

OFFICIAL REPORT OF PROCEEDINGS
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

DOCKET No.

In the matter of 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

Place Washington, D. C.

Date February 5, 1941

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BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

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: Public Conference concerning :
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: 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 :
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Hearing Room 1102,
Securities and Exchange Commission Bldg.
Washington, D. C.,
Wednesday, February 5, 1941.

Met, pursuant to adjournment, at 10 o'clock a.m.

PARTICIPANTS:

COMMISSION:

JEROME N. FRANK, Chairman, (presiding),
SUMNER T. PIKE, Commissioner,
ROBERT E. HEALY, Commissioner,
EDWARD E. EICHER, Commissioner.

STAFF OF COMMISSION:

JOSEPH L. WEINER, Director, Public Utilities Division.
ROBERT H. O'BRIEN, Associate Director, Public
Utilities Division.
GEORGE OTIS SPENCER, Assistant Director, Public
Utilities Division.
LAWRENCE S. LESSER, Special Counsel.
LESLIE T. FOURNIER, Supervisory Utilities Analyst.
ROGER FOSTER, Special Counsel.

OTHER APPEARANCES:

| <u>Name</u> | <u>Representing</u> |
|---------------------|--|
| Nevil Ford | Ex. Comm., National Association of Securities Dealers', Inc. |
| Emmett F. Connely | Pres., Investment Bankers Association of America |
| Cyrus S. Eaton | Otis & Co. |
| Harold Stanley | Morgan Stanley & Company |
| J. K. Starkweather | Starkweather & Co., New York City. |
| Churchill Rodgers | Metropolitan Life Insurance Co. |
| John E. Lockwood | Milbank, Tweed & Hope, Washington, D.C. |
| Arthur H. Dean | Counsel, I.B.A. |
| Robert C. Webster | Webster & Gilson, Nashville, Tenn. |
| Charles W. Kellogg | President, Edison Electric Institute, New York City. |
| Edward L. Love | Chase National Bank, New York City |
| James W. Moss | Preston, Moss & Co., Boston, Mass. |
| John J. Quail | Quail & Company, Davenport, Iowa. |
| Michael D. Dearth | Murdoch, Dearth & White, Inc., Des Moines, Iowa |
| Mr. Awalt | National City Bank of New York |
| Mr. Caldwell | Chemical National Bank, New York City |
| Hon. Robert Crosser | Congressman from Ohio |
| Burnett Walker | Smith Barney & Company |
| Mr. Cutler | |
| Mr. Bennett | |
| Mr. Hurd | |
| Mr. Scott | |

P R O C E E D I N G S

Chairman Frank: I think perhaps we will save some time if all the persons who desire to be heard will file their names now, or rise and announce if they care to be heard.

Is there anybody that wants to be heard today? We will just be arbitrary in the mode of selection. I think Commissioner Eicher would like to hear from Iowa, so we will take first Mr. Dearth, if he would like to be heard.

STATEMENT OF MICHAEL D. DEARTH

Murdoch Dearth & White, Inc., Des Moines, Iowa.

President - Iowa Investment Bankers Association.

Mr. Dearth: I would like to introduce the resolution of the Iowa Investment Bankers Association into the record.

(The resolution referred to is as follows:)

"Des Moines, Iowa

At a meeting of the Board of Directors of the Iowa Investment Bankers Association held January 27, 1941, the following resolution was adopted:

RESOLVED: That the Iowa Investment Bankers Association is unalterably opposed to the proposed rule of the Securities and Exchange Commission making mandatory competitive bidding in the sale of public utility securities, believing it not to be to the interests of the public in general and that it would work a great hardship on the investor and the smaller investment dealer.

BE IT FURTHER RESOLVED: That the President of the Association be instructed to forward this resolution to the Securities and Exchange Commission and that the reasons whereby they arrived at this conclusion be embodied in and made a part of this resolution.

Consideration was given to the report of the Public Utilities Division of the Securities and Exchange Commission dated December 18, 1940, and for purpose of briefness it is believed that the ideas of the Association can be covered in considering the points set forth in this report under:

'III. COMPETITIVE BIDDING AS A SOLUTION TO THE
PROBLEM OF ARM'S LENGTH BARGAINING AND
MAINTENANCE OF COMPETITIVE CONDITIONS.'

'(B) THE CASE FOR COMPETITIVE BIDDING.'

- '1. Competitive bidding may be expected to remove the threat (and actuality) of banker domination of utility financial policies.'

It is felt that the association of the banker with the public utility company is of material benefit to the investor in that it insures his interests being protected, the banker having an obligation to the investing public, as well as to the company whose securities he is underwriting. This obligation of the banker to the investing public tends to insure that the proper type of security is offered to the public and that the ultimate investor is adequately protected by the indenture

and security which is behind the issue being underwritten. Without this relationship between the banker and the investor, the company is going to be the sole originator of the instrument which is offered to the public and, therefore, the company's interests will be given primary consideration and the interests of the ultimate purchaser will be secondary. The Association is of the opinion that the banker is in a much better position to look after the interests of the investor, who is, after all, his bread and butter, than is the Securities and Exchange Commission, whose only interest would be to see that the law was complied with.

- '2. Competitive bidding should result in genuine arm's length bargaining for the securities thus sold. Not only would banker domination be eliminated but also any community of interest in the financing not to the benefit of the investors would be prevented.....'

The Iowa Investment Bankers Association feels that, contrary to the opinion of the S.E.C., this arm's length bargaining would not be to the benefit of the investor. The banker, it is felt, plays a very important part in seeing that the proper instrument is issued, as was mentioned above, which will be to the interest of the investor. In the case of arm's length bargaining, the banker will have to take the security which is offered by the company and the benefit of his professional advice will be entirely lost as far as the investor

is concerned. It is acknowledged that professional advice, whether it be that of a lawyer or that of a doctor, has its place in the scheme of things and is of great value to the client or patient. The professional advice of the banker is just as important to the issuer and elimination of this would create a hardship on the issuer, as well as on the investing public who buys these securities. Certainly no issuer will continue to deal with his banker if the banker does not give him value received, first, in advice, and second, in the price that he receives for his securities. The very nature of business today insures competition which, in turn, insures the issuer that he will get his dollar's worth of service for every dollar expended.

'3. Competitive bidding may be expected to reduce the concentration now found in the underwriting management of new utilities securities issues As we have seen, this concentration and the instruments by which it is maintained have been instrumental in preventing the normal play of independent competition and arm's length bargaining. This expectation is not unfounded since it is reflected in the experience with competitive bidding in the sale of municipals and, also, equipment trust securities. On the basis of the experience in these fields, investment bankers and dealers all over the country may be

expected to take an active part in organizing or participating in syndicates for the purpose of bidding on new utility issues, rather than accepting (as they do now) whatever crumbs may fall from the table of the few dominant investment banking houses.'

It is the belief of the Association that no part of the above presents a sound argument. In the first place, a comparison is made with municipals and equipment trust securities. It is well known that both of these types of securities do not require any assistance on the part of the banker in getting them into the proper shape so that the interests of the investor will be protected. Municipals are issued under law and the indenture behind them and under which they must be issued is, in actuality, the law of that particular political body. All of these issues are sold subject to proper legal opinion and this legal opinion when obtained insures that the issue is legal and that taxes must be collected and used to service it. In the case of equipment trusts, they are issued according to a set formula, either the Philadelphia Plan or the New York Plan, and the banker knows exactly what he is buying when he bids for the issue, as does the ultimate purchaser. This is not the case with public utility securities as every company has a different charter, operates under different local conditions, and is subject to different circumstances and methods of

operations, as well as having a different financial structure. Obviously there can be no similarity whatsoever as between the issuance of public utilities securities and the issuance of municipals and equipments, the former requiring much study and work of a highly professional character before it can be marketed, the latter practically none. It is agreed that the company can prepare the security for sale, but again, we point out, only at the expense of the investor for whose protection the law was enacted.

The statement is made that investment bankers and dealers all over the country may be expected to take an active part in organizing or participating in syndicates for the purpose of bidding on new utility issues rather than accepting 'crumbs.' This expectation, we believe, is without foundation as is evidenced by the same example which was cited above having reference to municipals and equipment trusts. There are comparatively few investment dealers in the United States who are capable of distributing or capable of taking the liability necessary when they bid as part of a banking group on a large issue. This would automatically eliminate thousands of smaller dealers throughout the country, who play an important part in their local economic scheme of things in obtaining securities in selling groups for distribution to their customers as they do under present conditions. It might be added here, incidentally, that this source of income to the smaller dealer is

of great importance to him in the majority of cases. The selling group concession received by the smaller dealer in the large municipal and equipment trust offering today, when there is a selling group, will not permit him to contact the small account as the expense involved is more than the remuneration received. It is our belief that the small dealer would not get anything in the case of attractive issues and that those 'crumbs' which are so important to him now would be gone entirely if utility securities are bid off at public sale.

'4. Competitive bidding should produce reasonable prices and fees.'

The purpose of the Act in the original instance was to insure protection for investors and the public generally. The attitude of the Commission appears to be that the issuer should obtain the highest possible price for his security. This, in turn, means that the investor is going to have to pay the highest possible price for the security he obtains. This certainly is not to the advantage of the investor, if the issuer, under present methods, is obtaining a fair price for his securities. The banker has always endeavored to give the investor a break on his purchases, knowing that he has to go back to this same investor to sell other securities which he underwrites.

On Page C-3 of this same report, dated December 18, the Commission proves themselves that competitive bidding tends

to create a price which is out of line with the general market and which, in turn, would create a hardship on the investor in that the security he purchases is priced at a maximum, and that he is not as well off in the case of issues marketed with public bidding as he is in the case of negotiated issues.

'2. It appears, however, that the price trend of the competitive issues for the sixteen weeks after public offering was slightly below that of the general bond market as represented by the Standard Statistics Utility Bond Index.

'3. A comparison of the market reception of competitive issues with that of negotiated bonds affords some slight evidence that the price quotations of competitive issues did not increase as much or decline more than that of negotiated issues.'

'5. Competitive bidding may be expected to reduce substantially the administrative task involved in regulating affiliate transactions, judging the reasonableness of fees and commissions

The Securities and Exchange Commission was set up by a Federal act to accomplish certain things and had certain duties designated to it. Funds have been made available for personnel and to enable this personnel to carry out the provisions of certain laws. It appears to the Iowa Investment Bankers

Association that the S.E.C. is apparently diverging from the spirit of the law when it endeavors to make its task easier through the application of rules which, in our opinion, are greatly to the detriment of the general public. It is the Association's considered opinion that this responsibility should be accepted and carried out as the law provided.

The Iowa Investment Bankers Association has endeavored to point out certain things in the proposed rule which it feels would hurt the general public, the investor, and, ultimately, the smaller investment banker. The general public is dependent on the smaller investment banker for a great many services in their local communities, which entail, among other things, financing of small local companies and the making of markets for small issues of local securities. This is their primary function. Any source of income which is taken away from them or any reduction in expected profits, which are reasonable, will tend to hurt this smaller investment banker and may mean the difference between his being able to remain in business or having to close his doors. His affairs are so interwoven with the affairs of the local community in which he operates that anything that hurts him or eliminates him will hurt local industry and the local investor.

For these reasons, the Iowa Investment Bankers Association has passed the above resolution and earnestly requests that the Securities and Exchange Commission not put into

effect the ruling of compulsory bidding for public utilities securities.

ATTEST:

Roy W. Leriche, Secretary

M. D. Dearth, President"

Mr. Dearth: I am here on behalf of the Iowa Investment Bankers Association, which is composed of 48 members. It is non-affiliated with the Investment Bankers Association of America, nor is it affiliated with the National Association of Security Dealers. The members of this organization, to a large extent, are smaller dealers who have small shops, with a small sales force, or, in a number of instances, it is just a two or three-man shop.

The resolution was passed by the Board of Governors, with the request that it be brought to the attention of the Commission in connection with this hearing.

This question of competitive bidding would very seriously affect them.

I am not going to be able to say what I have to say here without bringing our own firm in this, because we are very naturally interested in this picture. My house, a small house, we do some originating, but only in a small way, in the smaller issues. We are not connected, for that reason, or have no interest to speak of in the underwriting of public utilities securities. Issues of that type are too large for us to handle or head up. I do not believe that we have ever been, as a

matter of fact I know we have never been an underwriting group on a public utility security. However, we are, at least we feel we are vitally affected by this question.

Chairman Frank: May I ask, do you think that investment bankers in Iowa could themselves be the originating underwriters in connection with an issue of Iowa utilities securities?

Mr. Dearth: I think that is true. It could be done, but there again, you have a limited market out there; and, furthermore, the capital of the firms in Iowa, to a large extent, would not justify their taking the risk, even collectively, of underwriting a local issue of several million dollars.

Now I believe they could probably handle it, they could bank it, but at the same time I do not feel that collectively between them they would feel justified in taking the risk that would be entailed in such an underwriting.

The reason that the smaller dealer out there seems to be disturbed over the situation is for two reasons: The first is possible loss of revenue which, to a large extent, is small but at the same time helps to cover his overhead and helps to pay his rent, and those bills have to be paid out there just the same as they do anyplace else.

Secondly, they feel that there would be a certain amount of harm, as far as the investor is concerned, and they are the buffer between, you might say, the underwriter and the investor,

and that investor is their bread and butter, and if they have to give him securities at a price which is at a peak, the investor is not going to be benefited, and, on the other hand, he will probably be hurt. There are not any too many of these investors today. It is rather imperative, on the part of the smaller dealer, that that investor be treated properly.

Commissioner Pike: You infer, then, that issues on competitive bidding will be generally over-priced?

Mr. Dearth: I would not say they would be generally over-priced, but I would say they would be at the peak of the market, that would probably be all the market could stand.

Chairman Frank: I notice in the resolution which you have handed us the statement is made, "This, in turn, means that the investor is going to have to pay the highest possible price for the security he obtains. This certainly is not to the advantage of the investor, if the issuer, under present methods, is obtaining a fair price for his securities. The banker has always endeavored to give the investor a break on his purchases, knowing that he has to go back to this same investor to sell other securities which he underwrites."

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Now let us assume that is true, let us assume that as the result of competitive bidding the first issue of that kind came along and the price were pushed to the limit that you indicate, the result is, as you said, the members of your association would be called upon to decide whether they cared to participate in an issue that was priced that high. If you thought it was undesirable you could just say you would not do it, and if the investment dealers, bankers, all other the country took that attitude, that "this is too high for us to pay," - "it is bad for us to be in that relation to our customers," the result would be there would be just about one or two cases where the price ran that high, because the investment banker who was originating that issue would find himself without a market.

You might say, "Well, he would go to an insurance company." Well, we heard from the insurance companies the other day, that they were apprehensive, at least one of them was apprehensive that competitive bidding might push the price too high. Of course in his testimony, or someone else's testimony it was brought out that if that happened the bonds would come back on the market shortly at about the right price. If that were so, there would be no incentive for the insurance company pushing the price, because if they pushed the price up too high the investment banker would have to pay too high a price and he would wait until the price came to the right level.

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Assuming you make the assumption you do, that you do not want to be in a position, and that you are representative of dealers throughout the country, that you do not want to be in a position of selling securities at a price that is way up to the absolute limit because it is not good for your customer and therefore it is not good for you, if that is true I do not see how, for a long period, people are going to pay prices that are too high. We all know, and I think you agree with me, that there is no investment banker in the country that buys an issue for the purpose of investing his money into it, that all he does is he deals in that issue. I say that is a mistake.

Mr. Dearth: There are a lot of ramifications to that question, Mr. Chairman. Looking at it from our point of view, at the present time you have certain larger firms who have the capital and ability to buy certain issues.

Chairman Frank: To buy and keep them?

Mr. Dearth: No, to buy them and bank them through the smaller dealers.

Chairman Frank: Yes.

Mr. Dearth: The smaller dealer fits into that picture.

Chairman Frank: Of course.

Mr. Dearth: If it gets to competitive bidding you are going to, I think, change that picture very considerably. In the first place, before you go in to bid you are going to set up a group, which consists of a number of people, a number of differ-

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ent firms, such as is done in municipal underwriting today.

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No one banker, I do not think, under this proposed set-up of competitive bidding, if the rule goes into effect, would be willing to go in and bid for himself, not knowing that he was going to be able to form a selling group and dispose of it.

Chairman Frank: I would not think so.

Mr. Dearth: So in the natural course of events you probably have certain groups set up. In other words, you would go along with some corporation, Kuhn, Loeb & Company, or some other company, and take some participation in that underwriting. As these municipal groups, to a large extent, are set up today, you are with one crowd, and there are probably six different banking groups which bid on your larger issues.

Commissioner Pike: Are those pretty well set, from issue to issue?

Mr. Dearth: As a general thing that is true. One group, if they are once set up, will continue to bid together, and if you fail to go along on one issue the chances are you might not be invited into the group on the next issue. That means immediately that you are probably restricted to 1/6th of the merchandise. Let us say there was this group bidding and under the law of averages you would get 1/6th of their issue, you would restrict it immediately to 1/6th of the merchandise that you had before.

Furthermore, on this question of bidding up the price,

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paying a high price, they could probably afford to go up. Let us say they bid about the top of the market, you would not have three points in there, or two points, or two and one half points whereby you could set up a selling group and carry some of these people into it. On the other hand, by tacking a quarter of a point, or a half a point to your purchase price, that group could probably unload privately to an insurance company and take the profit out of there immediately and the small dealer would have no opportunity at all to get a profit. You cannot send a salesman out today with the commission that you have in a municipal underwriting, as a general rule, with a quarter of a point or a half a point at the outside that they might give you, and you do not know that you are going to get the bonds anyway, you have to ask for them, and by the time you get there they may be gone. The salesman naturally cannot go out and spend a half day and probably sell the investor one bond, and get a quarter of a point of commission to split with the salesman. Immediately he is faced with the situation: We have got \$2.50 profit on one bond, we pay the salesman \$2.50, and he may spend two days selling that, and there is no profit to the house in it, and the salesman is not going to make a living.

Now let us assume, to try to answer your question, you talk about bankers not bidding top prices for bonds unless there is competitive bidding ---

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Chairman Frank: (Interposing) Do not misunderstand me. There has been a good deal of misunderstanding in the belief that the Commission's interest in the possible competitive bidding rule is primarily with respect to getting the highest possible price. I will speak for myself and say that as far as I am concerned, in the present state of the market, it is not my primary interest in it. My primary interest in it is to see that investment bankers that advises the issuer, that he gives him the best possible advice as to the character of the security, as to whether that should be a bond or preferred stock or common stock, or the like. Consequently, to indicate that our interest in a possible rule of that sort is primarily to get a top price, that is something in error.

The question I asked you is this: We have been told again and again that competitive bidding will inevitably tend to push the price higher than it should be, so that the small investor who buys, or any investor who buys is going to pay a price which will ultimately meet with dissatisfaction on his part.

It seems to me, knowing the nature of the business generally, and what little I know about this business in particular, he cannot very well keep up a practice of pushing the stuff out at a price that is too high. You are going to have dissatisfaction as your very resolution indicates. If that is so, people will go in and bid competitively and push a price

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to the point where they will find themselves in a course of dealing that will produce dissatisfaction on the part of the persons with whom they deal.

Mr. Dearth: Mr. Chairman, may I answer that in this way: I would say competitive bidding would push the price up to probably a top price, that the market will stand, which in turn would narrow the margin of profit of the underwriter of that particular dealer or buyer. Now I think because of the competition you would be inclined maybe to overprice three or four issues, and then you would get quite a complaint from your customers, and on your fifth issue everybody will back away from it, and they will probably buy that at the right price.

Chairman Frank: That is, if you could not keep up that practice.

Mr. Dearth: I would like to continue that further. After the fifth deal went so well everybody would immediately be bidding the top prices, and the investor would get hooked again.

Chairman Frank: Have the investors in municipals got hooked?

Mr. Dearth: No, because we have had a money market that has been riding with the prices of municipal bonds, which pushed the price up.

Chairman Frank: You cannot make a generalization in one place and not in the other. The same market forces are operat-

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ing.

Mr. Dearth: That is a temporary situation.

Chairman Frank: I grant that.

Mr. Dearth: Money rates will not continue that way continually, with one trend, it has got to bounce the other way some time.

Chairman Frank: I do not know about these "go-to-be's". I am skeptical about it. It is historians that repeat, rather than history. I do not know. Our proposed rule, our contemplated rule, the rule the staff has suggested, has a nice piece of rubber in it. It says, "Wherever it can be shown" - I do not remember the precise language, - "that competitive bidding would be undesirable or impractical, that the Commission, under such a showing, would relax it."

Consequently, if we got to a market condition where such a rule was leading undesirable results, the rule itself carries its own remedy.

Let us assume we are in the present kind of market, we do not know that that market may cease to exist a week from now or ten years from now, in the present state of the market, the point you make does not seem to me to be very effective.

Mr. Dearth: I would like to take it from another standpoint, a purely selfish one.

Chairman Frank: That is right; you should.

Mr. Dearth: As far as the smaller investment banker is

concerned, rather than the investor. I would like to cite a very good example that comes to my mind at the moment.

Chairman Frank: I wonder if you would mind? Congressman Crosser is here. He wants to appear. He must return to Congress shortly. Would you mind suspending for the moment?

Mr. Dearth: No, not at all.

STATEMENT OF HONORABLE ROBERT CROSSER,

Congressman from Ohio.

Chairman Frank: We are very glad to have you here, Congressman.

Mr. Crosser: Mr. Chairman, and Members of the Commission. I shall take only a very few moments.

Chairman Frank: This is very unusual, to have a Member of Congress addressing us. I hope you will not feel, because we are on an elevated bench here, that we feel we are in any way your equal.

Mr. Crosser: Thank you for the implied compliment.

Commissioner Eicher: Usually it is the other way around; we are up there addressing you.

Mr. Crosser: I think it makes very little difference, as long as we endeavor to promote justice.

Mr. Chairman, and Members of the Commission: What I shall say will be confined to public utilities in the strict sense of the word.

When it is proposed to sell an issue of securities of

a public utility company then in my opinion, absolute justice requires that there should be competitive bidding among those desiring to purchase such securities. To constitute a public utility, the service rendered to the public must be furnished by an agency which enjoys the exclusive privilege of rendering such service and in doing so uses public property. In such a case the only way the public can be assured of absolute justice, is for public authority to be able if necessary, in the case of a privately owned and operated public utility, to direct just what shall be done in connection with the operation of such public utility agency.

That is not necessary in the case of a private corporation, for instance, which might be issuing securities, because others in the same business would generally be competing for the business and thus assure purchasers a fair and reasonable price for the service sold by such company. In the issuance by a public utility company, however, of any kind of securities, competitive bidding is not only desirable but, in my opinion, absolutely necessary in the public interest. I do not mean to say that a private arrangement made by a utility company and a proposed purchaser of securities may not be made in good faith. It is neither proper nor necessary to impugn the motives of those who may engage in such

transactions, but I remember the words of Burns when he said:

"I'll no say men are villains a' ;
 The real, harden'd wicked,
 Wha hae nae check but human law,
 Are to a few restricked.
 But Och! mankind are unco weak,
 An' little to be trusted;
 If self the wavering balance shake,
 It's rarely right adjusted!"

In other words, that is human nature. All members of society have equal rights in the benefits derived from the use of public property, and public authority should see to it that such rights are fully protected.

It may be asked "Why, in the sale of securities by a public utility company, has the public any interest?" The answer is that the public pays the money that provides the income on such securities. That is the justification for regulating a public utility company if we are to have privately owned public utilities.

Proper regulation of a privately owned public utility prevents any unreasonable profit from being derived from the operation of such public utility.

If proper care is not exercised to secure for the public utility company the best terms possible in the sale of its securities, it receives less money for the securities

than would otherwise be the case. That means that more securities must be issued to secure a specified amount of capital for company and the public must pay more for service in order to provide the stipulated return or profit on the securities.

As already stated, where the sale of securities of a company engaged in private enterprise is proposed, the reasoning here presented does not apply. Let me repeat, however, that there should be competitive bidding where an issue of securities by a public utility company is proposed.

As Jeremiah Black, the distinguished Attorney General in the Buchanan Administration pointed out, railroads are public highways and are held in trust by private companies on that basis. So it is with the public property utilized by any public utility.

Chairman Frank: Thank you very much, sir.

Mr. Dearth.

STATEMENT OF MR. MICHAEL D. DEARTH (Continued)

Mr. Dearth: The point I was going to make, I say this is purely selfish on the part of the smaller dealer, and I would like to give what I would consider as an outstanding example of

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how the smaller dealer might suffer in competitive bidding.

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Back about seven years ago, six years ago, the State of Iowa had a great many county road bonds that were outstanding. There was a refunding operation that went on at that time in every county in the state, and there were sixty sales over the period of about 30 days, and in each instance there were several millions of bonds that were being refunded. The market on those bonds then was on about a \$4 basis, up until about a month before these sales took place. I personally had sold some bonds to an insurance company out there, about a week before these sales took place, on a \$3.75 basis. That was the peak of the market. That was everybody's ideal price then. They hoped that they would go at a rather high figure. A very large middle-western house, a very wealthy house, came in and they had their buyers out at these sales, they covered everyone of them. They bought the great majority of those bonds. We bought the first block, I think there were sixty thousand. We paid on a \$3.65 basis for them. We thought we had our necks out quite far. We felt we were jeopardizing our capital in going any further on this thing. The majority of the issues sold at down around the \$3.50 basis, or \$3.55. We sold what bonds we could of the bonds we bought, and had to bank the rest of them. We had them for about five or six months before we finally got rid of them. Fortunately we had this money market which was moving up, which finally permitted us to get out.

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I think our gross profit on this deal, for taking the risk we were not justified in taking, was something about 1/8th of a point. After we completed this, the house that bought a great majority of these bonds, of these issues, paid a very fancy price for them, banked them at the coupon rate for a good many months. The money market took care of them. They finally sold these bonds out, a good many months afterwards, at a very, very handsome profit.

Now we could not afford to do it. We could not buy in that market and compete against them on that price, because we could not take the risk. The smaller dealer was absolutely --- I will not say absolutely, but to a great extent eliminated from that picture because of this competition.

Commissioner Healy: What would you say to this? Would you say that the fellow who took those bonds and held them, eventually marketed them at a profit, came much closer to doing an old-fashioned piece of underwriting than you did? This idea of the investment banker going in and underwriting an issue and regarding it as a failure or disaster if he does not sell it right out quickly after it is opened is a rather modern concept of investment banking, is it not?

Mr. Dearth: No, sir, I think there is another point in that. In underwriting an issue, let us say the old conception of investment banking, it meant a sufficient profit in that deal to justify banking it for a period of time.

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Commissioner Healy: That is right.

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Mr. Dearth: In this case we were paying above the market for those bonds.

Commissioner Healy: The other house that you say had the capital and held them, they made a handsome profit, they got paid, did they not?

Mr. Dearth: They made a handsome profit, but they did not have the profit at the time they bought them.

Commissioner Healy: No.

Mr. Dearth: I would say it was very unsound business, personally, that they were taking a risk which was not justified, and they were gambling on the money market. They were smart enough to get it.

Chairman Frank: You mean they were gambling, because in most instances, in practically every instance we can think of, the underwriter hasn't sufficient capital to justify his taking such a risk. That is, he is not really an investor, he is a buyer and seller immediately of securities. That is the nature of our investment banking.

Mr. Dearth: A manufacturer who had a market for his product, say, at \$10 a unit, and it cost \$10 a unit to make it, would not make many articles at \$10 if \$10 was all he could sell it for. If he knew he could sell it for \$20, he would be justified in going ahead with his \$10 proposition. I cannot see why the investment banker should buy securities right at

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the peak of the market, when that is all he can get for them.

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Chairman Frank: He should not.

Mr. Dearth: In this case that is what happened.

Chairman Frank: I do not know whether the man intended to hold, or whether the investor held it, but if a man intends to sell immediately it seems to me very unlikely that many times they are going to buy at the top of the market, particularly where the results will lead to dissatisfied customer credit.

Mr. Dearth: I think that is true. In municipal securities, for instance, today you pay peak prices in a larger number of instances, and they will go out and sell what they can at that price, and they have an unsold balance in the account which they will dump at any price at all in order to get rid of it. The people that bought on their first sale got hooked, and the ones who sat back and took the last bonds, when they were trying to clear their position, got a good purchase.

Commissioner Healy: Is it not the fact of the matter that modern development of investment capital has been largely due to less and less of capital distribution? Do you know whether the underwriters turn the entire capital over 18-1/2 times a year today?

Mr. Dearth: No, sir, I do not. I do not know of any manufacturer who works on a narrower margin of profit than

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the investment banker does.

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Commissioner Healy: I think that is probably so. I wonder if it would have to be so if the investment banker was doing the kind of real underwriting that used to be done some years ago, and was done in England, according to my information, up until the outbreak of the war. That is, where a man was not in a panic if his securities were not sold immediately, where he could put them on his shelf, and where he really was the source of capital for the issuer instead of being just a mere distributor. I do not know how you feel about this. I wonder if you will agree that there is not much assurance on a \$50,000,000^{issue}/that the issuer will get his money if you base that assurance solely on the capital of the underwriter, which happens to be, say, \$5,000,000. The ability of the issuer to get his money under those conditions rests very largely on the ability of the underwriter to do a selling job, and not upon his financial responsibility. Is that not so?

Mr. Dearth: I would say it also depends on the underwriter's ability to bank the deal.

Commissioner Healy: To what?

Mr. Dearth: To bank the deal.

Commissioner Healy: Yes, but on the basis of his own capital he really gives very little assurance to the issuer. Now the assurance comes from his ability to bank the deal and

from his ability to do a good selling job in distributing the securities. In other words, is not what the investment banker, in essence, says to the issuer, "I will undertake to get the money for you?"

Mr. Dearth: No, sir. You make a dozen commitments, in a great many instances, for those bonds to be delivered at such and such a date.

Commissioner Healy: Of course that is the form of the contract. I mean looking down to the substance of the ability to perform, in the end it depends either on his ability to bank the deal or to do a selling job.

Mr. Dearth: That is correct, but if you are going to bank the deal, -- and this is the point I am trying to make -- he should have a sufficient margin of profit in it to justify his banking it. If you know it is going to take a long time to sell, if you have got a very narrow margin of profit by virtue of the fact that your markets move one way or the other, you have got to sell them just as quickly as you can in order to eliminate a certain amount of risk, regardless of what your capital is. In that latter case, I would say it would depend on the selling job. If you go back to the old theory where you are really banking it ---

Commissioner Healy: (Interposing) Do not understand that I criticize anybody for eliminating the risk. I would eliminate all the risk I could if I was an investor.

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Mr. Dearth: A margin generally is paid for what he delivers. If a banker is going to deliver a certain amount of money to a corporation, and he knows he is going to have to bank that over a period of time, as he did in times gone by, I think you are entitled, in that instance, to a larger margin of profit than you are where you try to buy it and sell it out immediately. In other words, I think in that case you are entitled to more money. Now I think this competitive bidding is going to eliminate your banking end of it to the extent where the transaction is going to be simply a selling job and the question of how quickly you can get rid of the bonds.

Chairman Frank: You still have not answered me. The very point that you would have a dissatisfied customer would make it very unlikely that you would go on for any long period to do that kind of a job. You take the municipals, where they go out to a bank, sell out as many as they can and then there are some left over, a wise buyer waits around and gets them at the low price. The unwise buyer, in the first instance, is likely to be very dissatisfied. I do not think a house that did that a great deal to his customers would have many customers.

Mr. Dearth: That is what we are afraid of. We are afraid that we would not have many customers.

Chairman Frank: Therefore they will not be guilty of that high price very long, because somebody is going to be dissatisfied at having taken the bonds at the high price.

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Mr. Dearth: In the meantime I would say the smaller dealer, to a large extent, as I say, if for four or five times he paid too high, the next time he will back away, he will bid lower, and the next time he will bid at a high price again. If you do that four or five times you haven't got the customer, and therefore you haven't got the small investment banker. He is going out of business.

Chairman Frank: If he is wise he would refuse to participate in the sale of the securities if they are too high. The result is there would not be any outlet for these over-priced securities. Somebody would have to hold them for a time.

Mr. Dearth: That may be so.

Chairman Frank: You were not here the other day. We said again and again, - I do not know if you agree with me, - certainly the SEC in its history has not been notorious for lack of regard for the small dealer.

Mr. Dearth: That is right.

Chairman Frank: We, consistent with our duties and obligations under the statute, under our several statutes, have always had the small dealer very much in mind, sometimes to the disgust of the larger one.

I would like to ask this question. In this resolution the statement is made that if there is competitive bidding there is likely to be an absence of relationship between the banker and the investor of such character that the investor would be

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adequately protected, the statement being made that in those circumstances, - I will quote it, - "the company is going to be the sole originator of the instrument which is offered to the public and, therefore, the company's interests will be given primary consideration and the interests of the ultimate purchaser will be secondary."

Let us consider that for a minute. The implications of that language are these: That with respect to utility issues, under the Public Utility Holding Company Act, - and that is all we are talking about - the past history has been, - and that is the necessary implication of your remark, - that in the negotiated issues the underwriters have seen to it that the investors are so adequately protected that this Commission had very little to do.

Now the truth of the matter is that this Commission has a great deal to do daily with respect to such issues, seeing to it that the investor is adequately protected, and more adequately protected, in many instance, than the underwriter has seen necessary to require. And again, often to the disgust of the underwriter, we impose additional restrictions, and on occasions verbal bricks are thrown at us for doing so and we are said to be usurping power and interfering with managerial judgment, and the like.

Our history has not been that the Commission can take the issues that come to it and because the investment banker has

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carefully negotiated the deal in the interest of the investor, that we can take the deal and allow the securities to be issued substantially as they have been negotiated. Quite the contrary. In the last month, particularly, we have had several cases where the issues have been brought here, and as the result of discussion with us the standards and requirements have been stepped up very substantially over those that had been exacted by the negotiating underwriter.

So I do not think you are justified in suggesting that merely because there is going to be competitive bidding that this Commission is going to transform its character and disregard the terms. We are still going to be here. The terms of the issue, the percent of the issue of bonds to capital structure, the net property value, the earning power, all of those things are going to be considered by us. The same standards are going to be applied. There will be no relaxation of our requirements in that regard.

I do not think it can be denied that our requirements have been, in every point you can think of, more exacting than those of the investment bankers.

As we said the other day, in the previous session in the public conference, up to the time of the existence of this Commission Congress passed the Trust Indenture Act. The indentures would by no means protect the investor with respect to the obligations of the corporate trustee. There were many

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negotiated issues where it took governmental action to bring about what Congress thought was adequate protection for the investor.

I do not know why, because you have got competitive bidding --- Let us assume in this field, that is all we are talking about, utility issues, under the Public Utility Holding Company Act of 1935, I do not know why you think there is going to be any relaxation. This Commission is not suggesting that there should be any rule of this kind with respect to any other kind of securities, has not any power, has not any notion of going to Congress to ask for it. The considerations that we think may justify such a rule, - we have not reached a decision yet - are more or less along the lines of those indicated by Congressman Crosser, namely, that it is a particular kind of company, it is a public utility, and that therefore considerations are applicable there. We think Congress felt that there were considerations applicable there that are not applicable to other securities. We have not the slightest bit of power as to other securities. Right here you have in this statute the power which we daily exercise, to protect the investor, and where we exercise that power in a manner that is far more protective to the investor than the investment banker has thought necessary, I do not see why competitive bidding should cause you any concern on this point.

I am addressing myself solely to this point, that in those

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circumstances "the company's interests will be given primary consideration and the interests of the ultimate purchaser will be secondary."

There are very few utility executives, I think, that will agree with you that that has been our attitude.

Mr. Dearth: Mr. Chairman, I am not in a position to elaborate on that point to a considerable extent. It was our idea, our thought that the banker gave some definite protection to the investor, because, after all, he was the one that was dealing with the investor rather than the company.

If I am not mistaken, I think this is right, that a certain issue in Massachusetts that went to competitive bidding here, - it has not been so long ago, - the bankers actually rewrote the indenture because it was so loosely drawn in the original instance before they would even bid on it.

Chairman Frank: Let us turn to that for a minute. If it was an issue on which we had no jurisdiction under the Public Utility Holding Company Act, and I assume from what you say it was such an issue, then maybe what you say is true.

Mr. Dearth: I say this is only hearsay on my part. It was a Massachusetts company.

Chairman Frank: I do not know what issue you are referring to, and I do not want to surmise, because I might be doing somebody an injury to suspect, but I cannot believe that it was an issue over which we had jurisdiction under the Utilities Act.

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Now we might have jurisdiction as to the trust instrument under the Trust Indenture Act, and I would be surprised if the issue that you refer to was put out subsequent to the enactment of that statute.

Mr. Dearth: I say it was merely hearsay on my part, but it came from a pretty good source.

Chairman Frank: You do not know when that issue was put up?

Mr. Dearth: Oh, recently.

Chairman Frank: Well, maybe somebody else could enlighten us on it.

Mr. Dearth: Within the last years. I think I have taken quite a bit of time here. I am not much on making speeches, and so on, but our point in this whole thing was the protection of our business, insofar as we could protect it, and also to protect the interests of the investor, of these selling groups, and so on, in which the small dealer gets his participation. That helps to pay his overhead today. Under competitive bidding, with your selling group situation, you might have groups bidding for these securities, so the smaller dealer would not get the small amount each month which helps to pay his rent. In turn, I think that would tend to create quite a hardship on a lot of these small dealers who would have that source of revenue eliminated. As I say, that small dealer, while his finances may be limited, he may not have the capital to go

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into the banking group, and so on, but in his particular community he is a definite source of value to that community in maintaining markets in small issues, which enables the investor to keep his funds liquid and realizing on them when he has to, and at the same time providing money for a small local industry.

It is our opinion, after considering all the angles of this, that it would not certainly be to the benefit of the small dealer to have this competitive bidding, and from our limited experience over a period of years in the pricing of these securities, and so on, we think that a certain number of your investors are bound to be hurt over a period of time.

Mr. Spencer: May I ask the witness a question bearing on the narrow point of the dissatisfied customer, in the fact that because of competitive bidding he is forced to pay too high a price? The question arises in my mind as to what customer you are talking about. If you are talking about the initial customer and you are selling him a security that is in the market, it immediately rises in price on the market and the secondary customer pays that price. Is that the matter you are concerned about, that we only want the initial customer to make the profit and not the last one? Consequently is it not a fact that the investment banking business, particularly as conducted by the small dealer, is very largely made up over the counter, and is not that a very highly competitive undertaking, where

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every day you bid against other dealers to get securities and sell to your customers at the highest price you can exact for that particular security?

Mr. Dearth: No. I would say, as far as the over-the-counter trading is concerned, that is probably the largest source of revenue for the smaller dealer, your day-to-day trade, but he is not selling that security, I do not think, at the highest possible price he can exact from that customer, he is selling it to him, he hopes, and if he is going to remain in business, he is going to sell at prices according to the offerings at the market.

Mr. Spencer: In the market?

Mr. Dearth: Yes.

Mr. Spencer: If he attempts to sell to his customer at too low a price he cannot buy it at a price to make a profit to himself, whereas some other fellow who can appreciate it more accurately than he does will bid the market price.

Mr. Dearth: You always have bid and ask in any open market. You have got it on the Exchange.

Mr. Spencer: I grant that in the open account you can exact a higher margin of profit. I am simply talking about the price that your customer pays for it. He would have to pay approximately the market, otherwise he will not have the bond himself.

Mr. Dearth: I would say that the customer who buys the bonds

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at the market price is making a good buy, but what I am maintaining in this discussion, in this competitive bidding you are getting into a price that is above the market, and the customer is going to buy the bonds at a price over and above the market.

Chairman Frank: Is there anything further?

Mr. Dearth: No, I have nothing further. Thank you.

STATEMENT OF J. K. STARKWEATHER,

representing Starkweather & Company.

Mr. Starkweather: This subject that Mr. Dearth has been talking about is one that interests me very much, because I am in very much the same position that he is. I would like to say this: It is not a matter of high price, or too high prices that worry me primarily. I think there will be a tendency towards higher prices than are fully justified in a large part of the time. Certainly whenever the market is good and advancing I think there will be a strong tendency towards a higher price. However, that is not what worries me as a small dealer, and I think what worries most of the small dealers.

What really worries me is this: When you tackle the proposition of competitive bidding you have a strong tendency on the part of competing groups to narrow the spreads on which they are willing to work. The reason for that is quite obvious. The utility business, the utility security market is a fairly well established market. There is not a great

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difference in price. Ordinarily, in nine cases out of ten, in the views of different bond men, for instance, as to what a utility bond of a certain type is worth, there may be always a difference, let us say, of $1/2$ or $3/4$ of one percent. Nobody's views always coincide with everybody else, but the difference is not so great. If you say the normal level for a certain bond is 103, the question is what you will pay for it.

Under the negotiated system the spread today ranges from about $1-1/2$ to 2 percent. The tendency, we fear, will be for the different groups to pay, - the price being 103, we think that somebody else will bid a point and one half off, and we will just cover it by a quarter or we will cover it by a half of one percent.

Now when there is a narrow spread, what happens to it? In the first place, the winning syndicate has no obligation except to get out at a profit as fast as it can. The winning syndicate has no obligation to the dealers throughout the country. They are working presumably, as I think they would in most cases, on a narrow margin, where they can't afford to bank it as an investment business. They have to treat it as a merchandising operation. If they are working on a $1-1/4$ or $1-1/2$ of 1 percent basis, there is not a chance to take the risk. They will make any arrangement they can with the other dealer. We see it in the municipals all the time. The municipal spreads are small. You will find working on those spreads the

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groups which buy and keep most of the bonds themselves, and allow the dealer in the country to make 1/8th or 1/4th. If the dealer can sell it, all right, he can make out, but the bulk of the bonds are sold by the groups themselves.

There is no doubt in my mind at all that in competitive bidding on utility securities you would arrive at the same thing you have in municipals. You would have relatively small groups. Instead of having 50, 60 or 75 people in the groups I think you would be much more apt to have 20 or 30 at the outside. The people working on the narrower margins are going to have all the bonds themselves, in order to keep up the margin of all of the profit.

Take Morgan Stanley, for instance, who do no selling to the public. Their bonds come out through dealers like myself and Mr. Dearth. The business that they handle, and other underwriting houses of the type mentioned in this report, accounts for a very substantial part of my profit, and probably Mr. Dearth's profit.

I do not think there is any question in my mind as to what I would do if I were bidding on a narrow margin, if I were in Morgan Stanley's position. I would get in touch with the principal institutional buyers and sell every bond I could at the full list price, and if there were any left I would then offer them to the dealers throughout the country. I think in a case where their interest is around \$10,000,000

and they sell them to all dealers, I think we would be lucky to get one or two or three million dollars. You might say that that makes no difference to the public, and in theory it does not, but the point of view that I have, and I think the rest of the smaller dealers, is this, that we do perform a service, we perform a service which is recognized in the whole series of securities acts. We do furnish, in the communities we serve, a middle man between the issuer and the investor. We serve the investor in his current financial operations, in his trading operations, in buying and selling outstanding securities. If you do anything to upset the profits of the smaller dealers throughout the country I think you do a great deal to hurt, to harm the machinery on which the general investing public relies for its ability to buy and sell.

The average man has to go to his security dealer to buy or sell a security. He cannot find the customer himself, he has to operate through us. We have to make a certain amount of profit from day to day in the over-the-counter business, but we always count very substantially on the profit we make through these national syndicates.

The attitude of the staff in this matter I think is wrong in that they think that this would tend to distribute business more widely. I may be entirely wrong. I have read their argument with great interest, and I think it is a real contribution to this whole subject. I think they are wrong. I think

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this whole proposition would tend to concentrate underwriting in the hands of a few people.

I do not say that it would change the present methods. I do not say, in the case of Morgan Stanley, or Dillon Read & Company, I do not know that they would say definitely that they would get a certain issue. I do not believe there would be a single issue today of \$6,000,000 or more that one of those six firms was not in. I do say you would have a greater concentration in the hands of those firms than you have today, although no one would know at any one time which particular issue he would have. The reason for that is perfectly simple. There are but a few firms in this country who are capable of setting up and banking a large piece of business. I am not capable of doing it, and I doubt if Mr. Dearth is capable of doing it. There are not more than six or eight that can do it. The business is going to be handled by the six or eight, no matter what you do, in this rule. You are going to have a complete concentration, although, I will say, there may be some doubt as to which house may get a certain issue.

Commissioner Pike: That is why the six or eight are in here objecting to the rule. We have not had any in here, except one or two, that were for it.

Mr. Starkweather: I will say, Mr. Pike, just as an outside observer who is not a big underwriter, I do not believe there is any question but that most of those houses would be better off

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under your rule.

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Chairman Frank: Under what?

Mr. Starkweather: Under your rule.

Chairman Frank: Why do they object to it then?

Mr. Starkweather: I do not think they would be any worse off. The only person who has appeared in this room, who would be substantially benefited, I believe would be Mr. Stuart's firm. I think he would be then included in a lot of underwriting which he does not have now. I do not believe there is anybody else who has got the capital or the organization to do it. He has got it. He has got both capital and organization. I have been with him in various issues, I like the way they handle the business. So he is the only man in the country who is going to be benefited.

Commissioner Pike: Much as we think of Mr. Stuart, we are not trying to make a rule for his benefit. (Laughter)

Mr. Starkweather: I think that is about the way it sells out. I think all you do is make it a little more uncertain as to which house is going to have which business, but from the standpoint of the smaller dealer machinery, if that is of any value, you gentlemen have got to decide how much value that is. If you think that is of any value, I say that this rule would be a very serious thing for the small dealer machinery. I know it would in my case. I have seen it work in New England.

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Commissioner Eicher: You have just said the syndicating would work about the same as under present conditions. Why would there be any difference in ultimate distribution?

Mr. Starkweather: Because your spread would be narrow, and then these houses would sell among themselves instead of through me.

Chairman Frank: Is not this the implication, that today those houses are passing up a source of profit and giving it to the smaller dealer, but if the spread gets narrower they will absorb the profit themselves?

Mr. Starkweather: They are making a good profit today on their operations through their management features, and plus their underwriting profits. If you cut your spread there is not the room for them and they have got to make that up through selling it themselves, in my opinion.

Chairman Frank: But they could make more money, - if you are correct, they could make more money today under the existing system by selling themselves, and they are just giving up that profit out of, oh, generosity?

Mr. Starkweather: In a great many cases I think that is true. There is not any question in my mind that Morgan & Company, on a great many of the issues they have held, could have sold themselves. I have no doubts at all about it. I do not know why they gave it up. Perhaps you can guess.

Chairman Frank: I haven't the remotest idea.

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Mr. Starkweather: But there is a perfectly simple reason for it. All their issues do not act that way, and they want the dealer distribution, but if they are working on a narrow spread I think they will take all the profit they can on every issue they can. That is my view of it.

Chairman Frank: Mr. Love will be heard now.

STATEMENT OF EDWARD L. LOVE,

vice president of the Chase National Bank, New York City.

Mr. Love: Mr. Chairman, and Commissioners:

First I wish to state that I am appearing here today only as a representative of the Chase National Bank of the City of New York, and the things which I am about to say are to be considered as views put forward only on behalf of that institution. I have discussed the subject at hand with representatives of various other commercial banks, both in New York City and elsewhere, but I do not purport to act here today as their spokesman or as the representative of any of them in any capacity whatsoever.

In the second place, I wish to make it clear that I have not come here prepared to discuss at length, or to present a considered judgment as to, the merits or demerits of the recommendations of the staff of the Public Utility Division of the Commission as set forth in the report entitled "The Problem of Maintaining Arms-Length Bargaining and Competitive Conditions in the Sale and Distribution of Securities of Registered Public

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Utility Holding Companies and their Subsidiaries." I may say that, because of my general interest in the public utility industry, I have read this report, and I have also read the document addressed by the Investment Bankers Association to the Commission, which is entitled "An Examination of the Proposal of the S.E.C. Staff for Compulsory Competitive Bidding in the Sale of Public Utility Securities." However, as the institution which I represent is not engaged in the sale and distribution of public utility securities, I did not charge myself with the task of making a careful study of this highly controversial subject.

The staff report was not sent to us directly and my attention was first called to it by one of my associates. As far as I know, it was not distributed to the commercial banks of the country, the reason being, I assume, that it was not intended to affect them, as the report in fact is entirely devoted to a study of the sale and distribution of public utility securities by investment bankers, and the whole approach to the study springs from the administrative difficulties encountered by the Commission in passing upon the reasonableness of prices and spreads. The staff report contains not even a reference to the part played by commercial banks in financing utilities.

When the report was first brought to my attention, I noted that unsecured bank loans up to a term of ten years were exempted from the proposed recommendation requiring sealed bids,

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and the only direct concern which I had over the proposed rule, was the fact that the exemption did not extend to secured loans. Feeling that there was no reason for a distinction between secured and unsecured loans, I asked the Director of the Public Utility Division about this one feature of the proposed rule and suggested that the word "unsecured" should be deleted from the exception. After receiving this assurance, I felt that, so far as the Chase was concerned, there was nothing further for us to do. While we felt that all bank loans, regardless of term, should be excluded from the operation of the rule, as a practical matter the exemption granted, after the deletion of the word "unsecured", would permit us to continue to handle bank credits to holding companies and utility companies in the same way before.

This was the situation until Monday of last week, when I was informed, to my surprise, that criticisms had come from various sources of the exemption of commercial bank loans and that there was a possibility of reconsideration of the exemption and that the exemption might be confined to loans of considerably less than ten years. I then communicated with the director of the Public Utility Division, requesting that I and representatives of other banks be advised of the reasons for the change and be given an opportunity on adequate notice to be heard on this matter before any modification were made in the proposed exemption other than the deletion of the word "unsecured". A few days later, I

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received a telegram from the Director that I would have an opportunity to be heard today. So far as I know, no similar invitation has been sent to any other bank.

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I find myself today attempting to discharge a double difficult task. In the first place, the time available has not been sufficient for me to make the sort of a study and presentation of the matter I should have liked. As far as I know, there has never been any attempt to require competitive bidding on bank loans in any State in this country. There seems to be no prior experience to go by. The Report of the Staff frequently refers to the practice in Massachusetts and New Hampshire of requiring competitive bidding in connection with the issuance of utility bond, but, as far as I am able to ascertain, those States have never undertaken to apply the rule of competitive bidding to the negotiation of bank loans, irrespective of the term of the loan.

My purpose in coming here today is to set forth the reasons why I believe that a commercial bank loan, whether it have a maturity of 90 days, one year, five years or ten years, is entirely different from a security issue. The fundamental reason is that every bank loan is a special tailor-made job to fit a special problem. It remains such a job throughout its life. The essence of any bank loan is flexibility in its creation and in its administration throughout the life of the loan.

Public bidding requires specifications, standardization and rigidity. Any such standardization would destroy the essential qualities of commercial banking.

I think the most I can do is to try to give you as clear a picture as I can, without going too much into detail, of the function performed by a commercial bank in extending term credit to public utility companies, and to show how difficult, in fact impossible, it would be for us to continue this type of financing under a requirement for competitive bidding through the device of sealed bids. Frankly, I simply cannot see how we could furnish this type of service if we were required to adopt the competitive bidding method.

Now here I want to make it clear that I am talking about bank loans and not the purchase of a block of securities that can be resold to investors. It is the kind of a loan that the bank takes to keep, like every other loan it makes.

The Chase National Bank has for many years extended banking credit to public utility companies, including not only its banking customers but many other companies who wish to avail themselves of our banking facilities irrespective of whether or not they had been depositors. This banking service included not only the actual making of loans, but in many cases has taken the form of a firm commitment to make a loan the utility may avail itself of at its own option. For example, a utility company may have on hand a refunding operation, but negotiations with investment bankers for the sale of the refunding issue have not proceeded to the point where the utility has a firm commitment from the investment bankers which will

assure the company that the proceeds of the refunding issue will be available on or before the date selected for the redemption of the outstanding issue. In such a case we provide this assurance by actually making a loan or making a firm commitment to make a loan in an amount equal to what is needed for redemption.

Beginning about five years ago, we began to make medium term loans, and by that I mean bank loans of a maturity of more than three years. Since 1935, as you are undoubtedly aware from the declarations that have been filed with you, this bank has made many utility loans of terms longer than three years and now we have on our books a number of loans with a final maturity of ten years. Some of these loans are secured, and others unsecured. At this point I should like to emphasize that we are making bank loans in the truest sense. We are not purchasing securities. We loan the utility company money, and the utility company gives us its promissory note for exactly the amount loaned, just like any other bank borrower, and the utility makes agreement with us containing various restrictions. There is no question of price or spread to be considered and we do not purchase securities which can be sold to the investing public. In most of our term loans we require that the indebtedness be heavily amortized during the life of the loan. The amount of this amortization is always a matter of negotiation and is dependent upon a careful

study and forecast of the borrower's cash resources available for this purpose during the prospective life of the loan. This involves, among other things, an estimate and forecast of the company's construction requirements during the same period. There are matters which cannot be determined simply by analyzing the borrower's balance sheets and earnings statement, but require extended consultation with the financial and operating officers of the borrower and frequently call for inspection of the borrower's properties by our own engineering staff.

The determination of the amount we will loan and the restrictions which we decide to impose are all matters which require a careful study of the borrowing company's affairs, its properties, its past and prospective earnings, and above all, extended negotiations with the borrowing company, lasting sometimes over a period of months, and as often as not with investment bankers. The only way I know of in which a satisfactory loan of this type can be set up is to sit down with the interested parties and to discuss every detail of the particular piece of financing at length. The form and terms of the restrictions depend upon each particular situation.

In case after case, the idea of the borrowing company as to what they would like to borrow and the term of the loan and our idea as to what we are willing to lend are, to say the

least, not the same. In the light of my experience, the probability is that if a company were to undertake, without any consultation with us, to formulate a plan involving a bank credit and ask for competitive bids in terms of interest rate, the probabilities are that, so far as we are concerned, the plan would not be in accordance with our views and we would not want to submit a bid at any interest rate, and the most we could do would be to submit a counter offer.

The public utility bank loans which CNB has made have originated in a variety of ways. In a number of cases, the bank loan has been an integral part of a piece of financing involving the public sale and distribution of senior securities, and in many cases it has been the bank loan which has made the public financing possible. Frequently the borrowing corporation knows that a certain piece of financing can not be handled in its entirety by sale of securities to the investing public, and for this reason the borrowing corporation has approached the bank and carried on extensive discussions and negotiations with regard to the feasibility and size of the projected bank loan, and then we have been willing long before there was any firm commitment from investment bankers, and sometimes even before a registration statement was filed, to make a firm commitment to loan a definite sum of money at an agreed rate, so that we were firmly bound for a long period in the future, sometimes as long as 60 days, to

furnish junior money in the form of a term bank loan, subject to the condition that the corporation be able at or before the expiration of this period to proceed with its senior financing on stipulated terms and subject, of course, to the approval of the S.E.C. and other regulatory bodies having jurisdiction. In other words, we give the borrowing company an assurance that it will be able to get a loan from us if it carries out its public financing on a satisfactory basis, and I want to say here again that I simply cannot visualize making this type of commitment if we had to go about it on a sealed bid basis. When we make this type of commitment, naturally we are vitally interested in various elements involved in the senior financing and we stipulate, as conditions precedent to our commitment, certain terms of the senior financing. We are keenly interested in the type of mortgage that will be used in the senior financing and for our own protection we frequently insist on the inclusion of various provisions in the mortgage. These are things that require detailed discussion and negotiation.

While, as I have already said once, I did not come here to engage in a discussion of the proposal of the Staff to require competitive bidding for securities sold through investment bankers and am not prepared to discuss the pros and cons of that particular problem, there is one portion of the Investment Bankers Association document which I should like to

comment upon. It is section 12 in which it is stated that the proposed exemption of commercial bank loans from the requirements of competitive bidding will give to banks a special advantage in the purchase of issues maturing within ten years. If this is taken literally, I should like to say that so far as we are concerned, the bank loans which we make do not constitute a purchase of securities in the ordinary use of that term.

If, on the other hand, the suggestion is that the requirement of competitive bidding for the sale of securities will cause the issuing companies to refrain from selling securities to investment bankers and instead arrange financing by means of bank loans, I do not think this fear is well founded. I think that the issuing companies will continue as in the past to do public financing through the investment bankers when corporate management considers that such financing is best adapted to the company's needs. I believe that the best interests of the corporation will always be a paramount consideration in the determination of the type of financing. When public financing is best for the corporation, there will be public financing and resort will be had to bank loans only when the management is convinced that this is best for the corporation. As in the past, the great bulk of utility financing will be done through the sale of securities to the public. As in the past, I think resort will be had to bank

credit only when corporate management believes that this type of financing is advantageous to the borrower. That there may be advantages in bank loan financing, I think everyone will concede. For one thing, a particular company may have a financial set-up which causes the management and the investment banker to feel grave doubts as to the marketability of securities. At the same time we would consider that the loan was money good, as a banking matter, and we were justified in making such a loan if we could work out with the company appropriate restrictions and satisfactory amortization payments, and, of course, such a loan would be tested not only by our judgment as bankers, but it would have to be reviewed by the Commission as a part of its administrative functions under Section 7 of the Public Utility Holding Company Act. For another thing, a bank loan offers to the borrowing company a flexibility which is not available in a public issue under a trust indenture except by the cumbersome and expensive procedure of a bondholders vote. Frequently we have been asked by a borrower to consent to a modification of restrictions previously written into a loan contract. In such a case, if we are willing to consent to such a modification, we can do it by simply signing a short paper. We have eight cases of loans now on our books where, to facilitate the accomplishment of some proper purpose precluded by restrictions in our loan agreement, we have consented to a relinquishment of

these restrictions without, as we feel, in any way jeopardizing the soundness of our loan.

Term loans of the type described above offer the utility industry a vehicle of convenience which is of value not only to the company but to its consumers and investors, the reason for this being obvious. Substantial sums are saved in interest charges as a result of a refunding operation, not only as to the interest savings on the amount of the term loan but also to a far greater extent on the amount of senior securities sold to the public which, in most cases, are several times larger than the loan.

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Mr. Weiner: Before you sit down, Mr. Love, I wonder if you care to comment on the suggestion of, I think Mr. Ecker, of the Metropolitan Life, that the restrictions to commercial banks should be eliminated, so as to enable the insurance companies to enter into the same field?

Mr. Love: Well, as I have already stated, I have confined my study solely to the problems of the Commercial Bank, and frankly, I don't feel qualified to discuss that particular question. I have only had three days to really prepare for this hearing, and I am not familiar with the suggestion, I didn't know before that he had made such a suggestion.

Commissioner Pike: While you represent only the Chase, Mr. Love, do you have any opinion as to whether that would be the general view of other bank lending officers around New York?

Mr. Love: I am glad you raised that, because just before I came into the room I received a telegram which, if I may, I would like to read. This telegram reads:

"HAVE JUST SENT FOLLOWING WIRE TO JOSEPH L. WEINER DIRECTOR PUBLIC UTILITIES DIVISION SECURITIES AND EXCHANGE COMMISSION WASHINGTON DC QUOTE WITH REFERENCE TO THE PROPOSED RULE REQUIRING COMPETITIVE BIDDING BY UTILITY HOLDING COMPANIES AND THEIR SUBSIDIARIES WE ARE INFORMED THAT IN EXCEPTION A-2 RELATING TO UTILITY BORROWINGS FROM COMMERCIAL BANKS IT IS NOW PROPOSED TO LIMIT THE MATURITY OF NOTES OR BONDS WHICH MAY BE TAKEN BY

A J-2

COMMERCIAL BANKS WITHOUT COMPETITIVE BIDDING TO NOT OVER THREE YEARS STOP THE EXPERIENCE OF THE UNDERSIGNED BANKS IN TAKING CARE OF THE REQUIREMENTS OF UTILITY COMPANIES ON LOANS IS THAT A THREE YEAR LIMIT IS MUCH TOO SHORT TO MEET THE PROPER NORMAL REQUIREMENTS OF A BORROWING UTILITY STOP SUCH REQUIREMENTS GENERALLY MAKE DESIRABLE SERIAL PAYMENTS OVER A PERIOD LONGER THAN THREE YEARS AND IF BANKS ARE TO BE ABLE TO MEET THE LEGITIMATE BORROWING DEMANDS OF THEIR UTILITY CUSTOMERS A MUCH LONGER LIMIT IS NECESSARY STOP WE SUGGEST THAT IN THE EXCEPTION THE TEN YEAR LIMIT FORMERLY PROPOSED BE RETAINED STOP WE ALSO SUGGEST THAT THE WORD "UNSECURED" BE ELIMINATED FROM THE EXCEPTION AS MANY UTILITY CREDITS ARE ARRANGED ON A SECURED BASIS AND WE FEEL THE EXCEPTION SHOULD APPLY BOTH TO THE SECURED AND THE UNSECURED CREDITS

THE FIRST NATIONAL BANK OF CHICAGO BY E. E. BROWN PRESIDENT; AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO BY LAWRENCE F. STERN PRESIDENT; CITY NATIONAL BANK AND TRUST COMPANY OF CHICAGO BY PHILIP R CLARKE PRESIDENT; CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY BY JAMES R. LEAVELL PRESIDENT; HARRIS TRUST AND SAVINGS BANK BY HOWARD W. FENTON PRESIDENT; THE NORTHERN TRUST COMPANY BY SOLOMON A SMITH PRESIDENT

UNQUOTE"

Mr. Caldwell (Chemical National Bank): I just wish to add, to what has already ^{been} said by Mr. Love, that the views

as expressed by him likewise express exactly the views held by my own institution.

Mr. Awalt (National City Bank of New York): I have been authorized to say that the National City Bank of New York concurs in what Mr. Love has to say.

Chairman Frank: Does Mr. Quail care to be heard?

Mr. Quail: Yes.

STATEMENT OF JOHN J. QUAIL

Quail & Co., Davenport, Iowa.

Mr. Quail: I am identified with an investment banking firm which should be characterized as a small firm, located in Davenport, Iowa.

I have read the report of the Public Utilities Division of the Securities and Exchange Commission, and I think that it is a very well-drawn brief. I do not agree, however, that it makes a case for competitive bidding, at least in my opinion it would seem so, and I feel that the opinion of one who has been in the business for 20 years and has read the brief or the report, is entitled to express his opinion, and I express my opinion as opposed to competitive bidding.

In general, I don't think that there is any proof so far adduced that there is a crying need for the change, or the institution of the rule, or that there has been any scandalous happening under the present method of handling the situation.

Specifically, I think it would hurt small dealers very

much. For instance, at the present time and under the present way of handling public utility issues, our firm receives a selling group offering on nearly all public utility issues that are large enough to permit of a general selling group.

Under the proposal, it occurs to me that it would very likely be that the larger firms, the underwriters, would be split up into four or five groups, maybe two or three groups, in order to bid, and that having split those groups, they would reach further down the line and take into their bidding group smaller dealers, perhaps, who have been only in the selling group up to now; and that one of those three or four or five or six groups would win the bonds. The rest of us, if we were not in that particular group, would lose the offering of that particular security in all probability, or get it on a profit basis that would be very much reduced.

Now with the distribution as it is now handled, it seems to me that you have practically all the distributive force of the industry applicable in so far as the underwriter deems it necessary, to sell those securities. If it is handled as proposed, under competitive bidding, I fear that some of the dealers, probably most of them, will lose some of the strength back of the industry's ability to distribute.

Therefore, I think that I would like to leave, as our opinion, that the rule would take away some of our already inadequate profits through eliminating some of the securities

2 that our particular firm would have to sell.

That is about all I have to say.

Chairman Frank: Thank you very much.

Does Mr. Moss care to be heard?

Mr. Moss: Yes.

STATEMENT OF JAMES W. MOSS

Preston, Moss & Co., Boston, Massachusetts.

Mr. Moss: Gentlemen:

In submitting this statement I wish to say that no one has assisted in its preparation or read it except my own partners. I present to you for your consideration some of the more important reasons why, in our judgment, competitive bidding for public utility securities should not be made compulsory.

The participation as a selling group member in underwritings is of necessity a relatively small, but none-the-less important, part of my firm's business. We reserve at all times the right to be completely independent in our judgment of new issues and are of the opinion that hundreds of local dealers throughout the country acting in a similar capacity is healthy for the business and affords investors a real protection. If competitive bidding for public utility securities is made mandatory, we believe this part of our business would be reduced to the vanishing point. I think it might well cause us, for example, to discontinue our business in the State of New Hampshire where we have had an able representative

for the past eight years.

At present we, as a small local dealer, receive our allotment of bonds from the underwriters. We can then accept or reject this liability, and if we accept, have the protection of a dealers' concession of, let us say, three-quarters of a point. This liability is usually not sufficiently serious to impair our financial standing or force us to borrow. However, under competitive bidding we would be unable to purchase bonds except, if the experience of the last few years is true, at a small re-allowance. The other alternative would be for us to join syndicates, which would mean that we would probably have to establish a liability of 100,000 bonds or more, borrowing at the bank in many cases in order to carry. This would certainly tend to weaken the financial stability of the multitude of small dealers throughout the country.

It is stated in the Public Utilities Division Staff report, and I quote - "The main case for competitive bidding rests on the element of concentration in and the non-competitive aspects of the security underwriting business." I believe that a different interpretation of the statistics proves that such is not the case, but even though a substantial amount of underwriting is handled by relatively few houses as managers of the syndicate, I see no harm per se in such a condition. If, by virtue of a long and successful record, the possession of ample capital and other qualifications, a comparatively few

houses act as syndicate managers for a substantial amount of new utility issues, I cannot see why this is harmful unless someone suffers as a result. If it could be proved that through the private negotiation of financing with these houses the utility companies or investors are being harmed, then a change in the present system should be made. Actually, in view of the complete and valuable publicity to which the details of all new issues are submitted as a result of the rulings of your Commission, to assume that utility companies are not getting a fair price under present conditions is to assume collusion or stupidity on the part of management, and we have seen no evidence of either.

Because I believe that competitive conditions tempered by responsibility now exist, it appears to me that over the long run the imposition of unrestrained competition would merely accentuate cyclical swings. I think it would cause utility companies to get higher prices, investors to pay more, and underwriting spreads to narrow under conditions like the present. Similarly, I would expect in difficult times to find companies getting less than they otherwise would, to have underwriting spreads widened unduly, and to have investors offered bonds at lower prices than would otherwise prevail. I think that the removal of the element of continuing responsibility would tend to increase high-pressure selling at times and that the burden of this, as usual, would fall upon

the small investor.

And, finally, I would like to say a word about the human equation or personal relationship which is an important part, and one of the pleasant parts of our business life. Such relationships extending over a long period of years between investment banking houses of high character and integrity and corporations whose securities they have handled certainly must have great value. By competitive bidding issuers would be forced to sell their securities to the highest bidder regardless of whether the issuer wished to do business with that group or not. Business ethics, standards and ability differ between investment houses in our business just the same as in any other. Some houses are inclined to be more akin to what may be described as the "hit and run" type of sponsorship, while other houses deeply feel a continuing responsibility for the securities which they sell. Such sponsorship may almost be considered as a part of the quality of the security itself. It is possible now for a dealer to confine his participations to those houses whose past record and standards are such as to cause confidence in them. This we believe to be an added source of protection to the investor, be he individual, trustee or institution, whose interest it is one of the important duties of your Commission to safeguard. A most important function of the investment banker, to my mind, is the negotiation of a new issue of securities at a price that

is fair to the issuing company, fair to the investing public, and at a spread that allows a reasonable profit to the underwriters and selling group commission to dealers. In my opinion, this could not be as successfully done under compulsory competitive bidding.

Chairman Frank: May I ask a question?

Recognizing that there may well be differences between different investment bankers, do you think you can make the unqualified statement that the leading investment bankers of the country have sponsored all the securities they have issued, regardless of the adversities of the market or the character of the management of the companies whose securities they have issued, which have led to unfortunate consequences to investors?

Mr. Moss: Do you mean by that, Mr. Chairman, the market of securities over a period of years, that they have always protected the market?

Chairman Frank: Yes.

Mr. Moss: No, I don't mean that as much as I do in following it from the standpoint of information. You call up some houses and they always have all of the information. They can't be expected, of course, to protect the market in a decline, or anything like that, or if some unfortunate circumstance happens to the company's affairs.

Chairman Frank: You spoke of the highest bidder as inevitably getting the deal. As I recall the Staff's proposal,

it did not so provide, and an issue might come to the Commission under the rule - am I correct, Mr. Weiner?

Mr. Weiner: Yes.

Chairman Frank: (Continuing) -- and indicate that there were circumstances making it not desirable in the public interest that the highest bidder should get them.

Mr. Moss: Wouldn't that be apt to be the exception, in your opinion, rather than the rule?

Chairman Frank: I assume it would, but if the issuer felt there were circumstances affecting the character of the proposed underwriter, that the issuer thought would be injurious to them, I am sure the Commission would --

Mr. Moss: (Interposing) That would be probably a matter of opinion between the issuing companies, whether it was their wish to do business, and one which you probably couldn't pass judgment on.

Chairman Frank: On the basis of whim, yes.

Now you spoke of the swings or cyclical swings. I would like to ask - I am asking for information, for I do not know - whether those characteristics which you anticipate would be attendant upon competitive bidding for utility securities, have been found in the case of equipment trusts? Has there been this cyclical character so that when the market was good, the prices were too high; and when the market was bad, the prices were too low, and the company suffered?

Mr. Moss: I don't know, I can't answer that as regards equipment trusts. One of my partners, who does largely a municipal business, tells me that that has been true in his experience in municipals.

Chairman Frank: Well, it is obviously as true of municipals as it is of anything else that, when the market goes down, the security goes down, and we know that in the depths of the depression all the municipalities were in very bad shape, and it was very difficult to sell their securities at any price.

Mr. Moss: Well, I mean largely as regards to higher grade bonds; where you get a trend of very easy money conditions, which we have had, your market is going up, and I assume the same would hold true of equipments and municipals, when they are of the highest caliber.

Chairman Frank: You spoke of your apprehension that competitive bidding would lead to a narrowing of profits with the consequence that investment bankers that originated the deal would be narrowing the spread available to the smaller houses, smaller dealers. The implication of that comment must be this, that today they are giving up a source of profit which they could retain if they wished.

Now one could assume that they are doing so for one of two reasons: generosity - and that is unlikely, and it isn't cynical at all to comment that that is unlikely, because the

nature of business is such that you don't give away money in your business, you give it away after you have made it.

And the other impulse must be, if it exists, if it be true that they are now giving up a source of profit, that they think there is a desirable mechanism that should be maintained.

Well, we will assume that they still would think so, and let us recall that we are talking solely of the utility securities now, and that there is still a large field of enterprise for those same investment bankers, where they would need to use the mechanism of the small dealer.

So it would seem that the implication in your remark is that the margin of profit will shrink so greatly that they can't afford to maintain the small dealer.

Now that, in turn, implies a knowledge on your part of what their present profits are.

Mr. Moss: You mean the profits of the houses?

Chairman Frank: Yes, of the large houses.

Mr. Moss: Or the profit on any individual deal?

Chairman Frank: No, I mean what they are making on their capital today. You don't know, do you?

Mr. Moss: No, I don't. I have been told directly and indirectly by some. None of them, I assume, have made very much money.

Chairman Frank: But we don't know?

Mr. Moss: No.

Chairman Frank: They haven't put it of record, then?

3 Mr. Moss: No.

Chairman Frank: If they have been making very lean profits, then it might be that they would be compelled against their own best judgment to take a course of eliminating the small dealer because of the necessity of themselves remaining in business, but if their profits have been generous, that would seem to be a foolhardy course. Now we just don't know what their profits are, do we?

Mr. Moss: No.

Chairman Frank: So your apprehensions are based in large measure upon one huge element of conjecture, as to the rate of return on their capital?

Mr. Moss: Yes.

Chairman Frank: That isn't of record at all, is it?

Mr. Moss: No, but in the few competitive issues of utilities that I can recall, unless they change your re-allowance will be only a commission, a take-down, "first come, first served", the way municipal accounts are run, rather than allotting geographically to dealers throughout the country, which I think is a good thing.

I think you would be more apt to get concentrated distribution, whether through dealers or largely through the houses, as I believe it would be, in the accounts.

Chairman Frank: Now if the issuer, as has been indicated

in earlier hearings, thought it desirable to get that kind of distribution, the issuer could specify, in letting his bid, that there should be such distribution, could he not?

Mr. Moss: Well, I think --

Chairman Frank: (Interposing) It might reduce the price that would be bid?

Mr. Moss: I think that would be so. I think that would be a good thing, as a matter of fact.

Chairman Frank: But there is nothing in our proposed rule that would preclude that, so that if the issuer felt it desirable to pay a little more to get that kind of distribution, which is what you say the issuer is doing today, he can perpetuate that institutional device by specifying in his offer that there should be such distribution.

Mr. Stanley (Morgan, Stanley & Co.): Mr. Chairman, if I may interrupt. Without having to repeat what I said on the same subject last week, I think the same suggestion that you have just made, you made to me last week. I don't think it is practical.

The small dealers are not acting through generosity, and it isn't a matter of the profits of the issuing houses, either. But taking each deal by itself, there wouldn't be enough, in my opinion, to include the small dealer --

Chairman Frank: (Interposing) It gets down to price, doesn't it? Suppose the issuer imposes any kind of requirement

that is going to cost the competing investment bankers more money, well, one would assume, knowing human nature, that that factor would be taken into the calculations and that the price bid would be that much smaller.

Mr. Stanley: But in all deference, Mr. Chairman, I don't think such a thing as that would work. I don't think it is practical.

I might say, since our firm was mentioned, that the reason we include small dealers throughout the country is because generally the issuer wants it done, and is willing to pay us an amount that we can pay the dealer. It is not a question of generosity.

Chairman Frank: Why couldn't he insist on that in letting his bid?

Mr. Stanley: I don't think you could do it on a competitive basis with narrow spreads.

Chairman Frank: You wouldn't bid a price that wouldn't give you sufficient to cover your costs, you would be foolish to. If he put in that requirement, and that was going to cost you more money, assuming that it would, you would take that into account in making your bid?

Mr. Stanley: Then you get into regulating how the spread is divided; who knows whether you should pay an eighth or a quarter or three-quarters?

Chairman Frank: It would be up to you in making your bid.

Mr. Stanley: Excuse me, but I just don't agree.

Mr. Starkweather: Do you mean to say that you would have an issuer specify in his offer that the winning bidder must give three-quarters of a point to a large list of dealers, or do you mean to say that he must merely offer it to dealers, because if you mean the latter, he could satisfy that by offering us an eighth, which means practically that we are out of business.

Chairman Frank: Why couldn't he specify how much should be given, - in other words, if I am an issuer, and listen to and believe the testimony that has been put in here in the last few days, and I were convinced that it was good for my company, if I were an executive of a utility company, to have the kind of distribution that we have today, and that you fear would disappear under competitive bidding, then I would do something about it and I would say, "I am going to put in my specifications how much should be given to the distributing houses, to the small dealers". Well, the bidder, the bidding group would have to take that into account in making their bid.

Mr. Starkweather: Would you have him specify how much they would give to dealers, too?

Chairman Frank: If that were necessary to accomplish the result. I would put anything in that would accomplish my result. What is to prevent me? Nothing in our rule.

I am assuming that the executives are intelligent. They

want to accomplish a certain result and they specify that result. It costs them more money, as you say, but they are willing to pay that, according to the testimony here, they are willing to pay more money to get that distribution. Why can't they put, in the offer that they make publicly, a statement that to the end of accomplishing this result they want to specify how much the small dealer shall get, and that they want distribution of a certain quantity over the country.

Mr. Starkweather: In theory, I can imagine that, but in actual practice I find it very difficult to imagine an operation calling for a bid, specifying that of the issue, you should offer a definite percentage to dealers and distributors, and that you sell it to those dealers at a specified spread.

Chairman Frank: Is there nothing like that done in negotiations today?

Mr. Starkweather: I don't think so.

Chairman Frank: Then how is the issuer assured today, in a negotiated deal, that there is going to be the kind of distribution that you think desirable and that, according to the testimony, the issuers think desirable?

Mr. Starkweather: Well, the custom has grown up and it is a well-established custom, so that there is no reason for an issuing corporation to assume, in negotiating privately, that all custom is going to be thrown to the winds, and that the group is not going to do their business in the customary way.

Chairman Frank: We have had instances before us where the issuer at least went to the point of saying that he wanted such-and-such a house included, or that he wanted such-and-such a distribution in a certain State.

Mr. Starkweather: I agree with you, and that brings up another point.

How would you assure local representation in the syndicate under competitive bidding? You can't do it, as far as I can see. Any group can bid. If you have a local issue in Iowa, let's say, one group may include a lot of Iowa dealers, and another group may be all New England.

Chairman Frank: If I were the executive of a company operating in Iowa, and I wanted a certain amount of distribution in Iowa, if I thought that desirable, and I were negotiating my deal, I would say that, and I don't see why I can't say that just as well in letting the bid.

Why must you suddenly become tongue-tied when you are doing it publicly? Why can't you insist upon the same conditions of the deal when you are letting a bid as you do in private; why the sudden reticence about saying what you want?

Mr. Starkweather: I find it very difficult to jibe that kind of an offer with what is commonly conceived to be competitive bidding.

Chairman Frank: Well, we always like to make words rigid, but after all, let's stop using any known word, let's call it

something new, invent an abstract term such as "alph-alpha".

What you have done is to say that competitive bidding as we have known it has had certain undesirable characteristics. We answer by suggesting tentatively, "Let's have the competitive bidding that we might exact so phrased as to get rid of those characteristics."

Then you say, "It isn't competitive bidding."

So what? If we think it is desirable, call it something else.

Mr. Starkweather: You certainly, Mr. Chairman, wouldn't be able to put out a bid saying that every bidding group must have a certain number of local houses in that group. All they could possibly do under those circumstances would be to offer it to them on selling group terms, which, in itself, means a great cut in the earnings of local groups; in other words, I can't conceive of your offering an issue of bonds of the Des Moines Utility Company, and saying in it that each group must contain a certain number of Iowa dealers, and that those dealers must be offered a certain amount, and at such-and-such a price.

Commissioner Pike: You make it sound very difficult.

Mr. Starkweather: I must admit it sounds difficult.

Commissioner Pike: It may be difficult, but it is not inconceivable that it could be done or that you could put in certain minimum standards that you would like to see upheld,

and if the boys didn't come and bid under those circumstances, then you would say, "Well, that one failed, we will put out a new request for bids".

I think it is probably a question of mechanics. I think you are close to the business and you see technical difficulties, and the Chairman is not as close to it --

Mr. Starkweather: (Interposing) I don't want to raise artificial difficulties, certainly. They seem very real to me.

Commissioner Pike: I meant only "technical" in the sense that they are part of the business practice, and you are in the middle of that.

Mr. Moss: Isn't it fair, Mr. Pike, to at least hazard a guess that with the competition we have had in recent years, particularly for high grade utility issues, between underwriters, with insurance companies in private placements, that your spread is narrowed to the point where it is pretty thin, and if you got it down, as you presumably would, much further through competitive bidding, there would be very little in the nature of a re-allowance left to the dealers?

Commissioner Pike: I think the testimony has been almost unanimous, from both sides of the fence, during these hearings, that that is apt to be the case. None of us yet know.

Mr. Moss: That would be my guess, that it has gotten down to where it couldn't be reduced, with any reasonable profit, much further, and allow one-half or three-quarters of a point,

which has been the usual selling group commission.

Commissioner Pike: You are still on the area of opinion, but nobody seems to disagree much that the spreads are apt to be somewhat narrow. Our staff report suggests it, and the story from the investment bankers and the dealers has been along that line.

While you are here, something you raised worries me. I don't think that probably it is right in your area, but maybe some legal historian can help me.

You mentioned the service that the investment banker gives in the way of later information, helping the investor to follow the course of the security he has bought.

Some years ago, I think about 16 or 17 years ago, I was doing investment work for a group of insurance companies, and we had a case in New York called the Green Star Steamship Company against the Equitable Trust, which brought that matter right to the fore. It went up twice before Judge Proskauer, and before the case was decided the Equitable tied in with the Chase, and the company disappeared. But the two decisions were very much indicative of the fact that it was the legal duty of the investment banker to keep his clients aware of what had happened to the securities that had been sold to them. As I say, the case ended up with a settlement so that it never was finally decided, but two decisions on the point indicated that if he failed he was bound almost to the point of rescission for

not doing it.

I wonder, Mr. Dean, if you remember that particular case, the old Green Star Steamship-Equitable case?

Mr. Dean: I remember that very well.

Commissioner Pike: Didn't it pretty well indicate that it was the legal duty of the underwriter to keep his client advised, particularly upon application by the client, of changes that were taking place in issuers' affairs, whether favorable or unfavorable? Do you happen to remember?

Mr. Dean: Yes, there were dicta in the opinion to that effect.

Commissioner Pike: Of course, the case was never decided, the main case, but I think Judge Proskauer had it once in the Supreme Court and once in the Appellate Division, or maybe one step higher, the Appellate Division and the Court of Appeals.

Mr. Dean: You will recall that there was a very unusual hedge clause in that case, in which the Equitable Trust Company, I believe, brought out the securities, and as I recall it, the hedge clause read that while the above information is not guaranteed, it is the information which we ourselves have relied upon in connection with the purchase of these securities. And Judge Proskauer commented upon the fact that if it was good enough for the Equitable Trust Company, it ought to be good enough for the average man.

Commissioner Pike: Of course, there was another peculiar

thing in that case, that Mr. Kracke was both the Chairman of the Board of Equitable, and a Director of the borrowing Steamship Company, which was already in the Equitable up to its ears, and the net effect was to get the Equitable's loan out to the public. It wasn't such a beautiful picture.

Mr. Dean: I also think it was probably one of the quickest defaults on record.

Commissioner Pike: That is right, they never paid a coupon.

Mr. Moss: I don't know the legal aspects of that at all, but I do know that in practice there is a great difference in certain houses in their feeling toward how much information they give, the way they give it and how quickly. Some you can go to time and time again, and you don't get to first base with.

Chairman Frank: We had contemplated perhaps adjourning now until 3 o'clock. I have the names of certain persons that have asked to be heard.

Mr. Webster, do you wish to be heard?

Mr. Webster: Yes, sir.

Chairman Frank: We will hear you this afternoon. I can't tell whether these gentlemen wish to be heard or not. Mr. Hurd?

Mr. Hurd: My name wasn't put in to be heard, Mr. Chairman.

(Laughter.)

Chairman Frank: The unheard Mr. Hurd. (Laughter.)

Mr. Scott, do you care to be heard?

Mr. Scott: No, sir.

Chairman Frank: Mr. Cutler?

Mr. Cutler: No.

Chairman Frank: Mr. Bennett?

Mr. Bennett: No, thank you.

Chairman Frank: Mr. Connely?

Mr. Connely: No, sir; not at this moment.

Chairman Frank: Do you want to be heard this afternoon?

Mr. Connely: I don't think so, Mr. Chairman.

Chairman Frank: Before we adjourn, it has been suggested that perhaps you, or someone on behalf of the I.B.A., may care to reply to Mr. Love's comments on your reply to our Staff's report.

Mr. Dean: We will comment on that this afternoon.

Chairman Frank: Very good.

Mr. Burnett Walker: While the subject is fresh in your mind, may I make one comment on the subject of the specification by the issuing corporation that the bid should include a certain amount for the selling group?

I happen to think that that could be done. I don't think in practice it would work very well, but I think that the issuing corporation could say, we could say, "We want three-quarters of a point, or three-eighths of a point, or a point paid to the selling group". The thing that I think would cause the difficulty would be in tying the hands of the syndicate manager, the fellow who sits at the desk, to decide whether he

will put out the securities in Ohio or bring them in from Ohio, or put them out on the Coast, or bring them in from the Coast. If you should say simply that there would be a certain amount specified to the selling group, I think there is no practical way of saying how much of that would go to the underwriters' selling group interest, and how much would go to the people who are entirely disassociated from the underwriters.

So that I think it would be hazardous for any issuer to say, whether the issue were bought by competitive bidding or otherwise, that he must have a certain amount of that security sold in a certain area or in a certain group.

Commissioner Pike: It wouldn't be difficult to say that he must make his best efforts, would it, to do so-and-so?

Mr. Walker: No. I have never been a syndicate manager in the sense of sitting at a desk and handling an issue, but I have made it my business to sit at his desk and watch him operate, and I know he must be just as flexible as anybody in any walk of life, where he can at an instant's notice, put in or put out.

Chairman Frank: I have some other names here of persons who haven't indicated whether they care to be heard or not. Is there anybody else that wishes to be heard this afternoon?

(No response.)

Chairman Frank: We will reconvene at 3 o'clock.

(Whereupon, at 12 o'clock noon, a recess was taken until 3 o'clock p.m., of the same day.)