bidding, the small dealers are no longer included in selling groups, it must not be forgotten that the hundreds of thousands of small investors, the clients of these dealers, will not have the opportunity to buy the high quality investments formerly flowing to them through these channels. Investors in the interior of the country, small insurance companies, endowment funds of small colleges, fraternal organizations, no longer will be able to obtain high quality bonds through their local dealers. They must content themselves with second and third quality investments or establish new and direct connections with the large underwriting houses in the east. Thus these interior investors would be compelled to forego the quality issues among new offerings.

Broad general distribution of securities is generally regarded by corporate management and by investing institutions to be in the interest both of the issuer and of the public generally.

The viewpoint of the general public interest in this matter is well expressed in a letter written by Mr. M. A. Linton, President of the Provident Mutual Life Insurance Company, Philadelphia, published in the New York Herald Tribune on January 4, 1941. Pointing out that the country's investment banking machinery performs an essential function in the operation of a normally expanding economy, Mr. Linton says: "When the time happily arrives that capital is again flowing

into industry in a satisfactory manner the country generally, and the private investor and industry in particular, will suffer severely if there is not available a virile investment banking organization. To threaten the stability of this organization in the present abnormal situation is short-sighted from a long-range point of view." He adds: "For the general good . . . security issues should be distributed as far as possible through the regular investment banking machinery."

To achieve broad general distribution the gross spread must be sufficient to warrant paying dealers a compensatory commission for placing the securities widely. Dealers are not needed in concentrated sales made necessary by unjustly small spreads. Thus experience demonstrates that competitive bidding, if generally required in the issuance of corporate securities, would operate to the disadvantage of the smaller dealer.

It appears reasonable to expect that organizations similar in form and character to those which have been developed for the distribution of municipal securities, would be employed in the purchase and public sale of such utility securities, if competitive bidding were generally required in the sale of the securities of registered public utility holding companies and their subsidiaries. The available data (C-25) suggest that with competitive bidding the gross spreads on high grade corporate securities would, at the outset, average approximately one and one-half points, which is greater than the average spread on municipal securities bought in competition. (*Vide Franklin T. McClintock, Competitive Bidding for New Issues of Securities. Published by Harriman Ripley & Co., Incorporated, 1939.*)

Competitive bidding tends to create a situation in which, of necessity, underwriters work for an irreducible minimum of gross profit with no margin for error. To compensate for this they find it necessary to reduce distribution costs to a minimum. An underwriter or dealer who purchases an issue on the auction block in compulsory competitive bidding by sealed bids cannot be expected, at considerable sacrifice and expense to himself, to plan the sale and distribution of the securities in a manner most likely to serve the interests of, or build up goodwill for, the issuer. If an underwriter has paid the highest price possible he owes nothing to the issuer and need not concern himself with the inherent dangers such an issuer incurs by having his obligations concentrated in the hands of a few investors. The issuer has not paid for wide distribution—he has no right to expect it. The worse the job of distribution the higher the price the underwriter can afford to pay. In such circumstances, the underwriter's ability to arrange the dis-

tribution in a manner best calculated to serve the public interest becomes a prohibitive luxury. If he allows for the costs of wide distribution his bid will not win. He has no choice in the matter. The size and membership of an underwriting group will be based upon only two factors:

- (1) Distribution of risk.
- (2) Ability to place at full list price and in large blocks.

Obviously, the smaller the group can be kept, the more chance of profit for the participants. Accordingly, if compulsory competitive bidding should be extensively employed in corporate finance, we believe that (1) the number of participants in underwriting groups would, of necessity, be drastically reduced; and (2) the employment of selling group dealers would be all but eliminated through the operation of forces similar to those which have virtually eliminated selling group dealers from the distribution of municipal securities and from the sale of public utility issues purchased in compulsory competitive bidding, only three selling groups having been formed in the fourteen such issues so purchased and reoffered to the public since 1935.

Moreover, if competitive bidding should be generally required for corporate securities, leadership in the business would, as we have already said, probably be concentrated to a greater extent than at present—with underwriters possessed of substantial capital resources who employ highly trained staffs experienced in investigation and closely in touch with markets throughout the country.

Experience shows that while the larger municipal dealers or underwriters bid on only a small proportion of the total *number* of issues offered each year, they bid on about half of the total *principal amount* offered. About 95% of the total principal amount of corporate and foreign financing in 1938 was represented by only 145 issues of \$1,000,000 or more. Most of these issues were of reasonably good investment quality. The larger underwriters would perhaps bid on a very high percentage of the principal amount of available public utility issues required to be sold in competitive bidding. The percentage would probably be much higher than is now the case in municipal finance.

Moreover, the larger municipal dealers or underwriters have in recent years succeeded in purchasing, in the aggregate, about one-third of the aggregate principal amount of issues on which they have submitted bids. It is not unreasonable to suppose that approximately the same percentage might hold good (after a period of adjustment) in compulsory competitive bidding for the securities of registered public

utility holding companies and their subsidiaries. And, if the larger underwriters do bid on the great bulk of such issues offered for sale, and are successful enough over a period of time to purchase in the aggregate about one-third of the aggregate amount of the issues for which they make bids, the number of underwriters who could continue to engage in the business would be strictly limited. One or two unsuccessful over-priced issues would be extremely hard on smaller underwriters. Gradually the less successful underwriters and dealers would be eliminated. Experience derived from competitive bidding in "municipal" finance suggests that before long there would probably be no more than ten to twelve underwriters in a position to act as leaders of underwriting groups for the large issues. Groups would tend to include few underwriters in bidding for the smaller issues (up to \$10,000,000, principal amount), and while they might include a large number of dealers in bidding for the larger issues, the number of dealers participating would be much smaller than has recently been the practice in respect of the underwriting of public utility issues purchased in negotiation.

A course of action tending to weaken the position of the smaller dealers who carry on business in limited geographical areas will impair the discharge of one of the important functions of the capital market, that of financing small business enterprises. It has been one of the primary functions of the smaller dealers to provide service to local industry, to aid in the solution of local financial problems and to establish and maintain markets for local securities. Their facilities have been benefitted to an important extent by the income received from participations in large issues requiring national distribution. In operation, a compulsory competitive bidding requirement for public utility securities bringing with it a method of distribution which would eliminate the smaller dealers who now participate in this business, would, injure the operation of the capital market both nationally and in their communities.

In our opinion, the conclusion is inescapable that adoption of compulsory competitive bidding for the securities of registered public utility holding companies and their subsidiaries would tend to bring about elimination from the business of distributing such corporate issues of the one thousand or so dealers who now gain an important portion of their annual income from participation in selling groups formed to distribute such issues. The loss to their communities of this income would be severe. Also, a number of the smaller underwriters might find survival difficult because they could not bid directly, by virtue of their limited capital and could not compel larger underwriters to include them.

Since the P.U.D. Staff has plainly indicated that its proposed rule is primarily intended to be a means for regulating investment banking, the Commission has an inescapable responsibility with respect to the position of the smaller dealers in this matter. This responsibility cannot be met by the simple expedient of referring, as the Staff has done, (page 33) to various speeches of members of the Commission. Good intentions are not enough. The problem of the smaller dealer is inseparably interwoven with the problem of compulsory competitive bidding. It cannot be dismissed as "not within the province . . . ." of a proposed rule designed to regulate investment banking.

## VII

### **On the idea that the 1935 Act is an instrument for regulating investment bankers**

The P.U.D. Staff quotes (at page 17 of its report and again at page D-27) from a report of the National Power Policy Committee submitted to Congress in March 1935, the statement that "fundamentally the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry." Apparently the P.U.D. Staff desires the Commission to interpret and administer the Public Utility Holding Company Act of 1935 in accordance with this concept.

At page D-27, the P.U.D. Staff asserts the "elimination of banker influence over holding company management bears a close relationship to effective administration of the standards prescribed for types of security issues" etc. The Staff quotes Section 7 (d) (3) in particular as an illustration of the intent of Congress as to banker "influence." Yet nowhere in Section 7 of the Act is there any mention whatsoever of investment bankers or underwriters, or of dealers in securities; nor, for that matter, is there any reference to commercial or other bankers.

Section 2 (a) (11) (D) of the Act also is said by the P.U.D. Staff to empower the Commission to declare "particular bankers" to be affiliated with particular companies. Yet again it will be found on reading Section 2 (a) (11) (D) that it nowhere makes any mention of investment bankers or underwriters or dealers; nor does it make any mention of commercial or other bankers as such.

The only mention of investment bankers to be found anywhere in the Public Utility Holding Company Act is that contained in Section 17



(c) which provides that "no registered holding company or any subsidiary company thereof shall have, as an officer or director thereof, any executive officer, director, partner, appointee, or representative of any bank, trust company, investment banker, or banking association or firm, or any executive officer, director, partner, appointee, or representative of any corporation a majority of whose stock, having the unrestricted right to vote for the election of directors, is owned by any bank, trust company, investment banker, or banking association or firm, except in such cases as rules and regulations prescribed by the Commission may permit as not adversely affecting the public interest or the interest of investors or consumers."

If, as is the case, Section 2 (a) (11) (D) clothes the Commission with authority under certain circumstances, after appropriate notice and opportunity for a hearing, to determine, if the facts so warrant, that certain investment bankers stand in a relation of affiliation to a public utility holding company, it is equally true that the same Section 2 (a) (11) (D) makes no mention of investment bankers, but is applicable to "any person or class of persons" and is applicable to any corporation, firm or organization no less than to any underwriter or dealer in securities.

The fact that the statute is not concerned with emotional relationships as suggested by the Staff (page 8) is clearly shown by the position taken by the Commission itself as set out in the Commission's Release 1854 of December 28, 1939 (page 11) wherein it is said: "Obviously, Congress did not intend, in using that language (Section 2 (a) (11) (D))—nor did we in our rule—to include as an affiliate a person who is merely '*emotionally*' or '*psychologically*' an affiliate of an issuer. In other words, the mere fact that members of an underwriting house are not strangers to, but rather friends of, the officers of a utility company does not make the underwriting house an affiliate of the utility company." (italics supplied)

Nor does it appear, in any of the hearings held by the Commission pursuant to this section of the Act, that it has been found by the Commission that any of the principal underwriting houses named by the P.U.D. Staff in the discussion contained in pages 9 to 13, inclusive, of the report, stand in any relation of affiliation to any registered public utility holding company or subsidiary. The instances of "affiliation" which have been established with respect to those now engaged in investment banking have been the very rare exception rather than the established rule; and, in the more important instances, are concerned with those who at the outset were associated with the public utility industry

in a service capacity and who were, only incidentally, engaged in investment banking.

If the prohibition of interlocking directorates under Section 17 (c) can be interpreted as a grant of power under the 1935 Act to regulate the investment banking business, it must likewise involve the power to regulate thereunder all commercial banks, trust companies and banking associations or firms. But, obviously, Congress had no such intent.

It is clear that Congress intended the Public Utility Holding Company Act of 1935 to be what it is and nothing more—"an Act to provide for the control and regulation of public utility holding companies . . ." The "necessity for control of holding companies" and their subsidiary companies is recited in great detail in Section 1 of the Act and nowhere therein is there any direct reference to, or mention of, investment bankers or underwriters, or of dealers in securities, or of commercial or other bankers. Nor is there anywhere in the 1935 Act any language which could be construed as conferring upon the Commission authority to utilize that Act as an instrument for the regulation of investment bankers.

Reference to the "legislative history" of the 1935 Act, as recorded in the report of the Senate Committee on Interstate Commerce and in the report of the House Committee on Interstate and Foreign Commerce, also fails to show that the Congress intended the Commission in its administration of this Act to single out "investment banking" as a business to be regulated thereunder.

Congress has provided for the regulation of securities markets by means of the Securities Act of 1933 and the Securities Exchange Act of 1934; and has provided for the regulation of underwriters and dealers in particular, by means of the 1938 amendments (the so-called "Maloney Act") to the 1934 Act.

We believe that had Congress intended the Public Utility Holding Company Act of 1935 to be an instrument for the control or regulation of commercial banks or of investment bankers as well as public utility holding companies and their subsidiaries it would have so stated in the language of the statute. We believe, too, that had Congress not thought the provisions of the Securities Exchange Act of 1934, as amended by the "Maloney Act" of 1938, fully adequate to provide for all proper and necessary regulation of investment bankers, underwriters and dealers, it would have made provision for their further specific regulation as it did in Section 305 of Title II of the Public Utility Act of 1935 and in the Investment Company Act of 1940.

In his letter of February 29, 1940, quoted in the report, the Director of your Public Utilities Division said that "It is the Commission's duty to enforce the law *as written*." (italics supplied) With that view, we have no quarrel. We strongly support the desire of Congress to restrain and eliminate transactions which result in evils or abuses. But, an over-reaching interpretation of the law, designed to set up administrative controls and accomplish purposes beyond those provided for by the statute, is full of danger to the orderly processes of administration and is inimical to the public interest. We trust, therefore, that the Commission will not follow the suggestion of the P.U.D. Staff and attempt to read into the 1935 Act the power to deal with matters which are not within the province of that statute. The Commission's powers with respect to the regulation of underwriters and dealers are covered by the Securities Act of 1933 and by the Securities Exchange Act of 1934. Its powers under the 1935 Act relate solely to the fairness of the terms and conditions, including the reasonableness of the price to be received, and of the fees, commissions or other remuneration to be paid, by the issuer upon the issuance of securities of registered public utility holding companies and their subsidiaries.

## VIII

### **On advising management as to financing plans**

The creation of the indentures under which bonds and debentures are issued by corporations is one of the most important professional functions performed by investment bankers.

The P.U.D. Staff (page 26) takes the position that this professional function "should be segregated from the underwriting function" and that "services relating to financial programs of a utility company should . . . be placed on a professional basis to the extent needed, and purchased as such."

Further on, the Staff observes that "to an increasing extent the various regulatory authorities, including the S.E.C., both with respect to the 1935 Act and the Trust Indenture Act, have taken over the function of insuring adequate protection of investors by requiring the inclusion of certain provisions in indenture and preferred stock contracts."

Without considering the question whether the Commission or its Staff has the authority under the Trust Indenture Act of 1939 to prescribe or approve the substantive provisions of indentures filed under

that Act, the question arises as to the desirability, in the public interest, of transferring this professional function from investment banking and corporate management to an administrative agency of government.

Congress in enacting the Trust Indenture Act of 1939 gave no sanction to any such administrative absorption of managerial or professional functions.

One of the fundamental difficulties which would be encountered in endeavoring to carry into practice the idea that an independent body of experienced men could be assembled to take over the negotiation of indenture terms and to be paid on a professional basis for the work done on a given issue lies in the fact that such a group, although in close touch with issuers, would lack the experience which it is essential to have with investors and the market, and with daily operations under indentures such as the release of property, bonding of additions, recapitalizations, reorganizations and mergers. These are difficulties which could not easily be overcome. Experience shows that it is necessary to be directly engaged in the business of buying and selling securities to obtain well-informed contact with investors and that it is necessary also to have had long experience of both prosperity and depression to obtain that close knowledge of markets which is essential to the proper setting up of issues.

In our present system of free enterprise, the investment banker represents a constructive force in the development of industry. Actuated by the profit motive, underwriters are constantly seeking to create sound business by submitting, to corporate management, plans for financing. Many of the constructive solutions for difficult financial problems have come from investment bankers. Instances in which the force and initiative of underwriters in times past has caused unsound results have been widely publicized; but it should be remembered that the energies and brains of investment bankers are continuously producing procedures, adopted by corporate management, which have been wholly desirable, sound, and valuable in the public interest. These contributions to American business are not much advertised; but experienced management will readily testify concerning them.

Under a system of compulsory competitive bidding there would be little or no incentive for underwriters to use creative energies for the benefit of corporations and the public. It appears to us that this will involve a real loss to the public if the fruit of their work is to be picked by others. It is unrealistic to suggest that any agency of a government could supply energy and initiative equal to that which springs from

the constructive forces of sound business. To deprive management of the assistance and creative energies of underwriters of their own choosing, through the introduction of a compulsory competitive bidding system, would render ineffective a very important force for progress and growth in our economy.

A great problem which would confront independent experts attempting to develop financing plans and to create indentures would be the need for continuing contact with, and a thorough knowledge of the physical, financial and corporate organization of each issuer client, as well as of the problems peculiar to the writing of indentures. Due to the great diversity of the problems involved, standardization of the provisions of trust indentures is not practicable—even in the case of public utility companies subject to the 1935 Act. Inappropriate provisions may prove unnecessarily costly and burdensome to the issuer as well as meaningless and ineffective from the point of view of the investor.

The practical problems involved in assembling and maintaining an independent group of individuals for the preparation of trust indentures are substantial. During periods of activity, a large portion of the buying staffs of the principal investment banking houses are engaged in indenture and contract work. On the other hand, during periods of inactivity in the new issue market, the buying staffs of underwriters engage in other activities such as the development of future business and in research work. If indenture work were transferred to independent agencies, these agencies would be unable to handle peak periods without employing a staff corresponding in size to the aggregate number of individuals in investment banking now engaged in such work. The problem of maintaining such an organization during periods of inactivity would be difficult, if not impossible. Certainly the issuer would have to pay for services and advice now provided out of the "spread."

Another important difficulty lies in the fact that the position of such a group of so-called experts would at best be vague. If the draftsmen writing an indenture maintained that a particular covenant should be included, and the issuer objected, the draftsmen, in all probability, could not truthfully say that no underwriter would submit a fair bid for the issue unless the covenant was included. On the other hand, an underwriter negotiating directly is in a position to advise the issuer definitely as to the importance of various indenture provisions.

Underwriters have been deservedly commended for the results of their work in the creation of appropriate indenture. The record shows that their work in this direction has on the whole proved

highly constructive. There is grave danger that indenture work would be less effective if as a result of the imposition of compulsory competitive bidding, underwriters were no longer in a position to place their special knowledge and experience in this field at the service of corporate issuers and of investors generally. We do not find that in its report the P.U.D. Staff has introduced any evidence establishing that this is not so.

It is, however, true that in seeking to refute the statement that under compulsory competitive bidding underwriters would find it difficult to carry out thorough investigations or to place their special professional knowledge and experience at the service of corporate issuers and of investors generally, the P. U. D. Staff has quoted (page 27) at some length from an undisclosed source. It is indicated that the undisclosed author of the communication is an "investment banker"; but, evidently, the Staff does not believe that the views expressed by this authority would take on added weight by the disclosure of his name. It is explained by the Staff that the reply received from the unnamed contributor was "not typical." We add that it likewise does not present an accurate picture of the manner in which responsible investment bankers carry out their professional functions.

In the creation of corporate indentures it has been the function of underwriters to find a satisfactory meeting ground for the conflicting views of the borrower and the lender, to create a security which will prove satisfactory to investors, give them adequate protection, and attract funds at a fair rate. Yet the indenture must not unduly burden the corporate borrower in the proper conduct of its business. Moreover, underwriters must approach the problem from a long term point of view. The instruments created should operate fairly to both issuers and investors through the life of the investment which may extend for a period of fifty years or more.

The best test of the fairness and thoroughness with which this work has been done and of the ethical standards which have been followed by investment banking in the discharge of this professional function will be provided by examination of the indentures which have been developed in recent practice. We suggest that before taking action, on the advice of its P.U.D. Staff, whose proposal would have the result of throwing into the discard the experienced, honest and highly skilled organizations which have been developed by business for the handling of this work, the Commission should very gravely consider whether in doing so it would not do irreparable damage to the public interest and to investors.

The views on this point of corporate management, and of fiduciaries, should most certainly be consulted with great thoroughness before any final decision is reached by the Commission.

## IX

### **On the provisions of the 1933 Act and of the regulations thereunder as they relate to the proposed competitive bidding**

The competitive bidding rule which has been proposed by the P.U.D. Staff contemplates a procedure which would necessitate changes in various provisions of the Securities Act of 1933 and in the regulations thereunder.

Attention is directed in particular to the provisions of Section 11 of the 1933 Act, wherein the liabilities of underwriters are definitely related to those of issuers.

The liabilities to which an underwriter is subjected by the 1933 Act permit the purchaser to recover the consideration paid for a security if any part of the registration statement relating to the issue, publicly offered by or through the underwriter, "contained an untrue statement of a material fact required to be stated therein or necessary to make the statements therein not misleading." It is a defense under the Act if the underwriter can sustain the burden of proof "that he had, after reasonable investigation, reasonable grounds to believe and did believe that at the time such part of the registration statement became effective, that the statements therein were true, that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." In determining what constitutes "reasonable investigation" and "reasonable grounds for belief," the standard of reasonableness, as established by the Act, is "that required of a prudent man in the management of his own property."

The Securities Act of 1933 clearly did not contemplate that underwriting would be arranged other than through negotiation between the issuer and underwriters chosen by him. The theory of the Act was that there should be, between the issuer and the investing public, an underwriter who would be charged with heavy responsibility requiring thorough and searching investigation to be made by him of the facts concerning the issue so as to ensure that securities offered to the public would be offered only on the basis of true state-

ments of fact from which no information of material importance would be omitted.

Investigations heretofore made in major issues have been searching in character, and the experience of underwriters has been that in almost every instance their efforts have resulted in far higher standards of disclosure than would have resulted had the issuer worked alone. This does not necessarily imply that issuers do not intend to make full or fair disclosure. In practice, competent underwriters submit the entire enterprise of an issuer to the scrutiny of their counsel and to that of their buying departments, who have the background of experience with other issuers; and, as to technical matters, to engineers and others. This scrutiny is made for the account of the underwriter and not for that of the issuer. Thus it is not subject to intentional or unintentional bias in favor of management. As a result, it usually produces disclosure of a significance theretofore unappreciated by management, who are often too close to their own problems to see them objectively.

In such investigations each department head is personally examined, all contracts are checked, all corporate proceedings are re-reviewed, properties are inspected, and accounting methods reviewed. Activity on this scale is wholly impossible on a "town meeting" basis with a multitude of underwriters or under circumstances in which an issuer subjects himself to examination through his own employment of experts.

In the first place, the human equation makes it impossible to undergo examination time and again by successive underwriters, or by groups. The true inwardness of many complicated corporate matters may be revealed in extended conferences, but certainly this will not or cannot be done in "town meetings"; and, if conferences must be repeated with each of many possible underwriters and their several counsel, managerial patience cannot fail to become exhausted. Most managements feel amply self sufficient and it has been one of the benefits of the 1933 Act, up to now, that self-sufficient managements, recognizing underwriters' liabilities, have consented to undergo searching examination of their affairs which they would otherwise never have permitted. To believe that such managements will permit the same kind of investigation to be undertaken by several groups of underwriters is not realistic.

It is also unrealistic to assume that issuers will voluntarily employ experts to examine into their affairs when the experts are not



clothed with the authority of persons actually engaging in the transactions, with accompanying liabilities. Under compulsory competitive bidding, not only would thorough investigation by a number of underwriting groups be most difficult, but the method would put a premium on the cheapest investigation, or on none at all. If the purchaser in compulsory competitive bidding does not employ counsel and strips his payroll of his own engineers and investigators, he can greatly reduce expenses and so make a higher bid. A system requiring the sale of corporate issues of securities through compulsory competitive bidding would inevitably tend to the production of shoddy goods.

The procedure proposed by the P.U.D. Staff, which contemplates that the underwriter shall be simply a merchandizer who succeeds in buying on the auction block, through the submission of the highest of several sealed bids, breaks down the whole theory of responsibility which Congress had in mind in enacting the Securities Act of 1933. It would deprive the investing public of the protection now afforded by the responsibility for investigations attaching to underwriters. For, if the underwriter is to have no direct contact with the issuer, but is to be merely one of several dealers submitting bids, without adequate opportunity for the prior investigation of the facts concerning the issue, it is surely unreasonable under such circumstances to place on him the responsibility and the liabilities established by Section 11 of the 1933 Act.

Moreover, as we have already seen, the P.U.D. Staff desires to bring about a situation in which the professional functions of the investment banker with respect to the creation of corporate indentures and the investigation of issuers' affairs (page 26) would be segregated from the underwriting function and carried on by groups of independent experts. Thus the question arises whether reliance on the investigations made, and on the work done, by such an independent body of experts would establish that the investment banker had exercised "reasonable care" within the meaning of Section 11. and such a group of independent experts should not also be made liable.

If the proposed compulsory competitive bidding procedure is to be adopted, investment bankers who would purchase issues pursuant to that procedure, should, we think, be relieved from the Section 11 liabilities of the 1933 Act with respect to such issues, either by means of an amendment to that Section or by amendment to the definition of the term "underwriter" as contained in Section 2(11) of the Act. It

would seem only reasonable to exempt from the meaning of the term "underwriter," as used in Section 2(11), any person who buys an issue of securities from a registered public utility holding company or a subsidiary thereof pursuant to any rule adopted by the Commission requiring that such issues be sold in compulsory competitive bidding by means of sealed bids. Section 2(11) should also be changed to exempt from the definition of "underwriter" as used therein any investment banker purchasing an issue of securities pursuant to a compulsory competitive bidding requirement established under the laws of any of the several states.

The question also arises as to the propriety under the 1933 Act of the procedure which the P.U.D. Staff desires the Commission to adopt, whereby registration statements would be declared effective under the statute with respect to an issue of securities of a registered public utility holding company or subsidiary thereof, proposed to be sold in compulsory competitive bidding pursuant to a rule of the Commission, or with respect to other public utility issues sold under similar procedure pursuant to a requirement established by any state law.

The rule now proposed by the P.U.D. Staff would make it necessary to establish a procedure, under the 1933 Act, whereby a registration statement would become effective before the offering price had been determined and before other matters relating to price could become known. Congress, in enacting the Securities Act of 1933 obviously did not intend that a registration statement, incomplete in these respects, should be permitted to become effective. It is quite true that, under Section 7 of the 1933 Act, the Commission has authority, by rules and regulations, to provide that the information prescribed by Schedule A of the Act (or by Schedule B) "need not be included with respect to any class of issuers of securities if it finds that the requirement of such information or document is inapplicable to such class and that the disclosure fully adequate for the protection of investors is otherwise required to be included in the registration statement."

Nevertheless, Congress provided, in Schedule A of the 1933 Act, that amongst other things there should be stated in the registration statement and in the prospectus:

"(5) The names and addresses of the underwriters;"

"(15) The estimated net proceeds to be derived from the securities to be offered;"

“(16) The price at which it is proposed that the securities should be offered to the public or the method by which such price is computed and any variation therefrom at which any portion of such securities is expected to be offered to any class or classes of persons other than the underwriters, naming them or specifying a class . . .”

“(17) All commissions or discounts paid or to be paid, directly or indirectly, by the issuer to the underwriter in respect to the sale of the securities to be offered. . .”

Obviously, therefore, in the language which it used in the statute itself, Congress contemplated that registration statements, before becoming effective under the Act, would contain this important information.

It will also be observed that Section 6(a) of the Securities Act of 1933 provides that “a registration statement shall be deemed effective only as to securities specified therein as proposed to be offered.” In general practice, the Commission has refused to permit a registration statement to become effective unless the terms and conditions of the proposed public offering have been clearly stated therein on the ground that the Act requires the statement of these terms and conditions before the registration statement becomes effective. There have been exceptions to this practice. It is noted that in June, 1936, New York Edison Company filed a registration statement with respect to \$30,000,000 of 3¼% bonds, Series E, due April 1, 1966; and, according to Release 851 of the Commission dated June 16, 1936, it is stated:

“The company (New York Edison Company) does not expect to enter into any underwriting arrangements for the sale of the bonds before the effective date of the registration statement. . . but anticipates negotiations for an underwriting agreement at an undetermined time after the effective date. The price at which the bonds may be offered to the public, if the underwriting is arranged, the underwriting discounts or commissions, and the proceeds to the company have not yet been determined. . . When and if the company enters into underwriting arrangements covering the issuance of the Series E bonds, it contemplates filing a post effective amendment to the registration statement setting forth the statements of the underwriting and the price at which the bonds may thereafter be offered to the general public.”

The Commission authorized this procedure to be followed in the one instance mentioned, but refused thereafter to permit any similar registration statements to become effective until the underwriting ar-

rangements, if any, had been made and the price of the proposed public offering incorporated in the registration statement and prospectus.

In an article which appeared in the New York Times on August 13, 1936, under a Washington date line of August 12, with respect to this issue, it is stated:

“Although the procedure . . . was permitted by the Commission in the case of the New York Edison issue, the Commission consented to the company’s plan only as an experiment and so advised the company. This procedure appears to have had no adverse results in that particular case. However, the Commission is not prepared at this time, in the absence of further study, to consent to this procedure as a general practice. Accordingly, the information which you propose to omit\* from the registration statement should be in accordance with present practice filed as an amendment prior to the effective date.”

\*NOTE: The information proposed to be omitted related to the underwriting arrangements and the public offering price.

• Evidently, the Commission, in 1936, decided that it was not in the public interest to permit the establishment of a general procedure whereby registration statements might become effective before the terms of the underwriting, and the public offering price, had been made a matter of general public record.

It is clear, therefore, that the procedure now proposed with respect to compulsory competitive bidding for securities of registered public utility holding companies and their subsidiaries is contrary to that which the Commission has, in general, thought to be desirable in the public interest throughout recent years.

It is noted that, in several instances, the Commission’s General Counsel has issued opinions as to Section 6(a) indicating that it has been contrary to the policy of the Commission to permit incomplete registration statements to become effective. For example, in a letter dated August 30, 1939, the Assistant General Counsel stated: “I would call your attention, however, to the provision of the last sentence of Section 6(a) . . . In my opinion, securities cannot be effectively registered with a view to making them available in case it should later be decided to make an offering . . .”

However, in the recent offering by Boston Edison Company of an issue of \$53,000,000 First Mortgage Bonds, Series A, due 1970, the Commission permitted an incomplete registration statement to become effective and permitted the Boston Edison Company to advertise in

the press "invitations for proposals for purchase of bonds" on the basis of that registration statement. An advertisement relating to this appeared in the Boston Evening Transcript on Monday, November 25, 1940, page 13, stating that "the Company (the Boston Edison Company) reserves the right to reject any and all proposals." Here, then, is a situation in which the action taken by the Commission seems to be directly contrary to that which the Commission's General Counsel indicated, in his opinion of September 30, 1939, to be necessary to comply with the provisions of the Act; for it is apparent from the advertisement that when the registration statement with respect to the Boston Edison Company became effective, it had not been "decided to *make* an offering." It had merely been decided to make an offering *if* it became possible to obtain a satisfactory price; and the company, in its advertisement, specifically reserved to itself the right to "reject *any* and *all* proposals."

The procedure under which the advertisement of the Boston Edison Company was published, inviting "proposals" for the purchase of its issue of \$53,000,000 bonds, was established by Rule 880 of the Commission which provides as follows:

"If, in order to satisfy the requirements of State law in effect since a time prior to June 1, 1935, it is necessary to advertise in more than five newspapers for bids in connection with an offering of a security of a public service company, any matter contained in the registration statement may be omitted from a newspaper prospectus in any of the newspapers in which such advertisement is required pursuant to such law: Provided, That such advertisement is an invitation for bids only, and states that, prior to acceptance of any bid, the bidder will be furnished with a copy of the official prospectus. In such case, the provisions of other rules or instructions of the Commission regarding newspaper prospectuses need not be complied with."

The P.U.D. Staff has recommended that a similar procedure be established under its proposed rule. Clearly, therefore, in view of the special language of the above quoted Rule 880, it will be necessary for the Commission, if it is to act in accordance with the procedure recommended to it by the P.U.D. Staff, to adopt a rule under the 1933 Act permitting registered public utility holding companies and their subsidiaries to advertise invitations for bids.

Rule 880 has apparently been established pursuant to Section 10(b) of the Securities Act of 1933 which provides that: "There may be omitted from any *prospectus* any of the statements . . . which the Commis-

sion, by rules or regulations, designates as not being necessary or appropriate in the public interest or for the protection of investors.”

During the past seven years, the Commission has, as a general rule, rigorously restricted the publication of advertisements relating to securities. It has been possible, under Section 2(10), to publish an advertisement, generally described as a “tombstone” advertisement, doing “no more than identify the security, state the price thereof, and state by whom orders will be executed,” in addition to indicating “from whom a written prospectus meeting the requirements of Section 10 may be obtained.”

The only general exception to this rigorous restriction on the information which might be published in a newspaper advertisement relating to securities has been that contained in the Commission’s Release 357 of May 1935 relating to “newspaper prospectuses” generally. The information required to be set forth in such newspaper prospectuses has been broadly comprehensive in character and has always shown the public offering price and related information.

Otherwise, the Commission has rigorously applied the restrictions established under Section 2(10) of the 1933 Act. Illustrative of this is a letter, dated January 24, 1939, from the office of the General Counsel in which it is stated, after quoting the provisions of Section 2(10):

“It is clear from the language of the exception that an advertisement designed to meet its requirements must contain no information other than that which falls within the specified items.”

If, however, despite the practice which has been established, as indicated by the ruling above quoted and other similar opinions of the General Counsel’s office, it is proper for the Commission to adopt a procedure pursuant to Section 10 whereby there may be published an advertisement similar to that used by Boston Edison Company on November 25, 1940, there is apparently no limit to the extent to which the Commission may, by administrative action, authorize procedures which were in no sense contemplated by the Securities Act of 1933 as passed by the Congress.

In view of all these considerations, it would appear that, if the Commission is to adopt a compulsory competitive bidding rule with respect to registered public utility holding companies and their subsidiaries, and to establish a procedure as proposed by the P.U.D. Staff, it would be desirable to submit to Congress proposals for amendments to the 1933 Act which would clearly establish the legality of the proposed procedure and provide specifically for appropriate regulations.

## X

### **On consideration for the views of corporate management**

At the present time, the management of industrial enterprise generally is free to sell securities in whatever market it may select, in whatever manner, and in whatever form will bring the most desired results, subject, of course, to a proper regard for the "truth-in-securities" principle and to the fact that the public offering method of selling securities is discriminated against in favor of so called "private placements."

As we have said, information of a most comprehensive character concerning the earnings, properties, operations and other affairs of corporations which have issued securities publicly in recent years, is available to the management of other corporations as well as to investors and the public generally. The disclosure provisions of the Securities Act of 1933, and of other laws, have added importantly to the store of information available for the guidance of management in the conduct of its affairs. The credits of many corporate issuers are rated as to quality by statistical and advisory services. It is customary for issuers themselves to make statistical comparisons of their credit with that of other issuers. Information is readily available to them showing prices at which other issuers have sold comparable securities in the general market through investment bankers or directly to commercial banks, insurance companies or other purchasers. They also have available the prices at which securities of comparable issues are currently being bought and sold in the general market. Prices submitted by investment bankers are carefully compared with the statistics of the market, and with the cost of commercial loans and "private placements." The prices which underwriters offer and the terms on which they assume underwriting risks are constantly determined by this rigorous competition.

The fact that competitive bidding for new issues of corporate securities does not appear ever to have been voluntarily adopted as a general practice by public utility or other issuing corporations, although borrowing corporations have always been in a position to determine that their securities should be sold in competitive bidding had they so desired, is surely of the highest importance to the wise determination of the present proposal of the P.U.D. Staff.

It is also of importance that compulsory competitive bidding as a means for arranging for the sale of corporate securities has not, to our knowledge, ever been requested by investors, here or in any other coun-

try. It seems in fact to be urged only by those with whom issuers are apparently reluctant to deal.

No less important is the fact, reported by the P.U.D. Staff, (page 41) that "the corporate issuers that submitted replies to the letter of inquiry (the Commission's letter of February 29, 1940) were opposed, almost unanimously, to a competitive bidding or shopping around requirement."

Yet the P.U.D. Staff has advised the Commission to disregard the considered judgment of these experienced men in favor of the recommendations of a few unnamed persons and to impose upon corporate management a requirement which management considers to be both undesirable and unsound.

We are wholly in agreement with the view of the Staff that under the Public Utility Holding Company Act, Congress has charged the Commission with grave responsibilities. But, we think that the Commission will be helped rather than hindered in the discharge of its responsibilities by giving proper consideration to the informed judgment of corporate management.

The question at issue goes to the very fundamentals of corporate enterprise in a free economy, namely, whether American business, subject to the requirements of "truth-in-securities," is to remain free to market securities in the manner which it deems best, or whether by law or regulation or by force of the great authority accorded to the Commission's decisions, industry is to be compelled, against its best judgment, to resort to what it considers an unsound procedure.

The proposal which is before the Commission affects not only registered public utility holding companies and their subsidiaries; it affects, and will affect, the future issuance of every corporate security in the United States.

Moreover, the action taken by the Commission in this matter can scarcely fail to have profound influence upon the practices and procedures of the various State and other federal regulatory authorities.

The proposal put forward by the P.U.D. Staff is, therefore, not one to be determined arbitrarily but earnestly and thoughtfully, after giving full consideration to the views of all concerned and, in particular to the view of those having the experience and responsibility of corporate management.



## XI

### On the public's preference for Bonds rather than Stocks

Unawareness of economic fact seems to characterize some of the observations made by the P.U.D. Staff in its report. Illustrative of this we find (page 17) the statement that "having today little interest in buying equity securities" investment bankers could "not be expected to recommend *stock* financing to their clients."

Were there any general demand on the part of investors for new issues of public utility equity securities, and if investors were prepared to buy such shares, it is scarcely to be supposed that there would be any lack of interest on the part of investment bankers in the purchase and sale of such securities. But investment bankers, on the one hand, and the investing public, on the other, are too well aware of the uncertainties surrounding investment in the common shares and other equity securities of public utility companies, for the one to be disposed in general to recommend, or for the other to be disposed in general to buy such securities.

The "easy money" policies of the Government, the Public Utility Holding Company Act itself, the problems arising in its administration, the numerous restrictions on dividends imposed by the Commission, the attitude of the courts as to equities in reorganization—and not the aversion of investment bankers to equity securities—account for the fact that public utility financing, in recent years, has chiefly consisted of bond issues. It is also important to keep in mind the fact that by far the greater part of all public financing by utility companies in recent years has consisted of the refunding of previously outstanding bond or debenture issues and that it is not generally possible to retire a bond issue through the sale of equity securities.

Hard economic fact and an intelligent awareness of the existence of uncertainties, determines the attitude of the investing public towards the market for equity securities of public utility companies.

When some of the existing uncertainties surrounding equity investments in public utility companies, subject to the Holding Company Act of 1935, are cleared up or removed, we believe that there will be increased willingness on the part of the investing public to purchase such equity securities. Investment banking will be found ready to facilitate the issuance and sale of such securities on sound terms. But investment banking cannot create demand on the part of the public. Demand must

arise from changes in circumstances and conditions which can in no way be controlled or influenced by investment banking. In the meantime, it is scarcely to be expected that there will exist on the part of underwriters and dealers in securities a willingness or desire to buy equity securities which cannot properly be recommended or sold to investors. Furthermore, it must be recognized that issuers will, in fact, always seek to obtain capital on the most advantageous terms available to them. When they can borrow capital, at say 3% they will scarcely consider it sound business to prefer to obtain additional equity capital at a cost in dividends, of say, 5% per annum.

## XII

### **On the proposal to exempt bank purchases of issues due within ten years**

In its proposed competitive bidding rule (page 46) the P.U.D. Staff proposes that there be exempted from that requirement:

“The issuance or sale of any unsecured bond, note or other evidence or debt of a maturity of ten years or less to a commercial bank (*sic*) provided no fee or other remuneration is to be paid in connection therewith to any third person;”

The terms “banker” and “investment banker” have been used interchangeably throughout the P.U.D. Staff’s report. A careful examination of the one hundred and twenty-five page document comprising the report fails, however, to disclose any examination or discussion of the difference (if there be any difference) in the duties of the Commission under the Public Utility Holding Company Act with respect to issues of securities sold directly by issuers to “commercial banks” and those sold by issuers to “investment bankers.”

The provisions of the proposed rule which contemplate that the suggested compulsory competitive bidding requirement should not apply to issues maturing within ten years which are sold to a “commercial bank” are presented in the report without explanation or supporting argument.

Yet, the fact is that, the duties of the Commission under the statute, with respect to issues reaching a maturity in ten years or less, are no different than its duties with respect to longer term issues.

If the arguments of the P.U.D. Staff in support of its “case” for compulsory competitive bidding are valid as applied to issues having a

term of more than ten years, they are equally valid as applied to shorter term issues.

The fact appears to be that the Staff, in proposing its rule as drafted, including the "exemption" in (a) (2) thereof, is recommending to the Commission the arbitrary exercise of administrative power in line with the view entertained by the Staff that the Public Utility Holding Company Act of 1935 should be interpreted and administered as an instrument for regulating *investment bankers*.

The effect of the exemption in (a) (2) of the proposed rule would be to grant to "commercial banks" a special advantage in the purchase of issues maturing within ten years or less. Since such issues would not come within the scope of the proposed competitive bidding requirement and of the procedure which the Staff suggests be adopted to govern issues sold in compulsory competitive bidding, these issues, having a maturity of ten years or less, would apparently not need to be registered under the Securities Act of 1933 but could be sold directly to the purchasers in so-called "private placement." At the same time, the procedure proposed by the Staff would close all other avenues for the sale of securities without prior registration under the Securities Act of 1933.

Under such circumstances there might be a tendency on the part of corporate management to seek to arrange financing by means of medium-term issues sold directly to banks.

The result of this suggested provision of the proposed rule might, therefore, be to bring about further disruption and unbalance in the public markets and to deprive the generality of investors of the opportunity to buy high-grade short-term issues of registered holding companies and their subsidiaries.

### XIII

#### **On those provisions of the proposed Cumpulsory Competitive Bidding Rule which have not previously been discussed**

Paragraph (a) of the rule proposed by the P.U.D. Staff would exempt from the requirement of compulsory competitive bidding:

"(1) The issuance or sale of any security pro rata to existing holders of securities of the applicant or declarant."

As drafted, this provision of the rule would presumably perpetuate so-called "private placement" without registration under the

1933 Act, by giving to institutional investors who have previously purchased issues of securities of registered public utility holding companies and their subsidiaries a pre-emptive right to buy other securities issued to refund those previously purchased by them. If, for example, five or six insurance companies have, at one time, purchased an issue of, say, \$30,000,000 of bonds of a registered public utility holding company or its subsidiary, the issuer could arrange to refund such securities at maturity, or at any redemption date, by making a refunding offer of an equivalent amount of securities directly to the insurance companies or other institutional investors who had originally purchased the issue. In so doing, the issuer would not become subject to the proposed competitive bidding rule.

But, surely, the duties of the Commission with respect to the determination of the reasonableness of price, in respect of issues of securities sold generally to investors, also apply to the refunding of issues previously purchased by various classes of institutional investors. If compulsory competitive bidding is a necessary requirement when issues are to be sold to the public, it is no less necessary when securities are to be sold to a small group of institutional investors.

Undoubtedly, the stockholders of a registered public utility company or of its subsidiaries should have a pre-emptive right to buy pro rata any shares of stock of an issuer in whose equity they have invested their funds. But, holders of bonds or debentures have no such claim to preferential consideration. Nor, is there anything in the 1935 Act which warrants the establishment of a rule which would clothe such holders with special rights as contemplated by the proposed rule drafted by the Public Utilities Division.

It is our opinion that, if the proposed rule is to be adopted, the exemption provided for in (1) should apply only to holders of the common shares of the issuer and to the holders of other stock having pre-emptive rights.

The proposed rule also provides under (2) for an exemption applicable to bonds, etc., sold to any "commercial bank." This proposed provision of the rule has already been discussed under XII above.

Also, to be exempted from the requirement of competitive bidding under the terms of the proposed rule as provided in (3) thereof, is:

"The issuance or sale or any security to any registered holding company or subsidiary whose acquisition thereof has been approved by the Commission pursuant to Section 10 of the Act."

In our judgment, if a competitive bidding rule is to be imposed, it is only proper that inter-company or intra-system transactions such as are described in (3) should be exempted from the provisions of the rule.

The proposed rule would, also, exempt:

“(4) The issuance or sale of any security the total proceeds whereof to the issuer will not exceed \$1,000,000.”

If, however, one agrees with the major premise of the P.U.D. that “evils” attend the issuance and offering of issues of more than \$1,000,000 in amount, it is difficult to see why such a contention is not more important in issues of smaller amount. Surely, there is greater likelihood of an issuer not receiving “the highest possible price,” in a small, comparatively obscure issue than there is in one large enough to command wide-spread attention in financial circles.

We would like to point out here that it is our view that issues of \$1,000,000 or less in amount should be left to the control of state laws which, in our judgment, provide ample protection for investors in local enterprises.

The P.U.D. Staff would also exempt from the proposed requirement of competitive bidding:

“(5) The issuance or sale of any security, to the extent determined by the Commission, if upon application and after notice and opportunity for hearing the Commission finds that compliance with paragraphs (b) and (c) hereof with respect to the issuance or sale of such security is not appropriate to aid the Commission to determine the reasonableness of any fees, commissions or other remuneration to be paid directly or indirectly in connection with the issue, sale or distribution of such security or whether any term or condition of such issue or sale is detrimental to the public interest or the interest of investors or consumers.”

Explaining this provision of the proposed rules, the Staff says (page 42) that the rule provides “that an exception may be granted by the Commission in any case in which a satisfactory showing is made that competitive bidding, by reason of special circumstances, would be impracticable, incompatible with the best interest of the issuing corporation, or not appropriate to aid the Commission to determine the reasonableness of any fees or other remuneration to be paid in connection with the sale or distribution of the security, or whether

any term or condition of such issue or sale is detrimental to the public interest or to the interest of investors or consumers.”

It is our view that, if the Commission adopts the proposed rule, it will find in practice that necessity for resort to the provisions of the “exemption” in (5) will be the rule rather than the exception. Compulsory competitive bidding will not at any time be “appropriate to aid the Commission to determine the reasonableness of any fees or other remuneration to be paid in connection with the sale or distribution” of any security.

In fact, one of the members of the Commission, in Release 2446 dealing with the problem of “stabilization,” has suggested that it would be desirable to have in the United States, underwriting arrangements which would permit underwriters to purchase issues of securities and hold them for long periods of time before disposing of them to investors or others. The concept on which the P.U.D. Staff would have the Commission act with respect to its proposed competitive bidding rule is utterly foreign to the concept of underwriting which the Commissioner entertained in expressing its views with respect to the problem of “stabilization.”

Congress, in the Public Utility Holding Company Act, quite properly sought to control the payment of fees, commissions, and other remuneration *by the issuer*; but there is no support, in fact, for the view on which the P.U.D. Staff has operated, that the difference between the price paid by the purchaser, and the price at which that purchaser subsequently resells, is a “fee or commission,” etc., paid by the original seller.

Altogether aside from this consideration, we think it quite clear from the experience established with respect to compulsory competitive bidding for municipal issues, railroad equipment trust issues, and various other classes of securities, that, in periods of declining markets or when the issues offered for sale are not of the highest grade, competitive bidding quite generally produces results which are disadvantageous to the issuer.

Accordingly, it is our view that, if a competitive bidding rule is imposed, the Commission will find that it will not operate satisfactorily from any point of view and will prove especially disadvantageous to issuers in respect of the sale of lower grade obligations and, under existing conditions, in the sale of equity securities of the general run of public utility holding companies and their subsidiaries.

Among the several provisions proposed by the P.U.D. Staff in paragraph (b) of the proposed rule is a provision which would permit the issuing company to sell a part of its proposed issue to one group of purchasers and another part of the issue to other purchasers. We think this is a decidedly unwise provision. We would suggest that, whatever else is done with the proposed rule, this provision be deleted therefrom and that issues required to be sold in competitive bidding, if such an unwise requirement is imposed, be offered to prospective purchasers on an "all or none" basis.

Paragraphs (b) and (c) of the proposed rule would require that "at least ten days prior to entering into any contract or agreement for the sale of an issue of securities," the registered public utility holding company or its subsidiary publish an invitation for bids in "news-papers of general circulation."

After the bids are received by the issuer, they are apparently to be submitted to the Commission which is to determine whether or not they are "reasonable" and which will then take action permitting or refusing to permit the issuer to proceed with the issuance and sale of the securities as proposed by it. Obviously, therefore, the contemplated procedure will impose upon the Commission the same duties as to the establishment of the "reasonableness of price" as it is now required to discharge under Section 7 with respect to issues sold in accordance with the procedures which have hitherto been followed under the Act.

The procedure proposed by the P.U.D. Staff would require prospective purchasers to be under commitments to purchase, for a period of some days, without knowing whether the issuer is to be permitted to sell its securities to them. While such a requirement might, in certain circumstances, operate with a fair degree of success in periods of very stable markets, or in periods of rising markets, it would make it necessary for the prospective purchasers, for their own protection as a matter of sound business, to submit conservatively low bids in periods of unstable or declining markets.

#### XIV

#### **On the advisability of submitting all aspects of the problem for the consideration of an impartial body—preferably a committee of Congress**

The proposal which has been put forward by the P.U.D. Staff does not relate solely to the determination of a question of policy as to the administration of the Public Utility Holding Company Act of 1935.

While the language of the proposed rule may be addressed specifically to "the sale and distribution of securities of registered public utility holding companies and their subsidiaries," the action which the Commission may take with respect to this proposed rule cannot fail to have far-reaching effects upon the administration of other federal and state laws and on the issuance of corporate securities generally.

In view of this, we strongly urge that final action on the proposed rule be not taken by the Commission until a public hearing has been held on this subject before a disinterested public body which will accord to all interested persons full opportunity to present their views.

And again, we wish to state that, in our judgment, the body before which this public hearing is held should not be the Securities and Exchange Commission itself. It is apparent that issuers who must rely on the affirmative action of the Commission to permit the carrying out of financing plans subject to registration under the Securities Act of 1933, or the Public Utility Holding Company Act of 1935, as well as the underwriters of such issues and dealers engaged in the distribution of securities, are placed in an extremely difficult position in being called on to express their views before the Commission, particularly if such views involve criticism of the manner in which the Commission has administered the statutes entrusted to it by Congress. And, we think that the Commission would be in a much better position fairly to present its own views if it were not likewise charged with responsibility for determining the propriety and wisdom of its interpretations and policies.

We find ourselves in agreement with the view of the Commission's Staff that the Commission's present Rule U-12F-2 has not contributed in any way to the efficient operation of the underwriting and issuance of public utility securities subject to its provisions. We think it wholly proper that this Rule be repealed.

It is again our recommendation that, in place of the burdensome and costly procedures required under the existing Rule U-12F-2, that the reasonableness of the price, terms and spread of a proposed issue be established by comparing them with those prevailing for comparable issues selling or recently issued in the open market. Information on which to base such a determination is readily available to the Commission. But, if in any case, the Commission and its Staff cannot determine to the satisfaction of the Commission that the terms of a proposed issue meet the requirements of Section 7, then, we suggest, the Commission can very easily arrive at the facts by calling a hearing and taking testimony covering the views of the issuer, of the investment bankers pro-



posing to underwrite the security, and of other experts, as to the reasonableness of the price, and terms of the issue. Such hearing and testimony should be confined to the type of business done by the issuer; credit standing of the company; size of the issue; reception of past security issues; terms and conditions of the issue in general, in comparison with terms and conditions of comparable security issues; whether the security will qualify as a legal investment for insurance companies, savings banks and trustees in the leading commercial states; and, such other data as investment analysts usually compile in order to determine the relative merits of securities.

The testimony on such subjects of experts who are in constant touch with current market conditions and with the general price limits within which it is possible to market such a security on a basis fair alike to issuer and to purchaser, when supported by data of the character indicated above, should afford the best criteria obtainable by any means by which to establish whether or not the Commission may properly permit public utility securities to be sold.

By adopting such a procedure, the Commission could readily discharge its responsibilities under the Act, protect the interest of investors and of the public interest generally, without disrupting or destroying a system which throughout the years and under varied economic conditions has provided industry with many billions of dollars in capital on terms which have, on the whole, been satisfactory to the issuers and to the public.

If, as would be the effect of the rule proposed by your P.U.D. Staff, present methods of carrying out the financing of registered public utility holding companies and their subsidiaries are to be completely changed, we believe the burden of proof that such changes are desirable in the public interest lies primarily with those who desire to make the change. And we think, moreover, that determination of the question is not simply a matter of policy under the 1935 Act, but is one of broad public policy which should come before an authority other than the Commission itself.

The rule proposed by the P.U.D. Staff would strike at the whole organization which has been built up through the years to handle the underwriting and distribution of corporate securities. It would affect the future issuance and sale of every corporate security. It would profoundly affect the regulatory procedures of the several states with respect to the issuance and sale of securities, and it is of intimate and direct concern to the issuance and sale of the securities of common and contract carriers subject to the provisions of Section 20(a) of the Interstate Commerce Act.

It has been agreed by the Commission and by the representatives of the Investment Bankers Association of America, the National Association of Securities Dealers, Inc., certain of the registered national securities exchanges and other interested elements that a report suggesting certain changes in the Securities Act of 1933 and the Securities Exchange Act of 1934 shall be submitted at an early date during the present session of Congress for the consideration of the House Committee on Interstate and Foreign Commerce and of the appropriate Committee of the Senate.

Inevitably, the problems arising in connection with the proposal for establishing compulsory competitive bidding, with respect to the securities of registered public utility companies and their subsidiaries, will come before the Committees of the House and of the Senate in connection with the proposals relating to the Securities Acts.

We strongly urge on the Commission that no definite action on the rule proposed by the Public Utility Staff be taken until these problems have been so considered by the Committees of Congress, and we also strongly urge the Commission to join with us in a request to the Congress to have the broad questions of public policy involved in the proposed rule thoroughly explored at public hearings before the House Committee on Interstate and Foreign Commerce and the appropriate Committee of the Senate.

Respectfully submitted,

SECURITIES ACTS COMMITTEE OF THE  
INVESTMENT BANKERS' ASSOCIATION OF AMERICA

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