CHAPTER III

INVESTMENT BANKING

This is the famous [FN 1] "Bond Club speech" delivered at a luncheon of the Bond Club of New York, March 24, 1937, when Mr. Douglas was a commissioner, but before he became chairman of the Securities and Exchange Commission.

In large segments of the business of investment banking a noncompetitive condition prevails. This is due in large measure to the control—direct or indirect—of business by the investment bankers. [FN 2] Others have pointed out the implications for business of the practice of having investment bankers represented on the boards of directors of corporations. Yet all of the hazards and dangers to investors arising by reason of the fact that bankers are represented on the boards of issuers might continue even though such relationships were to be abolished. Such hazards and dangers are inherent in control. That control may result not only from having a representative on the board but also from having a voting trusteeship or a strategic investment position—usually though not necessarily in stock; or it may result from subtle ties of friendship, from long periods of association, from favors rendered, from zones of influence in financial circles, or from an inertia which has never been challenged. [FN 3]

When I speak of control I do not speak legalistically. I do not mean possession of the necessary implements with which to emerge successfully from a contest over election of a majority of directors. Rather I mean not only working control but also domination and controlling influence over policies however obtained or preserved. Any banker knows how subtle that control is. He also knows how valuable it is or can be. Certainly when that control is in the form of directorships, voting trusteeships, or a strategic investment position, the bankers who have it can commonly claim that company as their own. It amounts to a "no trespassing" sign on a financial empire. With control, underwritings as well as other patronage are commonly assured. These emoluments cover a wide range—depositaryships, paying agencies, indenture trusteeships, registrarships, stock transfer agencies, brokerage accounts, protective committees, and sometimes even the minutiae such as printing and stationery. Those who are in a position to control cannot and do not always absorb all of these themselves; they frequently dispense them to others in return for favors received or for favors expected. Nor can many of these emoluments be classified as illegitimate; nor are they always exploited. But the weakness in the situation lies in the fact that he who is in such a dominant position is not on competitive ground; he is dispensing the patronage of a monopoly. He is in a position to take unto himself all that he wants or needs or all that he can conveniently absorb and to dispense to others whatever he

deems wise or expedient. Furthermore, he may frequently levy toll on the company with little or no economic justification. As a result of his entrenched position he may exact fees for underwriting when there is no real need for it. Thus it may not be necessary for strong issuers [FN 4] to go through the steps of underwriting, syndication, and dealer distribution when it is known that most of the issue will be taken by institutions or that the price at which rights [FN 5] are offered is such that the stockholders will take practically all the offering. Yet instead of advising the use of some form of agency distribution, or instead of recommending no underwriting at all, the self-interest of the banker has often dictated the use of more expensive machinery.

This raises the whole question of the relation of present compensation of bankers to risks undertaken. This question is particularly significant as it relates to offerings to stockholders by means of rights. When such offerings are made at substantial discounts from the market price of the outstanding shares, as they generally are, there are often grounds for questioning the need of any "banking insurance." Some issuers have found that they have been able to dispense with underwriters entirely. The actual experience in connection with seven offerings of rights of over $1,000,000 on listed issues made between June, 1935, and June, 1936, illustrates the absence of substantial risk.

In six of the seven cases, underwriters took less than 5 per cent of the issue, in one case 11.7 per cent. Nevertheless, underwriters received overriding commissions at the rate of about 3 1/2 per cent of the value of the whole issue, which would be equal to about 70 per cent on the amount actually taken up. In addition, in four cases, there was also an underwriting commission payable on the shares actually taken by the underwriters. It is clear that we cannot measure the reasonableness of the compensation by saying that the underwriter is receiving only fifty cents per share. Even fifty cents per share may be too much when it is clear that 90 per cent or more of the stock will be taken by right-holders. The trend toward democratization may well result in the elimination of the double load, so that there may be either reasonable payment for insurance or for selling the balance not taken by stockholders, but not both.

The use of options [FN 6] as compensation to underwriters would certainly also come into question. This does not necessarily mean that the underwriters might not distribute as agents or under an option agreement. But the interests of investors and the issuers might be better served if the securities were distributed at a fixed return to the company and a stated maximum price to the public. It is not necessarily valid to say that the option route is a cheaper way for a corporation to raise money, for in the long run it is likely to be more expensive for the stockholders. If a corporation is raising capital, it should obtain enough to cover the expenses of raising the money. In the past, options frequently have been gratuities to the underwriters, who have received, in cash, the fair value of

their services and then taken options on top of that. And the existence of options stimulates endeavors to "jack up" prices to make the option valuable, and thus tends to work to the disadvantage of the public stockholder. Here too is a situation which more competitive conditions might rectify.

These are but a few of many like conditions which are nurtured by monopoly in finance. Under our present form of corporate organization there is no effective restraint on the banker in such a dominant position. His conscience and integrity supply the only safeguard to investors. The history of finance reveals the dangers which result from allowing such business patronage to be monopolized in that manner. The result frequently has been that under those circumstances legitimate business has become a preserve for exploitation. By reason of that monopoly tribute was exacted from investors. That monopoly made it possible for finance to become the master rather than the servant of business. The end result was a perversion of the banker's true function. The history of banker domination of industries such as public utilities and other types of holding companies shows how destructive such influences have been and may be.

This aspect of the business of underwriting deserves stress. A banker controlling a corporation whose securities he is underwriting is the arbiter of the reasonableness of his fees and commissions. Again, regardless of the strictly legal aspects, he is on both sides of the bargain. The situation is often not apparent since issuers and bankers can with facility dress the particular transactions in the garb of fairness and equity so as to give an appearance of arm's-length negotiation. Furthermore, in fairness to investors it should be said that what may appear to be modest fees may in fact conceal additional compensation, past or prospective, in other forms. Realistically the sum total of all such business patronage must be accounted for in measuring the reasonableness or propriety of any one single item. Restraint in one case may provide only the occasion for liberality, overreaching, or greed in another. Thus investors, under the impression that their company has succeeded in obtaining an underwriting on provident and modest terms, may in fact pay many fold for the ostensible sacrifices which the bankers are making.

The problem, however, is a manageable one. In my judgment the least which should transpire is that where the bankers are dispensing to themselves the patronage of a monopoly— whether by reason of directorships, voting trusteeships, strategic investment positions, or otherwise—a private sale of securities by the issuer to those bankers should not be made. Bona fide competitive bidding [FN 7] should be had in such cases in absence of affirmative proof that it would be impracticable. As a matter of broad policy I am convinced that the interests of investors can be served only by that practice. Those who are in a dominant position then could no longer dictate. Such a system would remove the premium presently resting on domination or control and place a premium on

disinterestedness: a step consistent with the broad objectives of a vitalized democracy, a necessary step if our financial processes are to be made healthy and above reproach. Such competitive bidding would effectively curb abuses. It would mitigate the practice of having the banker on both sides of the bargain. In this connection it should be observed that the economic utility of continuity of banking relationships [FN 8] is of unestablished value to anyone except the banker. It is the more difficult to prove where that continuity is based on control or on ownership of securities whose substantial value may lie in business patronage made available by reason of the fact of domination. Certainly revitalization of the profession is not to be found in monopoly. Democratization under such safeguards points the way to development of the service rather than the profit standards of the profession. When that phase comes into the ascendancy, health and vitality in financial relationships are assured.

It may be that competitive bidding alone will not give sufficient protection to the public interest, in its broadest sense. As against its many obvious advantages may be put the disadvantage that lively competition for stylish and readily salable securities may induce overissuance. One phase of this is well illustrated by the large number of investment-company issues that came out in 1928-29. Their popularity made it possible for brokers and bankers to make themselves sponsors, incorporate an investment company, and go on producing stylish and popular merchandise until the crash came.

In its broadest phases, the investment-banking problem reaches out beyond the mere question of pricing and of striking a fair bargaining balance between the interests of the issuer and those of the investing public. It is concerned with the basis of economic balance and stability, the accumulation of capital funds, and their proper distribution among industries. The bigger problem is not one of price, but one of overissuance and oversalesmanship. It is one of making sure that the industries which are most in need of capital, and not necessarily those whose securities are most salable, will have ready access to the capital market. That is to say, the problem is to direct the capital flow to those industries which can make the best use, both economically and socially, of the available capital supply, and to prevent an exhaustion of this reservoir, with available funds being siphoned to the type of security which can arouse the greatest consumer appetite. Therein lies the banker's most important function, to which all others become secondary. And the problem is, finally, one of building a system of adequate checks and balances in the issuing process.

Unfortunately, the investment-banking process often has been controlled by the salesmen. Then the investment banker tends to manufacture what the salesmen can readily sell; and he, himself, is often nothing more than the general in command of an army of salesmen. In other words, a type of dynamic salesmanship has taken root within the securities business in which it has no

proper place. On the other hand, if conditions are created under which the banker who acts as underwriter is compelled to take graver risks, he will not be as promiscuous in the production of securities which do not answer a deep-rooted need, but which are merely a passing fad. To the extent that the production of such so-called salable merchandise is reduced, the opportunity for merchandising economically sound securities will be increased.

The question then hinges, to a large extent, upon requiring that the underwriter be true to his real function; that is, to carry economic risks and hence act as a selective agent, as well as a profound student of economic and industrial conditions. He has not been required to act in this capacity, and often has not, except for such studies as may cover the short period of the marketing process, which is practically nonexistent in the case of highly popular securities. Such steps will, in the long run, work to the self-interest of the bankers themselves, since what is good for our industries and our economy is good, for everybody who participates in that economy. That this is so is exemplified again by investment trust history. In many cases there are definite indications that, while the underwriting profits of the bankers were large, these profits, and more, disappeared in the subsequent debacle, caused indirectly by the overissuance of securities and ease of issuing securities which permitted unsound capital structures, unreasonable management contracts, and a paucity of sound investment policies. It may be well to recall, at this point, that a number of large banking houses which resisted the trend up to 1929, realizing very well that these investment-trust securities would eventually bring no good either to the investor or to the banker, finally succumbed and, in one form or another, capitalized upon the popularity of these securities by bringing out issues of investment and semi-holding companies.

The problem is to make the issuer on the one hand and the distributor and the retailer on the other independent of the underwriter. If that were done, the underwriter would fulfill the true function of an insurer, with all the constructive features that go with a risk-taking function. It should come closer to providing an independent middleman who would stand between the buyer and the seller and represent the public generally. What is needed is someone to prevent economically wasteful issuance and sale of securities. Only theoreticians can leave this task to the forces of the "market," for the market too often likes the wrong thing at the wrong time. And there are always a number of people willing to oblige by cultivating such wrong predilections.

To be sure, this course might tend to slow up the process— certainly make it much more discriminating and, possibly, somewhat more immediately expensive. But that it will pay in the long run seems reasonable. It doubtless will require a number of important changes in the banking machinery, foremost among which is the increase of capital resources available for underwriting. This might entail

the assumption of such functions by other agencies, either by themselves or in conjunction with the banking houses. But given supervised competitive conditions, these new sources should be readily found.

All current indicia make clear that the position of the banker will in years ahead be more and more restricted to the performance of one of the two functions I have mentioned; namely, either underwriting or selling. Insofar as management, formulation of industrial policies, domination or control over reorganizations are concerned, it is my belief that the banker will be superseded. The financial power which he has exercised in the past over such processes will pass into other hands. It is not merely a question of finding some other agency or single group which will perform its functions. It is a question of finding proper and adequate devices for passing that power back to the owners of industry where it properly belongs. The key to the solution of current industrial problems is to be found in large measure in a process of democratization of industry.

New tools to express and serve the investors' interests have to be found. One current development of foremost importance is vitalization of indenture trustees. [FN 9] Enlightened indenture trustees will be found exercising wholesome influences in the cause of the security holders. This step, however, cannot be taken without necessary precautions against the ever-tempting opportunities for aggrandizement and power which are within reach of those who are in a dominant position in our financial empires. Measures designed to purge these trustees of conflicting interests cannot be thwarted or defeated by the pressure of the sheer self-interest of the trustees. Should they at any time lack the foresight or vision to undertake the exacting tasks of their new stewardship, other competent and reliable agencies will be found. The fact is that the job must and can be done.

The vitalization of the indenture trustee is only one of the necessary steps in the program of democratization in industrial control. Today, as you well know, we have a practical usurpation of the rights of the great body of investors which can only be described as financial royalism. Our present situation is a carry over from a previous age when there were only a small number of security holders. It should not apply when we are today a nation of investors. The problem is how to achieve some form of real representation for those security holders who are not associated with the management. One phase of this is an implementation of the position of preferred stockholders. If preferred stockholders are entitled to elect a majority of the board of directors after a stated number of dividend defaults, then they should have real representation from such directors. When the old management stays in control of the proxy machine, [FN 10] the preferred stock is not given real protection. If the preferred stock is sold on the theory that it will assume control of the corporation if the dividends are not paid, then some method must be devised to make this control a real thing.

Another phase of this problem relates to obtaining directors who will represent the public interest. This involves a reconsideration of the basis of directors' compensation and of the practice of directors acting on many boards. Possible solutions may exist in the principle of rotation of directors and the creation of so-called public directors. Advances in the same direction can be made through a series of related proposals. The elimination of nonvoting stock is one. The elimination of voting trusts as they are currently known is another. The latter are merely the apotheosis of the process of divesting the stockholders who own the company from control of, or any voice in, the affairs of the company. They afford promoters convenient devices for eating the cake and having it too. They merely make the stockholder an easier prey to whatever pressures are brought upon him by management or other dominant groups, whose power the stockholder is rarely in a position to challenge. If the corporation really needs continuity of personnel and policies, there are other ways by which to attain them. In sum the voting trust as currently observed is little more than a vehicle for corporate kidnapping.

Another or complementary method of reaching the same objective may be the development of some permanent national organization to which grievances could be carried and which could effectively intervene. Through such an agency views of the real owners of these vast enterprises could be articulated. They could be influential in assuring that management policies were dictated in the public interest and in the interest of investors and not in terms of the immediate and selfish interest of the management. The investors who today are by and large orphans of our financial economy must be provided with adequate representation by some such methods. Perhaps industry rather than government can provide it.

Investment bankers well know the basic needs for such representation. They have seen it in oppressive plans for mergers and consolidations, in bold but selfish endeavors to deprive preferred stock of its accumulated dividends, in inequitable plans for recapitalization, in management contracts and bonus arrangements which put a premium on inventory and other speculation, and in vicious and unsound labor policies. Many of these matters reach national proportions; all of them affect, directly or indirectly, national savings. They have an obvious and intimate relationship to our economic and social stability and cannot safely be left to the whim or caprice of a few.

The labor problem which I mentioned is one of the pressing contemporary conditions which cannot be imperiously treated. Management has a place in our economic sun, but so does labor, so does the investor, and so does the consumer. The real owners of these industrial empires have a growing feeling of distrust and lack of confidence in a management which treats imperiously, unfairly, or selfishly the contemporary demands of labor; they have an increasing

recognition of the fact that mid-Victorian attitudes are neither wise or expedient on the one hand nor fair and equitable on the other; they have a growing resistance to any course which will sacrifice and not protect the human values at stake. Ways must be found to make management responsive to the desires and demands of the real owners of the business. To allow management to continue to place itself above or to pay no heed to the interests of labor, investors, and consumers is to invite disaster. Remote control by an inside few of these fundamental economic and human matters is fatal. There can be in our form of corporate and industrial organization no royalism which can long dictate or control these basic matters.

In this trend toward democratization in industrial management, bankers can play an important role, even though they lose their position of dominance over industry. In final analysis they are the ones who control the lifeblood of the enterprise— its supply of capital. From this position they can provide a large measure of protection. They can exercise a wholesome influence on protective clauses and provisions in charters, trust indentures, and the like. They can, if they desire, assert an influence second to none to prevent complicated and unsound capital structures. An insistent demand on their part for respectable and healthy corporation laws could have a profound effect in legislative halls. They could make certain before the underwriting is consummated that adequate and proper provision is made for giving security holders an opportunity to participate directly, or indirectly through competent and honest representatives, in the formulation of management policies. The investment bankers stand in a peculiarly strategic position to make constructive advances along the lines indicated. This progress cannot be delayed so as to await future developments. It is a course of action made insistent by the increasing rapidity of the rate of change in our social and economic order.

[FN 1] The audience, which included nearly every investment banker of importance in New York, was "shocked into a state of profound grumpiness," according to Time Magazine. "When the speaker was introduced," said the New York Times, "the members rose and gave a spontaneous round of applause. When he concluded his remarks the spattering of hand-clapping was far from cordial…"

[FN 2] Mr. Justice Brandeis, in an earlier critique of investment banking, described "the proper sphere of the investment banker":
"The original function of the investment banker was that of dealer in bonds, stocks and notes; buying mainly at wholesale from corporations, municipalities, states and governments which need money, and selling to those seeking investments. The banker performs, in this respect, the function of a merchant; and the function is a very useful one. Large business enterprises are conducted generally by corporations. The permanent capital of corporations is represented

by bonds and stocks. The bonds and stocks of the more important corporations are owned, in large part, by small investors, who do not participate in the management of the company. Corporations require the aid of a banker-middleman, for they lack generally the reputation and clientele essential to selling their own bonds and stocks direct to the investor. Investors in corporate securities, also, require the services of a banker-middleman. The number of securities upon the market is very large…For a small investor to make an intelligent selection from these many corporate securities—indeed, to pass an intelli gent judgment upon a single one—is ordinarily impossible. He lacks the ability, the facilities, the training and the time essential to a proper investigation. Unless his purchase is to be little better than a gamble, he needs the advice of an expert, who, combining special knowledge with judgment, has the facilities and incentive to make a thorough investigation. This dependence, both of corporations and of investors, upon the banker has grown in recent years…" *Other People's Money*, pp. 5-6.

[FN 3] For a fuller discussion, see *Report of the Securities and Exchange Commission on the Activities of Protective and Reorganization Committees*, Part II, "Committees and Conflicts of Interest."

[FN 4] A "strong issuer" is a corporation whose reputation and credit are widely known and unquestioned.

[FN 5] That is, a corporation offers directly to its existing stockholders the "right" to subscribe to additional stock at a specified price, usually somewhat below the current market price.

[FN 6] In making a public offering of securities on behalf of a corporation, investment bankers do not always make a wholesale purchase of the securities. Sometimes they merely take an option on a block of securities, later buying the securities if they find they can be resold. Or a corporation may compensate its investment bankers in whole or in part by giving them an option to buy an additional block of securities at a favorable price.

[FN 7] "Competitive bidding for corporate issues drew immediate fire," said the New York Times. Since then it has been a subject of lively controversy. Investment bankers generally have shown strong opposition to the suggestion that they should compete through sealed bids for the business of underwriting security issues. Nevertheless, during 1938 and 1939 certain investment bankers seeking to compete for underwriting business raised a demand for competitive bidding in connection with a number of large bond issues, among them the issues of the Chesapeake & Ohio Railroad Co., Cincinnati Union Terminal Co., St. Louis Union Terminal Co., Southern Bell Telephone Co., Consumers Power Co., Louisville & Nashville Railroad Co., and Cleveland Union Terminal Co.

[FN 8] On the continuity of banking relationships, Mr. Justice Brandeis wrote in 1913: "Long ago monarchs invented, as a preservative of absolutism, the fiction of 'The divine right of kings.' Bankers, imitating royalty, invented recently that precious rule of so-called 'ethics,' by which it is declared unprofessional to come to the financial relief of any corporation which is already the prey of another 'reputable' banker." *Other People's Money*, p. 31.

[FN 9] When a corporation sells an issue of bonds it is the common practice to appoint a "trustee," usually a trust company, to act for the bondholders in enforcing their rights to the mortgaged property, should the corporation fail to meet its interest payments or default in some other way. Because the rights of the bondholders and the duties of the trustee are generally set forth in a legal document known as an "indenture," the trustee is often known as an "indenture trustee."

The study of Protective and Reorganization Committees conducted by Mr. Douglas at the S.E.C. revealed instances in which the rights of bondholders were endangered by faulty and loosely drawn indentures and by trustees who were lax or indifferent to their duties. As a result of these disclosures, Congress passed the Barkley Trust Indenture Act of 1939, setting minimum standards for trust indentures and minimum qualifications for trustees. See *Report of the Securities and Exchange Commission on the Activities of Protective and Reorganization Committees*, Part VI, "Trustees under Indentures."

[FN 10] For a fuller description of methods used by corporations to marshal the proxies of security holders, see the *Report of the Securities and Exchange Commission on the Activities of Protective and Reorganization Committees*, Part VII, "Management Plans without Aid of Committees."