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 6, 1941

Pages 894 to 911

CONTENTS

- - -

Grover
aj-1

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

- x

Public Conference concerning

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.

- x

Hearing Room 1102,
Securities and Exchange Commission Bldg.,
Washington, D. C.,
Thursday, February 6, 1941.

Met, pursuant to adjournment, at 10:45 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:

Name	Representing
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.
G. Coe Tarrier	Asst.City Sol.,City of Philadelphia.
Hon.Harry S. Truman	Senator from Missouri.
Fred L. Oliver	Committee on Public Utility Investments of the Mutual Savings Banks.

Mr. Cutler; Mr. Bennett; Mr. Hurd; Mr. Scott.

PROCEEDINGS

Chairman Frank: Let us proceed, gentlemen.

Major Oliver!

STATEMENT OF FRED L. OLIVER

Committee on Public Utility Investments of the Mutual Savings Banks.

Mr. Oliver: If the Commission please, I appear at the request of the Committee on Public Utility Investments of the Mutual Savings Banks.

As you know, the Mutual Savings Banks are Eastern institutions primarily, about 530 to 540 in number, with combined assets of approximately 12 billion dollars, and approximately 14 million depositors. Most of these are, with the exception of some large metropolitan institutions, small community banks.

We hesitate to suggest to you or to question the advisability of any well-considered opinion of this Commission, or even a tentative view. I think you know that our group has, from time to time, had occasion to appear and support legislation enlarging the Commission's functions.

Commissioner Eicher will recall that we consistently supported your Trust Indenture bill. I think some of us believed that the Trust Indenture bill did not go far enough to be of any practical benefit to the small institutions.

We are not taking an extreme position here, but our group is apprehensive of the results of your proposed competitive bidding rule.

We desire to bring to your attention our apprehension, and to air our grievance or complaint at the same time with respect to private placements, inasmuch as the question of private placements has a bearing upon the feeling or apprehension of our people as to competitive bidding.

As Judge Healy knows, the Savings Banks have been much concerned over private placements. They have seen their high yield, good utility bonds called and refunded without an opportunity to participate in the new issues. They believe that it is a practice that should be discouraged, and that feeling with reference to private placements has a bearing upon their apprehension as to competitive bidding. That is, on top of losing 60 to 70 percent of their good utility bonds because of refunding, it now appears that they may be required to pay artificially high prices for the remaining issues in which they are permitted to participate.

Now I have no expert knowledge on the subject, and I don't think our people have any statistics on the question of the result on the pricing. As I have stated too, it is their judgment that that will result.

Chairman Frank: Major, the matter has been discussed so frequently back and forth in the course of these four days of conferences - this being the fifth day - that rather than pursue the subject with you, I would like to suggest that for your clients you glance over the testimony at these hearings, and I think perhaps there will be some matter there that may perhaps affect your judgment on the subject.

Mr. Oliver: Yes.

Chairman Frank: That is, there have been arguments made back and forth, and some of them indicate that perhaps the surmise that there will be artificially high prices, as you call them, may not be altogether justified.

Mr. Oliver: That may well be true, sir, and as I say, we are not taking an extreme position.

Our banks have seen their good bonds go, their yields decrease, which reduces the dividends to the depositors who need the money, and who are the small savers. It appears to them now that there is a possibility or probability that they will have to pay higher prices for those bonds which they will get.

Chairman Frank: What would you think, if we can do it legally - I don't know that we can - of our imposing a requirement that in case of refunding, some priority should be given to those persons who hold the bonds that are to be refunded? Would that be helpful if we could do it, and if it were practicable?

Mr. Oliver: I think that would go a great way toward satisfying our institutions. I think that has been the main complaint. They have seen their portfolios raided of the good bonds, without having an opportunity to participate in the refunding.

I realize, perhaps, that there is no sound way that you can absolutely ban private placements, but it seems to us that there are ways by which you can discourage that, and we are fearful that this competitive bidding may actually give a greater advantage to those large institutions with concentrated purchasing power, than the normal way of distributing securities.

Commissioner Pike: That is very difficult for me to visualize. It has been shown quite clearly that if competitive bidding were the rule, the insurance companies would be placed on the same basis as the other bidders except in the matter of price. They are buying for themselves, and not selling, and there is a question as to whether they wouldn't be able to offer a little more. At the moment they have that advantage as to price, and have the additional advantage of being able to go in weeks, and sometimes months, before any papers have been drawn, and make a firm commitment that if the papers are so-and-so, they will take the bonds - and there is no more talk. No investment banker can do that. That, at least, would iron out that particular portion of the advantage which the insurance companies have, leaving one as to which there is no argument. They are buying for "keeps", and maybe they can offer a little more.

Mr. Oliver: Your judgment is perhaps better on that than mine, Mr. Commissioner, but it seems to some of our people, at least, that the competitive bidding rule -- under that four or five large purchasers can get together and make a firm commitment, where an investment banker might not be able to do that so readily.

Commissioner Pike: That is what worries me. When it comes just to a matter of private placement, I am unable to see why they can't do that now; whereas, under the competitive bidding rule, at least they will have to go in there at the same minute and with the same sealed bid as the others, and won't be able to make the firm commitment far in advance, which is one of
2 their principal advantages at present - at least so we are told.

Mr. Oliver: Yes. Well, I will tell you frankly that our primary interest is in the question of banning private placements.

Chairman Frank: Generally, and not merely with respect to competitive bidding?

Mr. Oliver: That is correct, sir. We realize that on the question of price, so far as our experience is concerned, as I understand it, with respect to equipment trusts, for example, the question of competitive bidding is not the primary factor which perhaps accounts for the high price, the primary factor being the unique position of the equipment trusts in connection with a bankruptcy, for instance. They have an impregnable position.

As a matter of public policy, Congress said that equipment trusts shall not bear any sacrifice to the mortgage creditors, so they ride through the bankruptcy proceeding, receive the interest during the meantime, and are undisturbed at the conclusion of the proceedings.

I think perhaps the competitive bidding is a factor in the price.

I don't know that I can say anything further, sir. We want you to bear in mind our situation, our concern over private placements; our fear, our apprehension, perhaps, - it may or may not be well grounded - that this competitive bidding may adversely affect our small investing institutions, and thus affect the small savers who are dependent in part on their savings.

Chairman Frank: Thank you very much.

We are honored this morning. Yesterday we had a Member of the House of Representatives appear, and today we have a Senator, Senator Truman, who has asked to be heard.

Senator Truman!

STATEMENT OF HON. HARRY S. TRUMAN

Senator from the State of Missouri

Senator Truman: Mr. Chairman:

I am here at my own request to insert in this record a little history with regard to railroad financing, as brought out by the Senate Committee, which spent about 3-1/2 years investigating railroad finance, and if the Commission will indulge me for a few moments, I will read to you a few excerpts from that history.

A certain banker here the other day said he didn't want that record placed in here, and I thought it ought to be brought out.

I am pleased indeed to state for the record of the Securities and Exchange Commission some facts developed by the Senate Railroad Finance Investigation. That investigation has to date resulted in the publication of 23 volumes of hearings and exhibits, plus 25 or more preliminary and additional reports. Those hearings were held pursuant to Senate Resolution 71, 74th Congress, and continuing resolutions. Naturally, I cannot summarize today all the material in the subcommittee's record pertaining to competitive bidding vs. "continuing banker relationships", as the present practice is sometimes described. But I can outline for you a few typical situations as developed in our record.

"Continuing banker relationships" have been defended by witnesses before the Senate Railroad Investigation, and perhaps here too, on the ground that a railroad or other enterprise can "in time of need" turn to its continuing bankers for short-term accommodations or other aid. The incident I have in mind in this connection comes from my own State, the State of Missouri. In testimony at a hearing before the Missouri Public Service Commission, about 1931, it was urged that the Missouri

Pacific would benefit by establishment of such a relationship with a New York banking firm. Said one witness:

"The Missouri Pacific in times of prosperity can finance its own needs. * * * Nevertheless, they have got to negotiate with some bank in order to procure the sale of their securities, and I think the Van Sweringens may be helpful to them in that respect. * * * Having a friend at court, even in a banking house, is much more helpful than detrimental."

The Missouri Commission was impressed by that argument. In its later opinion, that Commission declared:

"Mr. (John P.) Murphy (Van Sweringen attorney) stated that most of the banking business of the applicant (Alleghany Corporation) is done with J. P. Morgan & Co., and expressed the opinion that the Missouri Pacific Railroad Co. will be enabled to readily and easily finance its future requirements with this connection."

Thereafter, J. P. Morgan & Co. became continuing bankers for the Missouri Pacific. Less than two years later, the Missouri Pacific, a $500,000,000 railroad, needed $1,500,000 to meet an interest payment, and turned to this banking firm. The bankers refused to make the loan. Thereupon, the railroad went to the R.F.C., which agreed to lend the money, but could not do so for 15 days. The bankers then agreed to lend the railroad the $1,500,000 for 15 days, but "only on the basis of the expectation that the R.F.C. will lend you the sum necessary to repay with interest such loan at its maturity," 15 days later. Moreover, the bankers took that occasion - of making a loan of $1,500,000 for 15 days - to require the railroad to post $15,500,000 additional collateral for other loans which they and associated bankers held.

But here is the interesting point. Our subcommittee asked one Morgan partner whether at that precise moment his firm would have let the 13,000-mile Missouri Pacific Railroad, serving the whole Southwest, "go bust" for lack of $1,500,000.

"Why not?", he replied.

The incident, and I have no doubt that the experience of the R.F.C. would show it is not an unusual one, seems to me to show clearly one thing: If continuing banker relationship has advantages over competitive bidding, financial aid in time of crisis, even from so recognized a firm as J. P. Morgan & Co. which was then engaged in both private banking and underwriting, is not one of them.

Another argument against competitive bidding urged more than once upon our subcommittee, and perhaps urged here as well, is that the continuing banker relationship makes available to a railroad or other company the advice and guidance of its bankers. Here it seems to me a misconception must be cleared away. That advice, in case after case, is not "given", but rather sold by the banker to the company. Let me cite two or three instances.

Some years ago, the Missouri Pacific acquired control of the Gulf Coast Lines. Bankers for the Gulf Coast Lines arranged the transaction, for which they received compensation. The Missouri Pacific's bankers, Kuhn, Loeb & Co., in this case limited its services to "advising" the Missouri Pacific. For this advice it was to receive 1-1/4 percent of the amount involved - a sum which the Interstate Commerce Commission characterized as "excessive compensation", and two Commissioners further characterized as follows:

"Kuhn, Loeb & Co. are the regular fiscal agents of the Missouri Pacific. When that railroad issues securities, they are sold to the public through Kuhn, Loeb & Co. and its connections as a matter of course. One of the defenses offered for this variety of monopoly, which is widely prevalent in the railroad world, is that by such an arrangement a railroad enlists the friendly interest and advice of an experienced firm of bankers. In this case it does not appear that the Missouri Pacific secured such friendly interest and advice at anything less than the current market price."

This episode is not unique. Let me cite also the sale of certain stocks by the Delaware & Hudson to the Pennsylvania. This transaction was arranged by Kuhn, Loeb & Co., continuing bankers for both the buyer and seller. The transaction can best be described in the exact words of a late partner in that firm:

"Upon authority of Genl. Atterbury (Pennsylvania vice-president) I bid Mr. Loree $62,500,000 (for his Wabash and Lehigh Valley stocks)--which bid was accepted by him and his Committee. I stipulated with Mr. Loree that out of that sum K. L. & Co. are to receive a commission of $570,000, which he approved. I also advised Genl. Atterbury over the telephone that K. L. & Co. are to receive a reasonable commission (I did not mention the amount) in the manner above stated."

Mr. Benjamin Buttenwieser, a partner in this firm, has testified before our subcommittee as follows:

"* * * Through being continuing banker for a company, the company feels free to consult one banking firm for a great deal of financial advice which may not be definitely on the subject of a new security issue, but just in the general sphere of financial advice--very much as if one has a continuing lawyer, one feels free to consult him from time to time."

I think those two quotations will stand on their own feet. One describes in forceful language the theory of benefits accruing to a company from having a continuing banker. The other describes a typical case in which that theory is applied.

To summarize, even though it be conceded that a company needs advice from its bankers, that advice is a purchasable commodity. It is not, as cases like these clearly show, something thrown in by continuing bankers without compensation.

I might say here, before passing to another consideration, that when the compensation of the bankers in connection with the Gulf Coast transaction was under scrutiny by the Interstate Commerce Commission's Bureau of Finance, it was defended by the railroad's lawyers at the railroad's expense. The treasury of Missouri Pacific was the source not only of the banker's extraordinary fee, but also of the cost of defending that fee before the Commission.

This matter of "advice" deserves a little further discussion. Let me take as an example the formation of Pennroad Corporation, a railroad holding company. I can think of no better example, for a partner in the banking firm which assisted at the formation of Pennroad Corporation repeatedly described the advice then given as "the best advice we ever gave."

The firm was well rewarded for this advice. It received options to purchase Pennroad stock, from which options it netted a profit of more than $2,700,000. This profit involved no risk. It was in addition to a profit of nearly $2,000,000 accruing to Kuhn, Loeb & Co. and associated bankers in connection with the Pennroad stock offer. The $2,700,000 profit to which I refer was on options granted specifically "in consideration of your having acted in an advisory capacity and having given the organizers of this corporation the benefit of your experience and judgment in connection with the organization" of Pennroad.

The advice referred to cannot have extended over a period of more than 31 days - from March 23, when the subject was first broached to the bankers, until April 24, when the company was actually launched.

But let us look at the advice itself. It consisted of three points. First, the bankers advised the corporation to issue stocks rather than bonds. Perhaps that is what the partner in the banking firm meant when he said that his firm's advice to Pennroad was "the best advice we ever gave." And it was good advice. But what puzzles me is why similar advice was not given to the Missouri Pacific, the Delaware & Hudson, the Wabash, the Pennsylvania Company, and perhaps other clients of this banking firm as well. Every one of these companies maintained a continuing banking relationship with Kuhn, Loeb & Co. Every one of these firms thus had available the continuing advice of these bankers. Yet every one of them issued bonds through this banking firm and incurred fixed charges in order to buy stocks. In several instances this inverted-pyramid financing was a direct contributing cause to subsequent bankruptcy of these railroads. Our subcommittee has never been able to determine why these bankers, knowing as they did the dangers of financing stock purchases through bond issues, nevertheless underwrote such bond issues and even advised them. Why, in short, they gave Pennroad in this connection so much better advice than they gave the Missouri Pacific, the Delaware & Hudson, the Wabash, or the Pennsylvania Company.

So far I have mentioned one bit of advice given during a 31-day period or less, for which the bankers received the $2,700,000 I have mentioned. The second bit of advice was that control of Pennroad be lodged in a voting trust, thus sterilizing the power of investors to control their investment. One Kuhn, Loeb partner, discussing such devices as voting trusts, described them very succinctly as "inventions of the devil". I agree with that characterization, and I sometimes wonder whether advice to lodge control of a holding company in a voting trust is the kind of advice which merits giving one banking firm a monopoly over the securities of the company advised.

The third bit of advice given in return for those options which netted a riskless $2,700,000 profit to the bankers was that the initial Pennroad stock issue should not be underwritten. Instead of an underwriting, the bankers proposed an agreement to purchase a limited number of unsubscribed shares, if any, subject to certain conditions. Under an underwriting, the bankers would have had to assume a full liability. Under the Kuhn, Loeb proposal, the bankers assumed no responsibility unless stockholders of the Pennsylvania Railroad and perhaps others subscribed 85 percent of the offering. Again, if the issue had been underwritten, the bankers would have had to assume an $87,000,000 risk; under the Kuhn, Loeb proposal, the bankers' risk was limited to only $3,750,000. Finally, if the issue had been underwritten, the bankers would presumably have profited only by a "spread" of two points more or less. Under the Kuhn, Loeb proposal, the bankers profited to the extent of $1,954,577.27 - more than 50 percent on their total commitment of $3,750,000.

I like to think of that Pennroad transaction whenever I hear or read that the "advice" given by a banker to an issuing company is one justification, and perhaps the chief justification, for permitting one banker to monopolize the underwriting of that company.

Let me conclude with what is perhaps the most interesting part of the Senate Committee's record so far as it touches upon competitive bidding. As you know, the Interstate Commerce Commission has required competitive bidding for railroad equipment trust certificates since about 1926 - in my opinion successfully. The significant thing about our 23-volume record is that, while it is replete with instances of financial abuses resulting from continuing banker relationships, I do not recall a single instance of such abuses in the case of the tens of millions of dollars of equipment trust certificates issued under competitive bidding. So far as this class of securities is concerned, the competitive bidding requirement seems to have wiped out with one stroke the many types of abuse which, as our record abundantly illustrates, cluster about the traditional type of underwriting arrangements.

I thank you, gentlemen.

Chairman Frank: Thank you very much, sir.

Mr. Stanley: Mr. Chairman, may I ask Senator Truman one thing?

Chairman Frank: Yes.

Mr. Stanley: My name is Stanley, and I was a partner of J. P. Morgan at the time you mentioned.

At the time of the million and a half dollar loan to the Missouri Pacific, you stated that they had other loans at the same time. Do you happen to have the figure of those loans, Senator?

Senator Truman: I do not. I can get that.

Mr. Stanley: I would like to have that. They were large loans?

Senator Truman: They evidently were large loans, because you required $15,500,000 additional security.

Chairman Frank: I think that concludes the testimony of all persons who have asked to be heard, and the conferences will therefore be closed.

(Whereupon, at 11:15 o'clock a.m., the conferences were closed.)

- - -