BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

INFORMAL DISCUSSION OF RULE PROPOSED BY
THE INVESTMENT BANKERS ASSOCIATION AND
NATIONAL ASSOCIATION OF SECURITIES DEALERS

Room 1003,
Securities and Exchange Commission Building,
Washington, D. C.
March 10, 1941
10:30 a.m.

PRESENT: Commissioners Frank (Chairman), Healy, Eicher and Pike.

Messrs. R. McLean Stewart and
Emmett F. Connely, for
Investment Bankers Association

Messrs. Nevil Ford and
Francis Kernan, Jr., for
National Association of Securities Dealers

Messrs. Joseph L. Weiner, Director
Geo. Otis Spencer, Assistant Director
Roger S. Foster, Counsel
Leslie T. Fournier, for the
Public Utilities Division
Lawrence S. Lesser, for the
Legal Division
Edwin A. Sheridan

The Chairman: All right, gentlemen.

Mr. Stewart: Mr. Chairman, before we start I would like to say I discussed this matter with Arthur Dean on Saturday and he wished me to express to you particularly his regret that he is unable to be here today. He had to go to Oklahoma on business, had to be there until Wednesday and couldn't postpone it. He had once postponed the appointment there when it was thought we might come down here last Friday and he couldn't make arrangements to postpone it again. He did, however, ask me to say to you that if the Commission wished him to come down he would be at your service at any time after next Wednesday to discuss this thing with you in detail.

Commissioner Eicher: That is day after tomorrow?

Mr. Stewart: After Wednesday.

Commissioner Eicher: Wednesday of this week?

Mr. Stewart: Wednesday of this week, yes.

He really wanted to come. He thinks very highly of this proposal, as I think you know.

We feel, gentlemen, that this proposed rule which has been suggested to you is one that will work and that the industry will make work if you decide that you wish to adopt it. It is, as I think you know, the product of a great deal of thought and discussion on the part of the underwriting houses and of the Investment Bankers Association and the National Association of Securities Dealers, who of

course will speak for themselves.

The underwriting houses have not changed their position with respect to competitive bidding. They do not like it and they do not think it is in the public interest.

Commissioner Healy: I just question the good taste, if I may say so, of using an invitation to submit a suggestion for a rule here to restate all of the arguments in the letter that were stated in the public hearing, especially if it is contemplated that it should go into the record. There is nothing in the early part of this letter that you didn't say through your representative over and over and over again in those meetings.

Mr. Stewart: That is true, Judge Healy.

Commissioner Healy: Now, as I understood it, the purpose of this aspect of it was to give us your suggestions as to the kind of a rule you thought we might get along with in connection with cases where any affiliation was suspected.

Mr. Stewart: If I may say so, it is one of the faults of the democratic process that when you have groups of men who must be consulted you must be guided by what they think. It hasn't been easy to get an agreement on a problem of this kind and in order to get that agreement it has been necessary to condition it upon a letter of the kind we wrote to you. I am sorry it was necessary to write it, but otherwise it wouldn't have been possible to put the proposal forward.

Commissioner Healy: If, as you say, it is part of the democratic process, it works both ways and as a democrat I have the same right.

Mr. Stewart: Had I been able to decide what should have been done the letter probably would not have come to you.

(Off the record.)

Mr. Stewart: We did attempt to meet what the Commission had in mind.

The Chairman: I would like to ask two questions. I am not clear about it. Do I understand that you think that your proposal is better than the Rule U-12F-2?

Mr. Stewart: Yes.

The Chairman: That you think a rule on the subject covered by U-12F-2 is or is not desirable?

Mr. Stewart: We think it is necessary in view of the Act.

The Chairman: You think it is necessary?

Mr. Stewart: Right.

The Chairman: In other words, you think some rule by way of substitution for U-12F-2 is necessary?

Mr. Stewart: We think it is absolutely necessary that you have such a rule unless you amend the Act.

The Chairman: And, finally, do I understand that it is the opinion of the I. B. A. and its Counsel that the rule

which you propose is valid under the statute?

Mr. Stewart: Yes; definitely so.

The Chairman: I would like to ask as to that last question whether Counsel for Morgan, Stanley take the same position?

Mr. Stewart: I would say yes to that.

The Chairman: That they believe it is valid?

Mr. Stewart: Definitely so.

Mr. Connely: Yes.

Commissioner Healy: Do they support the rule?

Mr. Stewart: So do other counsel.

The Chairman: The reason I asked about Morgan, Stanley, I was thinking of the argument made by them as to the Rule U-12F-2 in the Dayton case and, without having studied that recently -- that was Mr. Brownell -- and not having read his brief or argument recently, it seemed to me it was inconsistent with the position that the rule that is now being proposed by you is valid.

Mr. Stewart: I think he should answer that himself; but certainly it can be said that Mr. Brownell has sat in on all the discussions on this matter, supports the rule and thinks it is a desirable alternative.

The Chairman: Before we go further, can I find out as to the letter you have written us -- I understand that the National Association of Securities Dealers is not proposing

any rule?

Mr. Kernan: The N. A. S. D. executive committee does not feel they have that authority without going to the membership.

The Chairman: Nor does the board of governors?

Mr. Kernan: Well, the board of governors -- we didn't have time to get them together. But the executive committee as such, with possibly one exception, as individuals think this is a very good rule. They didn't think that they could take a position for the Association without going to their members.

The Chairman: Mr. Weiner, can you let me know what was the date on which we closed our competitive bidding public conference?

Mr. Weiner: February 6th.

The Chairman: You had from February 6th until March 7th to present such a rule, the N. A. S. D. did.

Mr. Kernan: Mr. Commissioner, I am chairman of that N. A. S. D. special committee and I haven't had time to do anything else since then except work on this rule. It seems to me you have to approach one thing at a time. We have had considerable difficulty in selling this rule -- in getting agreement on a rule with all the leading people. I put it "leading" people; perhaps what you might call the biggest people.

The Chairman: Let me get some other dates. We had a conference many months ago at which Mr. Ford was present with a committee of the N. A. S. D. When was that?

Mr. Ford: I wasn't there. Yes, I know you did. It was last summer some time.

The Chairman: I thought you were there.

Mr. Ford: No, I wasn't.

The Chairman: It was a conference at which we discussed Rule U-12F-2. And at that time we were told that we would be given suggestions as to a substitute, so that perhaps I am being altogether too generous in suggesting that the lapse of time should be dated from the time when our public conference was held. It should go back to last summer. And to say that you worked ever since then on this rule --

Mr. Kernan: Well, I am talking about this specific rule.

The Chairman: Well, this rule was a proposed substitute for Rule U-12F-2 and this suggestion of a substitute goes back for many months.

Mr. Kernan: Of course we did propose a substitute.

The Chairman: Yes. And obviously you, yourself, think it is inadequate.

Mr. Kernan: I think it would be a good rule but the Commission apparently didn't like it and therefore it obviously wasn't practical.

The Chairman: At any rate, the invitation was extended by the Commission to the N. A. S. D. to suggest to us any substitute rule, and the fact is that we have nothing from the N. A. S. D. whatsoever. We have only a statement of what certain individuals think is desirable.

Mr. Kernan: Well, the special committee is unanimously for this rule and I haven't any hesitation in saying the membership would adopt it if the Commission wanted to put it into effect.

Mr. Ford: Let me state this. I am not attempting in any way to defend N. A. S. D.'s position because I perhaps have been as critical of it as you are, and properly so I think. I think much too much time has gone by but, as Mr. Kernan has intimated, this has not been an easy question to deal with, as you all well know, I think. An attempt was made to have the N. A. S. D. committee take official action on this matter. But the rule had to be formulated in the first instance and many people consulted. The committee has been working on it actively and the I. B. A. and many of us as individuals have been working on it.

The position that some officials of N. A. S. D. took was that this was a matter that affected so strongly certain of their members that they felt if they dealt with this suggested outline of a rule without giving them an opportunity to consider it, to use an expression one of them used, they were "playing with other people's chips" and therefore they should be given

an opportunity. There have been many divergent views. Out of that welter of discussion did come something which has been agreed upon by a substantial majority of the people affected. We don't think it is an ideal solution. As Mr. Stewart said, we would prefer to have things remain as they are. Recognizing the fact that they are not going to, we will agree on this. It was not possible to get that process finished in time to give the cumbersome N. A. S. D. time to function officially. The officers were kept advised as individuals and I think probably the decision these men made last Friday is the only one they could make, really, that under the rules and regulations of the Association they had no right to commit the Association until the matter had been discussed with all its members. Those are the facts, and this is more in the nature of explanation than of excuse.

The Chairman: May I ask if Counsel for N. A. S. D., Mr. Jackson, who appeared before us at the public conference, has expressed his views on the proposal?

Mr. Ford: His partner, who happened to be East, has been sitting in on this -- because necessarily we had to work fast -- so he has dealt with it.

The Chairman: Does he think this rule is valid?

Mr. Ford: I can't say categorically, but he has discussed it with Jackson and Hostetler and I believe they all do.

Commissioner Healy: I talked to Harold Stanley and the

last time he was very much opposed to this kind of a rule. He said frankly he would rather have a straight competitive bidding rule than this kind of a rule. Has he changed his position?

Mr. Stewart: He has given this proposal his support and I think I can confidently say that he sincerely believes it to be preferable to a requirement of compulsory competitive bidding.

Commissioner Healy: He seemed very sincere when he expressed himself before.

Mr. Connelly: There has been a lot of mental evolution in trying to get a meeting of minds. It has been quite a task and we really approached it from the standpoint that nobody could possibly get what they wanted and that everybody would have to realize they were meeting changing conditions and they would have to give something up. So I think maybe that accounts for Mr. Stanley's change of mind.

The Chairman: Am I correct there has been put in our record a suggested rule proposed by Dillon, Read & Company? Is that correct?

Mr. Fournier: That is correct.

The Chairman: And that is substantially different from this?

Mr. Stewart: It is a proposal for a retroactive definition or, rather, for a stipulation as to affiliates.

The Chairman: Yes.

Commissioner Healy: In the first place, you are trying

to reduce this to a determination of an affiliate by a formula, whereas the statute doesn't say "affiliate." It says a "person" where the relations are such -- it doesn't confine it to that. And then I notice, also, in this definition of "affiliate" here you have gotten into the question of control; whether one person controlled another inside of a certain period of time. Of course, this matter of trying the issue of control is just as difficult. I think you are just getting out of the frying pan into the fire.

Mr. Kernan: I think it should be made clear, Judge, that the definition of "affiliate" as here defined is perfectly satisfactory with the people in the industry who have been consulted but that that is not a necessary part of the competitive proposal rule at all.

The Chairman: I thought it was.

Mr. Kernan: It is optional with the Commission as to whether or not you want it.

Mr. Stewart: I think I said in my letter that the Commission might decide in view of the competitive proposals which are to be required that it would not be necessary to distinguish between affiliates and non-affiliates in the operation of the rule.

The Chairman: If we didn't adopt that definition of "affiliate" the proposed rule would require that we arrive at some other definition, that we arrive at a determination as to "affiliate" in some other fashion, would it not?

Mr. Stewart: No. Our feeling was that you would

have genuine competition between at least three registered dealers -- that is, between underwriters, -- or in other words that the competition of itself would establish the bona fides of the operation, and the question whether there was or was not an affiliation would not be important. We did, however, suggest the affiliate rule as a possible aid to the Commission in working the matter out.

The Chairman: Let me call this to your attention on the top of page 2 of the draft, it being (b)A, I gather it says:

> "The applicant or declarant at least _____ days before the filing of such application or declaration shall have invited at least three persons, including at least three registered dealers (of whom two shall not be affiliated with the issuer as defined in section 2(a)(11) of the Public Utility Act of 1935), to submit written proposals," etc.

Mr. Stewart: That is correct, sir.

The Chairman: Doesn't that require a determination of whether there is an affiliation, and by reference to 2(a)(11) you then come right back smack into the question of how we are going to determine.

Mr. Stewart: If you accept the rule as drafted, yes, but we put the rule forward, not as a definitive rule, but as a proposal for discussion.

The Chairman: Then if you dropped that parenthesis the result would be that the invitation would be to at

least three persons, all three of whom might in fact be affiliates.

Mr. Stewart: They may be, yes, but --

Mr. Kernan: That is really the reason I think there should be some protection against their all three being affiliates.

The Chairman: The minute you get into that question you are driven into some manner of determination by the Commission of whether they are affiliates and we come right smack back to our rule U-12F-2 or some substitute for it such as you suggested or some other, which then means that we are back to the administrative difficulty against which complaints have been directed by many persons of that determination because, as Judge Healy has pointed out, your proposal as to the definition of "affiliate," assuming it is valid, would bring up the very difficult question of control, which is a factual question and, therefore, involves a hearing and all that that implies in the way of delay and difficulty.

Mr. Stewart: This is an imperfect document but if that question is going to arise under it I think we should change this definition so it could not arise.

The Chairman: That is unavoidable.

Mr. Stewart: If you are going to have that administrative difficulty the rule --

Commissioner Healy: I don't believe you can get a rule that will work automatically when you rest the rule on the affiliation point. It is true there are certain types of affiliates that you can detect at once, but Congress very plainly said that there are certain types of affiliation that you can't detect at once and therefore it said that any "person" should be regarded as an affiliate who stood in such relation that there was likely to be absence of arm's-length bargaining. It didn't even say "affiliation" in that line and paragraph in that Act. It said "in relation." You have got to meet that some way.

Mr. Stewart: We think this rule automatically cures that. There is not going to be any possibility under it of someone standing in such a relationship to an issuer that there could be an absence of arm's-length bargaining.

Commissioner Healy: If the three people are affiliated, you are not going to get anything worthwhile out of this. This suggestion can only work on the assumption that the three people are completely independent of each other and of the issuer.

Mr. Stewart: It will only work if the competition is genuine and I am quite sure that it will be genuine.

Commissioner Healy: When you get down to your definition, it is my opinion that you attempt to state these are the only circumstances under which that relation can exist and there will not be any others. This does violence to the statute.

Mr. Ford: Isn't it possible to draw a definition of an affiliate from, call it a strict legalistic point of view, so that if there was clear affiliation by interlocking directorships or ownership, or anything of that nature, the Commission could determine easily and stop there. Perhaps I am mistaken in my approach. It seems to me the great difficulty facing the Commission is the borderline question, and to insure the maintenance of the competitive condition will be less difficult if you had a hard-and-fast affiliate rule, a legalistic definition. It seems to me probable you might not be faced with the difficulties you have in the past with such a rule as we have here, because with three people in the ring you are pretty well assured that there will be real competition.

The Chairman: If it is sure they are not all three affiliates. Suppose all three came within the, not what you might call the automatic definition of affiliate, but within 2(a)(11)(D). Now, there is that staring us in the face: How are we going to know that all three of them aren't? As I understand your rule it is this, that if you have two, then that will safeguard against the difficulties that we might otherwise confront. Very good. How are we going to make sure that one is? Your own rule contemplates that difficulty and attempts to solve it and, as the Judge says, it brings you right back and you come out where you entered.

Mr. Ford: Our feeling was, even though one invitee was an affiliate, he would be purged of the evil of that position

by the fire of this competition.

The Chairman: Suppose all three were affiliates or, as the Judge says, affiliates of one another. Suppose one is an affiliate and the other two are affiliates of that one. Then what?

Mr. Ford: What I was suggesting was, isn't it possible to draw a legalistic definition, let's say, that would insure you against real affiliates, leaving out of the question the emotional affiliates, a phrase that is in disfavor.

Commissioner Healy: You think you can get up a formula or a definition that will describe all the affiliations?

Mr. Ford: No. I won't go as far as that, Judge, but somebody ought to be able to evolve a definition of legalistic affiliation leaving those in the area of doubt or granted questions of emotional affiliation to the maintenance of competitive conditions through the process of this rule; evidence of competition by the fact that you have got three fellows in the ring.

Commissioner Healy: Congress wasn't able to do it.

Mr. Kernan: Well, they did it in the Barkley Act, of course, and they have done it in other instances.

Mr. Stewart: It seems to me this rule must rest on good faith. If everyone who is to be governed by it is going to try and give it the "run-around," it won't work; nor will any other rule. But I don't think there is any likelihood of that being attempted by anyone in the investment banking business or in the

public utility industry. I am perfectly certain that if a rule of this kind is adopted by the Commission you will find the public utility companies concerned will be very, very careful to make sure that it is genuinely applied.

I am also quite certain that the underwriting firms themselves will make the competition genuine. I think they fully recognize that this cannot be merely a gesture. It is a reality; and when it is put forward I am sure it is put forward in genuine good faith, with determination on the part of all concerned to make it work if it is adopted by the Commission. The competition under it will be genuine competition, which I should think would cure your difficulties as to any question of possible affiliation.

Mr. Connely: In any underwriter's mind, he knows certainly whether by the farthest stretch of the imagination he is either an actual or an emotional affiliate. Now, that being the case, it seems to me that question No. 1 he is going to ask Consolidated Edison, for example, is: "Do you think I am an emotional affiliate."

The Chairman: May I say for the record that I don't know what an "emotional" affiliate is?

Mr. Connely: Neither do I.

The Chairman: Congress didn't use the term. I don't understand it. It sounds to me like a slightly immoral relation. I didn't think that existed in the investment banking industry. (Laughter)

Mr. Connely: Anyone who had an idea that he might be in an affiliate category would immediately raise the question -- that is, anybody with sense. If he is, you can't ask two who are, without asking a total of four. You have got to have two who are definitely in their own minds, and can stand up under scrutiny of examination, not affiliates.

The Chairman: It seems to me that the Dillon, Read memorandum -- although I have difficulty with it on another score -- was much more realistic in this respect at least, that it recognized that we are up against the definition in 2(a)(11)(D) and that to avoid getting into the administrative determination of fact and law that is there involved, if this rule were to work, some method would have to be found. The method that it suggests is consent, but I would think that would be undesirable. It would mean that the Commission was putting a gun at somebody's head in compelling them to stipulate. That is the way it strikes me. I don't know how it strikes the rest of you. I think this would be a very unfair device.

Commissioner Healy: Somewhat the same idea is running through my head in this definition of "affiliate". First of all, you put a fellow under a cloud who had a preferential right and yet you don't say a word about the investment company which within the same years might actually have been responsible for the creation of the very company that he is dealing with.

For example, we come along and we find that one of the

City Service subsidiaries has a contract giving Halsey, Stuart preferential rights; we come along to the United Corporation and we find that Morgan and some associates created the corporation. They got it up; they brought it into being; they assembled the securities that constitute its portfolio and traded them in for securities, they controlled the distribution of preferred stock, what people could subscribe for the preferred stock -- I mean if there is any significance whatever as to affiliation flowing from one of these optional agreements, such as is described in your first paragraph, how about any such relationship as I describe now and which actually existed?

Mr. Stewart: Of course, our proposed rule only attempts a definition of "affiliate" as the condition exists today. The situation which you have described does not exist today. Our effort is concerned with a present-tense definition.

Mr. Weiner: Number one does --

Mr. Kernan: I don't think anybody has any objection to making that "affiliate" rule as complete as you want to make it.

Mr. Stewart: In a present-tense definition.

Mr. Kernan: As long as it is definite, yes.

The Chairman: The difficulty I have with a definition of "affiliate" is that I don't think we have any power to take 2(a)(11)(D), to crystallize it into rules which are conclusive in the absence of evidence. I don't think we can

say that just because a person had a contract with someone as your point one says, that that makes him an affiliate. That part of the proposed rule does bring in, Mr. Connely, this whole notion of "emotional" affiliates, which I don't think Congress ever intended was to apply and which I don't think we have any right to apply. When we have to find that a person is in a certain relationship, that is a question of fact, and I don't think we can lay down categorically that some specific act establishes that relationship. I don't think we have the legal power.

Mr. Kernan: If they were talking to more than one who was an affiliate they would certainly discuss it with you in advance. They wouldn't want to go through it and then find that two out of three are affiliates. They have got to be sure that there isn't more than one affiliate. You probably have got to have a 20-day period for discussion of plans before they file their declaration. They are not going to waste that time, they are not going to take a chance. As a practical matter they are going to be perfectly certain.

The Chairman: To indicate another difficulty I have -- I communicated it to Mr. Dean when we chatted about this -- I don't know how under this kind of a rule you could meet this situation: Investment banking house A, let's say, is an affiliate, determined to be so. It comes within the precise statutory definition of an affiliate. A is invited

as one of the bidders. B and C are the other bidders who are invited. What is there to prevent the issuer, A, and B and C having the whole thing set up so that A is really controlling the situation and that the bids are not real? Or that the deal is set up by A in advance in a way and with an understanding that will actually preclude competition by B and C? In other words, how can you prevent, under such a rule as this, no matter how you worded it, an understanding between the three invitees, a situation which I would think couldn't possibly exist if you had bidding open to everybody?

Mr. Stewart: I don't think you are right as to that, sir. When you get into compulsory competitive bidding for a security issue of large amount there is just as much danger of that situation arising, if it be a danger, as there would be under this other proposal of ours. There aren't so very many groups in this country with the capital to form accounts to bid for a hundred-million-dollar issue. You see that in the municipal field despite the fact that the banks are engaged in business as municipal dealers --

The Chairman: You had better analyze that argument because if that were so about the competitive bidding --

Mr. Stewart: I haven't said that it exists. I said that if there be a danger, it is just as real as applied to competitive bidding as it would be if applied to our alternative proposal.

Mr. Kernan: I don't think there would be an objection to including a statement that there had been no consultation with the competing investment banking houses and subject anybody to perjury.

Mr. Ford: Do you think as a practical matter, Mr. Chairman, that such a set of circumstances, collusion, could happen more than once? I think it wouldn't happen at all, but if it did it wouldn't happen more than once. The facts would all be laid before the Commission ultimately as the plans stating the proposals are to be submitted to the Commission for their consideration after the company makes its choice. When the selected proposal is received and others, and there may be more than three, you will have all the cards on the table before you and I think you could determine if there were any impropriety along that line, and you could certainly take steps to see that it didn't occur again. I shouldn't imagine any company would care, or if it cared would even dare, to engage in such a practice a second time. I shouldn't think it would be a real danger with which you would be faced. I gather that it would be theoretically possible.

Mr. Weiner: I would like to ask a question on this. If I understand the mechanics that would be employed under this rule, the actual bargaining for the price of the new securities would take place some time after the proposed managing underwriter had been selected?

Mr. Kernan: That's right.

Mr. Stewart: At about the time of the market offering.

Mr. Weiner: There would then be a situation that could develop comparable to that which we had in the San Antonio case. After the face of the securities was known, as they would be under this, any outsider could come along if he chose and offer a price.

Mr. Kernan: That is true in competitive bidding.

Mr. Stewart: We hoped that you might be able to change the rule so as to prevent that occurring. Our proposed rule is not based on competition as to price but under it there would always be genuine competition as to spread.

Mr. Weiner: But never any competition as to price.

Mr. Stewart: Not as to price. But there would be competition as to spread and competition as to management fee. What possible competition as to price could be had at a time weeks in advance of the contemplated public offering? Some irresponsible fellow might say, "I will pay you so and so for it." But if he doesn't have to put cash on the line when he makes his offer it wouldn't mean a thing.

Mr. Weiner: Suppose some responsible person came along?

Mr. Kernan: You are talking about after everything is set for the actual issue of the securities? The same thing occurs in competitive bidding. You can't foreclose anyone coming in and making another offer.

Mr. Weiner: Yes. I would say two things: First, the period would be probably shorter but, more important, I would

say that there is a pretty general consensus of opinion that where everyone has had an opportunity to bid simultaneously the issuer or buyer is not only justified but is rather under an obligation to disregard anybody's second thought on the subject. There is a general feeling of condemnation of the man who has either made a second or third bid and then attempts to put the first bid after they are all disclosed, hoping to get it at a lower price but bidding what he was prepared to bid in the first instance, or stay out of the bidding entirely, letting everybody else run the risks of it and finding out the price after the highest bid was made was such that he could still top it and make a profit. Under those circumstances, typical in all municipal bidding as I have seen it, which hasn't been very extensive but not inconsiderable, the man who comes along with a later bid was just out.

Mr. Stewart: Because the law governing the sale of municipal securities in most cases specifically requires that the issue shall be sold to the highest bidder who puts his bid in through a certain prescribed procedure.

Mr. Weiner: Yes. And the general moral situation, besides that law, so that there will be no incentive to try to make a departure, those laws have stayed on the books. People have thought that that was right and consequently and without any misgiving you disregard those later bids.

Mr. Stewart: There is a marked distinction between municipal finance and corporate finance. There are no

stockholders in a municipality who can bring suit against the management for selling a bond to the highest bidder pursuant to a law of the state which directs that it shall be so sold. It is a different matter in corporate finance.

Mr. Weiner: Precisely. But I still think that in corporate finance that result would be obtained. And we have also had a great deal of municipal competition in contractual work which was not compulsory. It was adopted as a safety measure on the basis of the same rules adopted in a state and where a taxpayer's suit could be brought.

Mr. Stewart: Suppose you did put your competitive bidding rule into effect, after the issuer had advertised for and received bids what is to prevent underwriter X from coming in after the fact and saying, "I will bid one point higher than your highest bid"?

Mr. Weiner: Nothing can prevent that, but how would you as an officer of an issuing corporation regard the problem of rejection of a bid under the circumstances?

Mr. Stewart: I think that unless there is some way of foreclosing the matter by rule it would be no less difficult to reject a bid under your proposed competitive bidding procedure than under the circumstances that arose in the San Antonio case.

The Chairman: As I understand it, in ordinary competitive bidding in whatever field it has been employed, you have a deadline.

Mr. Stewart: By law -- in the case of municipal finance -- the state law specifically provides.

The Chairman: Now, it seems to me that the person making the offer, whether it be an issuer or a city or what-not, governmental agency, or if it be the Federal Government, is amply justified in acting on the basis of the bids submitted by a certain date and can say that that is the guiding rule on the subject and after that date has been closed I don't have to consider other bids, and he is morally and legally protected in those circumstances. Whereas you have the sort of thing you had in the San Antonio case and the poor issuer is in a miserable position. The officer, Mr. Wolfolk, was in a terrible position. He got bids every minute and he didn't know when he could close his deal. I suppose if he waited a week longer he would have gotten even higher bids, but he had to saw off some time, and he did. I think that kind of competition is highly undesirable.

Mr. Stewart: So do I.

The Chairman: I think it puts the executive of the issuer in an impossible position and I don't think it is fair to the banking house if it is acting in good faith. It has made an offer and worked for months on the deal. But from that kind of competition we can't protect issuers and investment bankers; there is no possible way except through some competitive bidding rule. The difficulties that you depict might arise just as much under your rule. In other words, a last-minute offer could be

embarrassing theoretically to an issuer even if you had your rule.

Mr. Stewart: Unless your rule made it clear that the issuer after he had gone through this process of competition was free morally and legally.

The Chairman: That's right. I assume any competitive rule, whether of the kind the staff proposed or the one you are proposing, should provide --

Mr. Stewart: Should so provide.

The Chairman: I think you are again going to be in kind of hot water.

Mr. Stewart: I don't argue against such a provision. I do, however, emphasize my view that the difficulty arises under the proposed competitive bidding rule as well as under the proposed rule which we are discussing this morning.

Mr. Weiner: That is what I fail to see.

Mr. Kernan: Suppose you had competitive selling and bids and after the bids were let somebody offered a point higher. Now is the issuer protected?

The Chairman: Because I think the existence of a rule itself, an appropriate provision, would be a protection because it would have shown appropriate diligence and good sense in stopping short at some point.

But, as I get Mr. Weiner's point, if you limit it to three -- is this your point?

Mr. Weiner: Yes.

The Chairman: That since you haven't then given everybody a right to bid, you can't say "I fixed a certain date. I can't go on forever listening to everybody, but everybody had a chance up to this date." It seems to me he is amply protected if there is open competitive bidding. But where he has only three people, of which one may be an affiliate, then he can't say he has made a best effort up to a certain date to get the best bid.

Mr. Weiner: May I add that under this rule these three people have never even as among themselves had the occasion to say what the particular securities should sell for or what they were willing to pay for them. The proposals may be entirely dissimilar and investment banker A whose suggestion as to the type of securities was rejected might be perfectly willing, for all we know to the contrary, to pay a far better price on the type of securities that were accepted than investment banker B who proposed it.

Mr. Kernan: We have gone on the theory that the question of the actual price has not been of great concern to the Commission and more attention has been given to determine whether or not the price arrived at is fair.

Mr. Ford: It would be possible under this rule to insert price as a requirement. That idea was abandoned for the reason that many people felt that submission of price as far in advance of the probable sale date as would occur under the set of circumstances provided for by this rule

would be totally inconclusive. Really, you would have to put the price in here some twenty days, or more probably a month, ahead of the date at which it might reasonably be expected the securities would be sold to the public and that price could give only an indication of what the eventual offering price would be. It wouldn't be very conclusive.

Mr. Kernan: Of course, there is nothing to prevent the issuer, if he wants to, getting before the time of the issuance price ideas from any or all of these three people if he wants to do so. He has got at least three people completely familiar with it, people who have studied it, and there is nothing in the world to prevent him discussing it with any or all of the three if he wants to. Furthermore, as far as any responsible firm not having a chance, I should think the issuer would be in a pretty indefensible position. For instance, Halsey, Stuart, if they said they would like to make a proposal on the securities they were qualified to submit one on, I should think an issuer would be in a pretty indefensible position if he refused to let them submit a proposal.

Mr. Weiner: But that has happened in a number of instances in the past year.

Mr. Ford: There has been no such rule as we suggest in effect.

Mr. Weiner: I am at a loss to see what difference the rule would make. I should think the rule would strengthen the issuer's stand because he feels that he has complied

and Halsey, Stuart are not one of the fellows selected.

Mr. Ford: The rule says at least three.

Commissioner Eicher: Does anybody know whether Halsey, Stuart have submitted any views?

Mr. Stewart: It hasn't been discussed with them.

Mr. Kernan: I should think they might like it.

The Chairman: As I recall, when Mr. Dean was down here somebody -- Mr. Pike or somebody -- asked him what Halsey, Stuart thought of it, and he said he would find out. I am not sure that he said it just that way.

Mr. Sheridan: The way he put it was that "I would be very glad to ask Stuart." That is exactly what he said about it.

Mr. Stewart: I don't think that has been done so far.

The Chairman: You see, one of the suggestions made in that informal discussion by someone was that the rule should provide that at least one of the persons invited to bid should be a banker in the region. Objection was made to that by Mr. Dean, who pointed out several objections, but it was pretty obvious that the person who made the suggestion was thinking of a situation where the utility was located, let's say in and around the Midwest, and in those circumstances the idea of the person who made the suggestion -- I have forgotten who it was -- was that Halsey, Stuart ought to get a crack at it.

Mr. Kernan: I don't think there is any objection on the part of any one I have heard discuss it in the industry. I think Dean brought it up from the point of view of the utility companies who might be forced to talk to some local underwriters who might not have the capacity or the experience to handle large issues, and you would get the thing to a chamber of commerce, say in the City of Omaha, and it would put the utility in a very embarrassing position. I think if that could be limited in some practical way to a situation where you had to talk to any issuer who was qualified from the point of view of capital in the business --

The Chairman: You mean underwriter?

Mr. Kernan: Yes.

Commissioner Healy: What do you mean by "qualified from the point of view of capital?"

Mr. Kernan: I mean if Commonwealth Edison were financing. Halsey, Stuart would be qualified to manage an underwriting for them. They have the capital and the experience.

Commissioner Healy: I don't quite get your point as to capital. What difference does it make as far as capital is concerned? Does it make a difference if it is Commonwealth Edison?

Mr. Stewart: The capital of the underwriter, not the capital of the issuer.

Commissioner Healy: There have been any number of these cases that we had where the capital of the underwriter was less than the amounts underwritten.

Mr. Ford: I think we know they have people and departments who know how to handle deals. What we are fearful of if competition is opened up wide is that some irresponsible Joe Zileh who had an ambition to buy a deal and wouldn't know how to handle it properly might through force of circumstances be high bidder, which wouldn't be fortunate from anybody's point of view.

Commissioner Healy: I don't see the distinction between someone with a million dollars underwriting $20,000,000 and someone with $8,000,000 being a principal underwriter of a $200,000,000 issue.

Mr. Kernan: There is this distinction. After all, a managing underwriter has to negotiate the price. The other underwriters are very much interested in going along if that underwriter has his capital at stake in thinking those price ideas have been well studied.

Mr. Stewart: It seems to me the capital of the underwriter has to be related to the commitment which he takes as an underwriter. If you have an underwriter with 7 or 8 millions of real capital taking an underwriting of $5,000,000 there is no question that his capital is adequate to his commitment. If you have an underwriter with $300,000 capital taking an underwriting commitment of $5,000,000 there is grave question whether his capital is adequate.

Commissioner Healy: Leading underwriting houses in

this country have been doing it right straight along.

Mr. Stewart: Speaking for my own company I can assert that our capital has always been adequate for our commitments.

Commissioner Healy: I have seen underwriters go through here where the amounts underwritten were far in excess of the capital of the underwriter.

Mr. Stewart: I think it should be related to the underwriting participation.

Commissioner Healy: I don't think there is much of an argument on this capital point. Personally, I don't believe the kind of underwriting we are getting in this country at the present time is based upon giving the issuer an assurance that he will get his money. I think the underwriter must become a good distributor

Mr. Stewart: I think that is a fallacy, but I know that has been your view.

Mr. Kernan: I agree with you.

Commissioner Healy: It seems to me that is all there is left of it.

Mr.Stewart: There has never to my knowledge been an underwriting contract signed where the issuer wasn't sure of getting his money. There was no question about Bethlehem Steel getting its money in 1937. It got it right on the line despite the fact that many underwriters lost money on the transaction.

Commissioner Healy: You boys have seven or eight "conniption fits" if the issue doesn't go out the window like a skyrocket.

Mr. Stewart: We don't like to lose money.

Commissioner Healy: Of course you don't. And your capital is so restricted that you must want the stuff to be sold quickly; otherwise it is a failure. If you had real underwriting that isn't what would happen.

Mr. Stewart: I am sorry, but I think you are mistaken as to your views about underwriting.

The Chairman: I would like to go into this underwriting by Zilch, Zilch and Zilch. It seems to me the answer there would be that if such a house made an offer under a competitive bidding rule properly worded -- and I think the staff rule has such a provision -- if the issuer could come to us and say, "We are not going to take the highest bidder," he wouldn't have to take the highest bidder; he can say, "We are rejecting this bid, even though it is seemingly on the surface the best, because it is obvious that this fellow can't do the job." And any rule that didn't have rubber in it enough to permit that would be absurd because I doubt if even Mr. Zilch could set up a deal to make a sensible bid.

But suppose he did get some fellow with brains, an astute fellow that knew how to set up a deal but he sat in a little shop and had no contacts or capital for setting up proper syndication, well, they will just say, "You see, this is just an organization that can't handle the operation," then that would be ample justification for rejecting such a bid.

Mr. Kernan: I don't think you will find anybody in the industry opposing some practical rule that required taking people in the locality served by the issuer

if there was something to protect the utility companies from doing business with somebody who couldn't do the job.

Mr. Sheridan: Suppose you took Federal Reserve districts, I think you could phrase it some way so that it would give you the region in which the utility operates principally.

Mr. Stewart: It would be wholly unrealistic because of the fact that the bonds are not sold in the district in which the utility operates. If a company out in St. Louis floats an 80-million-dollar issue you can be perfectly certain that the bonds won't be sold in Missouri.

Mr. Sheridan: We had a case of Consumers Power where the allotment for the Michigan area was suddenly raised by several million dollars, proving that additional securities could have been sold in that region. There was an appetite for them.

Mr. Connely: I believe that the increase in the underwriting allotted to Michigan dealers was $1,000,000 exactly.

Mr. Ford: Did you trace the ultimate resting-place of those securities, Mr. Sheridan?

Mr. Sheridan: No.

Mr. Spencer: Let's take Consumers Power Company as an example. Assuming this rule was in effect and they had gotten three proposals, one proposal for 28 million of bonds and 3 million of common stock, the second one would be 18 million of bonds, 10 million of common stock to the public and 3 million of stock to the holding company, and the third bid was another combination. Now, the company, if it did

what it did, would have accepted the first bid of 28 million of bonds. And we came down to this Commission and the Commission said, "That does not meet the standards of Section 7." What happens then?

Mr. Stewart: You mean?

Mr. Spencer: How does your rule work under this rule? We have followed precisely what you have said and followed the Commission's rule. The company has gotten a bid that this Commission won't approve.

Mr. Stewart: I suppose as a practical matter most issuers would come down and see you beforehand as to what were the chances of the plan being approved and if a particular plan is not going to be satisfactory to you they probably wouldn't accept that.

Mr. Spencer: What we propose in our rule is that everybody bids on one.

Mr. Kernan: Your suggestions to the utility will run along the lines in most cases of "We suggest additional common and/or preferred stock." For instance, I mean you won't say it ought to be 10 million common and 5 million preferred because you want to know what the market is.

Mr. Spencer: But in our competitive bidding rule the issue is fairly crystallized before any bids are asked for.

Mr. Kernan: Judge Healy has always raised the question of the "competition of brains," and he said that under the

present system you don't get it.

Mr. Spencer: You don't get it because nobody comes in under this rule. You had the competition before they came down here.

Mr. Kernan: Yes, but you have had at least some assistance in getting the ideas of several men who are qualified to know what markets are.

Mr. Spencer: This rule might put the Commission in a very serious position of a company having gotten a proposal that wasn't entirely satisfactory to the Commission.

Mr. Kernan: But it isn't made public. It comes down to you, these proposals come down to you.

Mr. Spencer: Then do we say, "Do it all over again?"

Mr. Kernan: You may say, "At least you have had competition on the spread and management fee, which is the principal --

Mr. Lesser: But you had different proposals. You had one for stock and one for bonds, one for bonds and one for stock, and your proposals as to price and as to spread aren't comparable.

Mr. Kernan: The utility comes down with three different proposals and you say, "I don't like them" or "I like a combination." Here is a situation --

Mr. Spencer: The point I am getting at is what happens?

Mr. Kernan: You have got three people that are in a

position very quickly to give their ideas on price.

Mr. Spencer: Do they compete with each other?

Mr. Kernan: Certainly.

Mr. Spencer: Would you get competitive bidding for ideas, then having decided on the plan, let the three bid against each other on the price?

Mr. Kernan: Bid against each other on spread and management fee.

Mr. Spencer: Then all you have done is, having crystallized the issue, reduced the competitive bid to three people instead of ten people. You are right back where we started.

Mr. Kernan: Yes, but you have satisfied the requirements of the Act.

Mr. Spencer: You do if you have competitive bidding.

Mr. Kernan: No, you would have competitive bidding that has a lot of objections surrounding it.

Mr. Spencer: You are getting precisely to the same place.

Mr. Kernan: No. You would have your competition on spread and on the management fee.

Mr. Spencer: Among three people.

Mr. Stewart: Or more.

Mr. Sheridan: Why did you take three?

Mr. Kernan: Just for the convenience of the issuer. If you like five it is all right with us. It is going to

come to a question of competitive bidding on everything except price, and there may be some tendency to use the other person to negotiate price.

Commissioner Eicher: There is another objection that I don't believe has been mentioned. I have difficulty with the final application of the exercise of the Commission's jurisdiction that this rule contemplates; namely, the invitation to the Commission to determine whether or not reasonable managerial discretion has been exercised and good faith exercised in the selection of the three underwriters. Now, it is notorious, of course, that good faith is one of the most difficult standards. It is hard enough for courts and juries, but it is doubly hard for administrative bodies in arriving at factual determination. Then this invitation to us to exercise reasonable managerial judgment, or to determine whether it has been exercised, seems to us is an invitation to us to go into a field which we have been seriously criticised for entering in the past. I think Mr. Connely, for one, hasn't "pulled his punches" for entering the field of managerial judgment. Here is an express invitation to us to do so.

Mr. Kernan: The real purpose of that catchall is where you have had competitive statements made on spread an on management fees, obviously, if they get somebody that

will do the job for 25 or 35 thousand dollars and they pick somebody that is going to charge a hundred thousand dollars, and were going to give them a hundred thousand dollars, I think that is pure bad faith. Those facts will be right before you. It is a perfectly simple matter.

Mr. Spencer: Let me get back to what you said. That is, we have three proposals submitted.

Mr. Kernan: Yes.

Mr. Spencer: This Commission refuses to approve that proposal. That is your Consumers case right over again. This Commission says, "No, we won't have all bonds. It must be bonds and common stock." Now what happens? One fellow has bid on bonds and common stock. The company has selected bonds and we say, "You can't have bonds. It must be bonds and common stock." Now, does that mean that you give it to the other fellow and the two other men that had bid on different competition are out? Does it come back and we say, "You can sell bonds and common stock and you three fellows bid on that combination of securities?"

Mr. Kernan: I would think the company would then go back to A, B and C, the three underwriters, and say, "Here is the plan the S. E. C. is going to permit us to do and we are going to go ahead with it." We and the S. E. C. have had the benefit of your ideas on the plan in the "competition of brains" and so you want to know what will be the underwriting spread and the management fee on 10 million of

common stock and 8 million of bonds.

Mr. Spencer: The only difference between that rule and the one we propose is you have two competitions instead of one.

Mr. Kernan: The second competition is really part of the first. It doesn't take any time.

Mr. Ford: Mr. Chairman, we were discussing a few moments ago the possibility of regional financing. I showed some of the gentlemen at this end of the table some charts my firm has prepared showing the distribution of two issues. One of them happens to have been an issue sold at competitive bidding and the other one was a negotiated deal. They are not greatly significant because they are only two deals, but they are interesting in illustrating the way bonds settle around the country under the distribution process. I am having prepared for my own use, and would be glad to submit to the Commission if you want it, an average chart running back over all the pieces of business my firm has handled over the last four or five years, which would be far more significant than these two isolated instances. If these two would be of any use I would like to submit them.

The Chairman: We would like to have them.

(Two map charts were submitted.)

Mr. Stewart: It seems to me they are charts indicating

the distribution to dealers and not charts indicating the ultimate distribution to investors, and that fact should be kept in mind.

There was some mention made recently of the distribution of Consumers Power. The fact that additional amounts were given to dealers in Michigan does not mean that investors in Michigan became ultimately the holders of these bonds.

Mr. Weiner: Is that correct, that these charts show distribution to dealers rather than to the ultimate purchaser?

Mr. Ford: I think they reflect both.

Mr. Sheridan: The converse is also true, is it not, that the amount allotted the Michigan investors might well have ultimately taken more than the amount allotted to Michigan dealers?

Mr. Stewart: I don't think so. I have studied that subject and a great many statistics and I have never found any evidence of that.

The Chairman: Well, there is something in the T.N.E.C. record, I happen to know, a letter -- I don't know as of what date -- from one of two partners in an underwriting house to another, with reference to distribution in St. Louis. As I recall it, it indicated that they were going to give a small amount to St. Louis dealers but the originating house was going to handle the bulk of the St. Louis business themselves; so that it might well be that there would be more bonds sold in St. Louis than had been allotted to St. Louis dealers.

Mr. Sheridan: I think that must be so.

Mr. Connely: I know from experience that we have had as to Michigan distribution in Detroit Edison, and it goes back over a great many years, where we have been one of the underwriters, that we are always consulted to see how many bonds we actually think the Michigan market will take by Michigan dealers. I think there are a lot of Edison bonds probably sold in Michigan by others than the syndicate.

The Chairman: For instance, from Chicago.

Mr. Connely: Yes. But we try very hard to say that Crouse, and Watling & Cray, McFawn and others can distribute a certain number of bonds. We have got quite a long time of experience. We know, for example, we can go back to 1932 and see whether they took the bonds that were then given them and if the bonds came back through the syndicate manager as unplaced or having been picked up in the over-the-counter market. And you do get a basis of judgment. Now, I assume that other areas are treated somewhat in the same way by the principal underwriter consulting a local underwriter and getting his judgment on it. We know that the Michigan market is good for about so many Detroit Edison bonds year in and year out.

Commissioner Pike: I didn't see any room for the poor insurance company in this rule.

Mr. Stewart: Yes, there is, definitely. The insurance

company can put a proposal in.

Commissioner Pike: They can be asked by the issuer?

The Chairman: Are you speaking as a guardian of the insurance companies?

Commissioner Pike: I have to speak a good word for them.

Mr. Stewart: (A), at the top of page 2, says that the applicant shall have invited at least three persons, including at least three dealers; so that might include three insurance companies as well.

Commissioner Healy: What is the magic in "three?" Why did you make it three instead of five or six?

Mr. Stewart: No magic.

Mr. Kernan: We would have made it five except we thought the utility wouldn't want twenty people marching around and going over their books.

Commissioner Healy: You were very careful to see that at least three registered dealers were in the thing.

Mr. Kernan: That is so you couldn't have just one dealer and two insurance companies.

Mr. Ford: A simple, forthright statement.

Commissioner Eicher: In order to have an insurance company in the picture you would have to make it at least four.

Mr. Kernan: As a matter of fact, you could exempt insurance companies in (a)(5) of the first page, so we really haven't got at them. You can exempt them there.

Commissioner Healy: We ought to go on and encourage private sales and fix the investment banker so they won't get any --

Mr. Stewart: That definitely is not our view. Our view is that this applies equally to insurance companies.

Commissioner Healy: Why didn't you put in (A) at the top of page 2 at least three of them must be insurance companies?

Mr. Kernan: There is no holiness about that word "three."

Commissioner Healy: Let me ask another question. We are having a little fun with words. I want to get over to this affiliate thing on 4. Assume it is No. (1) and your X years has some virtue in it, what would you think the reaction would be if you expanded that to the point where it includes the persons who were responsible for the creation of the company that you were dealing with?

Mr. Stewart: What basis in law could there be for that?

Commissioner Healy: What basis is there for this one?

Mr. Stewart: We are dealing with the proposed present tense definition. The basis for it is that it is a reasonable rule. Lawyers tell me that if you reach back ten years the proposal becomes unreasonable.

Commissioner Healy: You have reached back. You have started by saying any person who in those years prior.

Mr. Stewart: Let's say six months, then, or --

Mr. Kernan: I don't see any objection to making it as stiff as possible.

Mr. Weiner: The first I have heard of this rule, I

might say, the suggestion, as I understood it, contemplated ten years in that blank.

Mr. Ford: The original consideration was a retroactive rule, but all the lawyers told us there was no basis in law for a rule --

Mr. Weiner: The 10-year suggestion came from Arthur Dean.

Mr. Kernan: He said if you went back to the date of the passage of the Act that that might be all right.

Mr. Foster: Have any holding companies been promoted since the passage of the Act?

Mr. Kernan: Anything that is legal. We don't care what it is.

The Chairman: Someone might surmise that it is that provision that has induced the Dillon, Read counter proposal.

Commissioner Healy: Suppose you expanded this No. (1) to include a person who had created or promoted -- I am not trying to indicate language now, but an idea -- persons who were responsible for the creation of a corporation, expand the application of your paragraph (1) as between that person and the corporation so created and its affiliates, and then assume that any of the statutory type of affiliation that is under 11(a), (b) and (c) had existed within some shorter period that might be named, a year or two, how do you think that would do in your ranks?

Mr. Stewart: I think they would prefer open competitive bidding to that in a great many cases. If you are talking

about United Corporation, as I think you are because that is the specific case that was mentioned earlier this morning. I am quite sure that the underwriters concerned would not be prepared to accept such a rule.

Commissioner Healy: You say I am talking about Morgan and the United Corporation, and I am. Of course, there are other instances of investment bankers who created holding companies. Who are you talking about? Persons who have options?

Mr. Stewart: I don't think there are any such contracts in effect at the present time.

Commissioner Healy: But there have been within "X" years.

Mr. Stewart: The "X" represents sloppy drafting. I mean leaving it there. It was not intended to mean "ten" years; it was intended to mean "blank" years.

Commissioner Healy: It doesn't mean anything if there aren't any in effect. The rule doesn't have anything to apply to.

Mr. Stewart: I think I can tell you who has had these optional purchase contracts within the past ten years: Halsey, Stuart has had certain of them.

Commissioner Healy: Yes, Halsey, Stuart has or had; and they haven't been consulted about the effect of this kind of a rule that puts them under the cloud of "affiliate." But it seems to me that kind of a setup, resting on an old option so far as affiliation is concerned, is far less significant than the relation that grows out of the fact that the

investment banking house created and promoted and sold the holding company.

Mr. Stewart: I agree with you. But let me say, speaking for the Securities Acts Committee of the Investment Bankers Association, which I represent, that the "X" in the draft rule is not intended to represent ten years at all. Our view is that there should be a present-tense definition in the rule so as to prevent a man who is on a board jumping off, underwriting an issue and then going back on the board.

Mr. Weiner: This rule, as I understand it, was canvassed considerably and discussed before you submitted it. And I assume that in the course of that discussion one of the things that undoubtedly cropped up at all times was, who would be affected by that rule?

Mr. Stewart: Yes.

Mr. Weiner: Can you name any person in a position of an underwriting house who would be an affiliate under your definition?

Mr. Stewart: At the present time?

Mr. Weiner: Yes, under this definition.

Mr. Stewart: No. I know of no one who would be.

Mr. Weiner: So that the whole rule is simply --

The Chairman: Let me see if I understand that. Then, if that be true, you have this consequence, that you have a rule which indicates that one of the three persons, if there are three, is not to be an affiliate. Then you define

"affiliate" so there will never be any such person?

Mr. Kernan: I don't see why in that case, on the basis of this competitive proposal rule, you can't put in the "affiliate" definition anything you want, make it as strict as you want. I would include anybody who organized a holding company, sure; I think they should be included.

Mr. Ford: That rule is designed as a present-day rule.

Mr. Kernan: Do you think, Mac, there would be any objection to putting in a retroactive rule?

Mr. Stewart: Yes, I think there is very strong objection to a retroactive rule. I think there is no objection to putting in a hard, strong present-day rule.

The Chairman: And do you think that by some inadvertence you have brought us in a retroactive rule?

Mr. Stewart: Yes, that is true. We intended to leave that provision of the proposed rule blank, and our intention in I. B. A. was to suggest, say, one year to provide for a situation in which a man might resign as a director today, handle an issue tomorrow and go back on the board of the issuer the next day.

The Chairman: As you construe your own definition of "affiliate" it would not include the person who would come within 2(a)(11)(D)?

Mr. Stewart: I don't know that there are any such underwriters at the present time.

The Chairman: Well, if that is so?

Mr. Stewart: I don't know that there are any such affiliations existing today.

The Chairman: I want to restate my question. Under 2(a)(11)(D) there may be persons who, because of historical relationships, are affiliates. We haven't found any case which we might --

Mr. Stewart: The Byllesby case is the only one we know of.

The Chairman: We have two cases pending, and let's assume that we were to decide that in one or the other of those cases such a person was an affiliate. In those circumstances there would be limitations upon that person's action. The proposed rule would completely limit the activities of such a person or, to put it more specifically without indicating what our decision is, suppose that the Commission were to find that Morgan, Stanley is an affiliate of Columbia, and in the Consumers Power case that it is an affiliate of Commonwealth and Southern -- let's suppose we had made that determination and then we adopted your rule. Morgan, Stanley for purposes of bidding under this statute would cease to be regarded as an affiliate.

Mr. Stewart: Unless they prove to be an affiliate within the meaning of this definition.

The Chairman: You say they wouldn't be.

Mr. Stewart: I don't think they would be. That is merely my opinion.

The Chairman: So that means that we would abandon 2(a)(11)D in so far as it affected the question of underwriters with respect to securities.

Mr. Stewart: If this rule is not sufficiently farreaching in the present tense we would be perfectly happy to make it much stiffer in the present tense. We don't recommend a rule that would go back ten years.

Mr. Weiner: The difficulty is this: When you say "in the present tense" you are shifted back to Rule U-12F-2, which deals only in the present tense but makes it a question of fact. In other words, I think your proposal to make it comprehensive in the present tense would have to read right back to the language of the statute and of the existing rule, which brings us back to the difficulties which I thought this setup was intended to get away from.

Mr. Stewart: We don't see what the difficulties would be here.

Mr. Weiner: We are not saying there are difficulties here but, as the Chairman pointed out, the difficulty is not in what you have put in but rather in what you have omitted, and your suggestion that we go back to what you have omitted gets us right back to where we are today.

Mr. Stewart: I think not. It seems to me what the Commission is seeking to get is more competition. The Chairman on occasions during the competitive bidding hearings said that the Commission was not principally concerned about

price and spread. We were very much impressed by the discussion between Judge Healy and Mr. Kellogg at one time during the hearings, in which Judge Healy asked Mr. Kellogg if he didn't think that it would be desirable to have a procedure under which an issuer went to two or three underwriters and got their views as to the kind of setup most suitable to the issuer -- had available to him the "competition of brains". That is where we got that phrase in here. We think that that kind of real competition, and it would be real, would fully dispose of the question of affiliation. So that the question of affiliation is not important to this rule.

Mr. Weiner: I was going to say, without disagreeing with anything you have said, the logic of your position is that the whole provision as to affiliation is really superfluous. It adds nothing to what you have proposed and if you dropped out the parenthetical clause in the first part of your rule you would really be expressing what you are proposing.

Mr. Stewart: We think we would still have a very sound rule, a rule that would guarantee very real competition.

Mr. Weiner: Well, you would have a rule which in fact departs in no real sense from the rule you have proposed.

Mr. Stewart: I think not.

Commissioner Healy: It seems to me that may not be entirely so because this kind of a rule will not work from anybody's point of view if the people who accept the invitation are affiliates of the issuer or of each other.

You will get no real "competition of brains" under those conditions, or any other kinds of competition. Suppose we struck out completely your definition of "affiliate" -- it begins at page 4. Then we turn back to page 2. At the top of your page, under (A), we find a reference to affiliates.

Mr. Heiner: Mr. Stewart will strike that.

The Chairman: He would strike that.

Mr. Kernan: I don't think you can do that under the Act.

The Chairman: The minute you say you have got to, then you come right back to a determination under D.

Mr. Kernan: I think there are several ways under the statute that you could meet that. You could meet it by changing it from three to five, because there isn't any company that could have three affiliates on any basis.

The Chairman: If the number is sufficiently large you approximate competitive bidding. If you said twelve you might just as well have open competitive bidding.

Mr. Stewart: Much better.

The Chairman: You have almost got it, then. I am just thinking out loud.

Commissioner Eicher: You haven't got it as well as in competitive bidding because you would have twelve different plans.

The Chairman: Assuming that difficulty is out -- I am just again thinking out loud -- if you did say that with respect to issues over a certain size, and if the Commission

would be satisfied with six bids, it may be that you would have the equivalent of competitive bidding there because on the issues over a certain size it may be -- I don't know -- that there are not over six that would bid in any event.

Mr. Stewart: You are talking about competitive bidding now?

The Chairman: No. I meant that if you said on an issue of over a hundred million dollars there need only be six bidders I suspect you would arrive at the same result as competitive bidding because there probably aren't over six that could bid. Is that right?

Mr. Ford: I think that is a fair statement. It might not be six if you had an issue of a hundred millions.

The Chairman: It just occurred to me as a possibility -- I don't know if there is anything in it -- that might have some sort of a staggered system, if that would make you feel any better.

Mr. Kernan: I think the way it will work practically is that an issuer is not going to go through all this dressing-up period and spend all this period of time unless he is darn certain that he hasn't got more than one person you people down here consider might be an affiliate.

Commissioner Healy: I wonder in how many of these instances the invitation would be accepted? Suppose you said five persons. How do we know that anybody except one or two would make any kind of bid?

Mr. Ford: I believe there would be the most intense competition for invitations. People are already laying their plans that know of this proposal here.

The Chairman: You could facetiously put another way what you have said, that the result of all the discussion is that the Street is thinking maybe competitive bidding may not be so bad, maybe a little competition might be fun.

Mr. Connely: There is a good deal of confusion in the minds of the industry on this and they have given it a lot of thought. There are many firms that have agreed to this that obviously are giving up something that they now have, particularly firms that have never in any way been accused of being affiliated, but in the interest of the development of competition in the business, and the development of "competition in brains" in particular, that they would like to see the Commission try this out, polish this rule up if necessary, but give it a trial, rather than a fixed, hard-and-fast competitive bidding rule, and that after a perfectly fair trial the case can be reviewed.

Mr. Kernan: I think everybody expects, from the fact that it was so difficult to bring their minds to agree, first, that this thing is going to develop into a much sterner kind of competition than we have had before. I don't think there is any doubt, as Mr. Ford says, everybody is already laying their plans to go out and get business that

heretofore they might not have gone after because they thought somebody else was handling it well.

Mr. Stewart: I want to add this to what Mr. Connely said. I really think that in putting forward this rule the underwriting houses and certainly we in the Investment Bankers Association have been actuated by the belief that it is for the greatest good of the greatest number in the business. We do seriously and definitely believe that competitive bidding would hurt the small dealer and the small underwriters and we think that under this proposed rule the small underwriter and the small dealer would fare probably just about as well as he does today. We think that is a highly important consideration.

Mr. Ford: That is really the reason this proposal is put forth. I concur entirely in what Mr. Stewart said.

Commissioner Healy: Of course, you have now changed this quite a lot from the written form as it came in.

Mr. Stewart: You mean by this discussion?

Commissioner Healy: Yes, sir. Or you have suggested a number of changes in the written form.

Mr. Stewart: No. I said in my letter on the "affiliate" question -- perhaps I didn't make it clear --

> "The definition of an 'affiliate' has been included with the draft rule so that the Commission may more easily determine that two of the persons invited to submit proposals are non-affiliates. It is, of course, recognized that the Commission may decide that since at least three persons (underwriters,

> dealers or other prospective purchasers) must be requested to submit plans, it may not be necessary to distinguish between affiliates and non-affiliates in this connection."

So from that point I think I haven't changed.

Commissioner Healy: Suppose this rule were changed to read five, and suppose only one person came in. The issuer made the effort to get the five people but suppose only one person came in.

Mr. Stewart: I would amend the rule to say that the issuer should be required to obtain proposals from at least three people rather than invite at least three people. I think that is a fault in the rule as drafted. I would certainly amend the rule to that extent.

Commissioner Healy: Suppose the Commission got down to the consideration of a thing of this sort in an actual case, under your item (B), and found that all of those items had been pretty well complied with except that the Commission thought that the negotiations between the issuer and the persons selected, or the persons making the proposals, had not been conducted in good faith possibly because of some, well, let's say some affiliation between an issuer and one of them; we would be in rather a "hot spot" at that point, wouldn't we?

Mr. Stewart: I think if you question good faith, if this thing isn't bona fide done in each case, then the rule will fall down. I am sure of that.

Commissioner Healy: Haven't we got to make provision against the possibility that it may not be bona fide done?

Mr. Kernan: You have got:

> "Nothing in this rule shall be deemed to preclude the Commission from entering any order which would otherwise be appropriate under applicable provisions of the Act."

And if you have the authority under a competitive bidding rule you could certainly enter it in a specific case.

Commissioner Healy: It is conceivable that even in a rule of this sort along the lines that have been discussed you might get a case where the Commission might want to step in and say, "In this case you ought to have competitive bidding. You fellows have just been getting into (something different) and you haven't really observed the substance of this thing. We are going to throw it all out."

Mr. Stewart: We have had some pretty frank discussion and they recognize that if the Commission adopts this rule it has to be made to work by genuine, unquestionable competition for this business. I am sure there is a definite recognition and acceptance of that.

Commissioner Healy: You would want it to work, wouldn't you?

Mr. Ford: Yes.

Mr. Stewart: Yes.

Commissioner Healy: Then it should be strengthened as much as possible so that it will work. Isn't that right?

Mr. Kernan: That's right.

Mr. Connely: You very soon in a trial period would determine whether there was any collusive effort. I think anybody would be stupid to do it on any other basis but all the cards face up on the table. I can't imagine an issuer or a suspected affiliate wanting to get jockeyed into a position that the Commission would use this power they have got.

Mr. Foster: May I ask whether it is contemplated that the person whose proposal is not accepted would participate as a co-underwriter in the offering?

Mr. Stewart: There is no prohibition against that in the rule as drafted.

Mr. Kernan: It is probably bad to make a prohibition against that for this reason, suppose California Edison were financing. Now they want it to go to three underwriters. They would certainly want it to go to Blyth and Company, or Dean, Widder. They are the two biggest underwriters on the Coast. If Blyth and Dean, Widder didn't win the competition it would be very foolish not to permit them to be in this business because they are the largest organizations on the Coast and to preclude their selling organizations from being in this business would be a bad thing for the company. It would prevent getting as good a price as you could if you had their organizations available.

Commissioner Healy: Well, this thing sort of shapes up, it seems to me, when you consider these suggestions that have grown up around the table. It would seem to indicate

that instead of the rule as written what we have really got to deal with is a proposed rule under which at least five are invited to participate, under which you get proposals from at least three. Now, suppose that the thing is rigged up that way and suppose you don't get proposals from three, then what does the Commission do?

Mr. Ford: I would say in that case the issuer would have to go through the performance and endeavor to make sure that he did get proposals from three.

Mr. Connely: He would come to the Commission and explain his dilemma. Let's assume it was ridiculous, assume it was a 500-million-dollar issue and it wasn't possible, there weren't enough underwriters in the country. You would consider the circumstances and say it was all right to proceed along those lines, giving very broad discretionary powers.

Commissioner Healy: You say he didn't succeed in getting three but he got one. You think in that case he should be given opportunity to show that he should be allowed to go ahead with that one?

Mr. Connely: It would seem like common sense to me.

Commissioner Healy: Suppose that one were a statutory affiliate?

Mr. Connely: The Commission might not determine it was improper; it might determine it was proper to proceed.

Commissioner Healy: Would that be an appropriate case

for competitive bidding?

Mr. Connely: It might be, but I should think it would be extremely difficult to provoke competitive bidding when they had been unable to obtain three people from whom they would get proposals.

The Chairman: I would like to ask this question and see if I can rephrase about what you have suggested.

In effect, you have dropped the subject of affiliates. That is really what you are saying? (Addressing Mr. Stewart) That you, at least, are saying?

Mr. Stewart: Yes.

Mr. Kernan: Or adopt any kind of stiff rule.

The Chairman: Assume that we dropped affiliates, I understand that you are now suggesting that we have a five-invitation rule. Also, am I correct in the understanding that you would include in such a provision that there will be some invitation on a regional basis?

Mr. Ford: We would like that very much in N. A. S. D. but you haven't provided something in the rule to prevent the necessity of the issuer accepting a proposal from one who wasn't qualified, an irresponsible person. We believe that a prerequisite.

Mr. Stewart: I am sorry to interrupt. I didn't suggest that invitations be obtained from five persons. My suggestion was that the rule be made to require the issuer to obtain proposals from at least three persons. I don't think there

is any need to go beyond that number unless the issuer chooses to do so of his own volition. I wouldn't go any further than to require that he must obtain proposals from three.

Mr. Kernan: I don't care, if it is all right with the utility companies it is all right with me.

Mr. Ford: I think you might run into the difficulty that the Judge brought up, that on a large issue they might find it very difficult to obtain five proposals. Then that would throw it back in your laps again. It seems to me three provides the competitive element which we are seeking to provide.

Commissioner Healy: It would be feasible to provide that he should invite at least five, then provide that they should have at least three proposals and then devise some way of taking care of the situation where you couldn't succeed in getting even the three.

Mr. Ford: Yes, you could do that. That would put flexibility into it.

Mr. Stewart: The difficulty is, of course, that people who are going to go genuinely to work on these invitations are going to incur quite a lot of expense and put a lot of labor on the development of their plans. If their chances of success are reduced from one in three to one in five there is less justification for their doing the work. That is really the reason that we suggest three initially rather than five, and I would like to keep to that point of view, changing the rule, however, to say that the issuer must obtain

proposals from at least three.

Commissioner Healy: I think you would help your case, you would make a better case, if you had said five.

Mr. Kernan: I think if it helps you on the affiliate idea, I don't see any objection.

Mr. Fournier: I would like to explore the question of the expense if you had a considerable number of invitees to submit proposals. To turn to the beginning of the rule, the proposals are to bear upon not alone the kinds of securities that might be issued, but also the terms which the proposed securities should contain in reasonably comprehensive form. I would like to know what expense would that impose upon invitees in a sizeable issue, a 50-million-dollar issue? Is my understanding correct that only one of those that submitted proposals would have his expense reimbursed by selling the issue?

Mr. Ford: That is the way it stands.

Mr. Stewart: The best way I can answer your question is to say that when we went to work on the Port of New York Authority and set it up in my own company we were out of pocket something in excess of $50,000 without considering the actual time that our executives put on it. It was a complete financing plan for the whole refunding of some $200,000,000 of securities, but the issue sold initially was a relatively small one -- I think about 30 million. That is a concrete

case. Besides putting in between six and nine months' time, for which there was no compensation at all, we were out of pocket $50,000.

Mr. Foster: How much of that would be applicable to this initial stage?

Mr. Stewart: In the integration proceedings -- in arranging for the sale of common stock or portfolio securities, anyone who is going to do a real job must sit down and put substantial labor into the development of plans, perhaps at considerable cost. Of course, if you were merely refunding a 10-million-dollar bond issue it wouldn't take much time nor involve much expense.

Mr. Weiner: Mr. Stewart, could I ask a question on a somewhat different point? Assume the issue were fairly substantial, 25 or 50 million dollars, under the rule as you have it set up would it in fact be practicable for any insurance company to come in even if you expanded it to five?

Mr. Stewart: I would think so.

Mr. Weiner: What would be your thought of the way this would come in, "We will take 50 million dollars of bonds, and here is our price"?

Mr. Stewart: They have done it in other cases. I assume they would do it again.

Mr. Ford: Would you not have the same set of circumstances that existed in Georgia Power where, really, the company came very close to going through the same procedure that is suggested in this rule here. We all know they

took it to several houses and asked for their ideas on the thing. They undoubtedly have sold their bonds to insurance companies. They evidently were talking to insurance companies at the same time they were talking with the various investment banking houses they called into consultation. It might work the same way.

Commissioner Healy: Suppose you had an issue of the size Mr. Weiner mentioned, it is possible to have four or five insurance companies that might do it but the rest of the insurance companies would be pretty much out in the cold, wouldn't they?

Mr. Stewart: They could always get some dealer to put in a bid for them. They do it now. As a practical matter, I don't think they would have any difficulty in arranging to enter the competition.

Commissioner Healy: They can't undertake a joint responsibility.

Mr. Stewart: They can't enter into a joint undertaking now but I don't think that has proved to be an obstacle to them in the negotiation of so-called private purchases. Let us suppose an issuer wanted to invite proposals from Metropolitan, Equitable or Prudential -- the issuer could call them up and say, "We would like to get proposals." They might very well reply, "Well, we can't do that directly but you call So-and-so and tell him what you want and we will see that he gets our proposals to put in." It could be done. Something very similar has happened on occasions in the past.

Mr. Foster: How about the small insurance companies?

Mr. Stewart: They will probably be happy to buy from the underwriters and get their securities at a fair price, as they now do.

Commissioner Pike: I would like to suggest we are going to find a more difficult type of financing to appraise than we have had in the last few years. For the typical refunding issue you take the present capital setup, check on the current bond market and figure out the savings - a purely mathematical procedure, with proper adjustment for income taxes. Since about 1936 this has been the ordinary process, but refundings in the utilities field are possibly two-thirds completed. If present indications are any good a bigger proportion of future financing has got to be new-money financing and I think it is reasonably probable that a great deal of it has got to be junior financing because most of the companies are getting bonded up pretty close to the limit. I suggest that this sort of financing involves more than the mere study of interest rates and maturities.

Commissioner Healy: Isn't that the trouble with this proposal: What will be more needed in the future is a competition of brains, not merely a competition of price and spread and as it is expanded under this setup practically you are invited to make proposals. One will say you ought to do it by bonds, the next by preferred stock or preferred and common stock, and I hope somebody will have the sense to say

by all common stock. The insurance companies fall by the wayside. All they can talk to you about is bonds.

Mr. Ford: I believe the statement Mr. Pike made is one of the strongest arguments against competitive bidding. I think he is entirely right in what he says about what we all face. This era of refunding that has been pretty simple is about closed and we are going to face a different type of financing than we have faced in the last few years. It is going to be more constructive financing, I believe. And I think it is going to be more difficult to handle that kind of financing under competitive bidding than otherwise. To my mind, one of the effects of such a rule as we have here will be to promote that type of financing. I would hope, as you would, that many of the proposals will suggest equity financing.

Commissioner Pike: I realized that when I said it. I do mean to suggest it is going to take more work, whether it is done by competitive bidding or in any other way.

Commissioner Healy: If we can get better capital structures out of all of this effort, it is doubtful if we ought to sacrifice that possibility for the sake of giving insurance companies a chance at some first mortgage bonds.

(Off the record)

Mr. Kernan: Of course, if a utility security were exempt from the operation of the 1933 Act, that would solve that problem.

The Chairman: How is that?

Mr. Kernan: If a utility security were exempt from the registration requirements of the 1933 Act that would solve that insurance company problem because then we could compete on an equal basis with them.

The Chairman: No, you couldn't.

Commissioner Healy: I agree with the Chairman.

Mr. Kernan: On bonds?

Mr. Weiner: The Georgia Power case shows you couldn't because they wanted the securities.

The Chairman: Your competition comes from the fact that they put the money on the line weeks in advance.

Commissioner Pike: You can forget that registration hindrance as far as an issue of any size is concerned, I am pretty well convinced. I was trying to see how much advantage they would lose if we made them all register.

Mr. Stewart: It might be very important, particularly if we are going to get a tightening of money rates.

Commissioner Pike: The fellows who don't have to register seem to be just as anxious to place privately as those who do.

Mr. Stewart: The idea that private placement is advantageous to the issuer has been well "sold" by the insurance companies around the country. They are good salesmen.

Commissioner Pike: I find that.

Commissioner Healy: They have been a little too good in some respects.

Commissioner Pike: I recommend to your attention an editorial in this morning's Washington Post. It is the first one I have seen that looks as if they have read that report.

(Off the record)

The Chairman: Is there anything else?

Mr. Stewart: First, as to the matter of publicity: We have not given any publicity to the proposal from the I. B. A. and we would prefer not to do it until we come to a point where there is an understanding between you and ourselves as to what is going to be done about it.

Mr. Sheridan: On that point, Mr. Stewart, I don't know how much control there is over it. This proposal is to be part of the public record and a lot of people, a lot of newspaper men, have been asking when you were going to submit a proposal. I have told them I didn't know and that it was not my business to tell them. But they may be watching the record. It was the understanding that it was to be part of the public record.

Mr. Stewart: We have no objection to giving the matter full publicity when it is made a part of the public record.

Mr. Connely: We have no objection to it.

Mr. Ford: We have no objection to it.

Mr. Sheridan: You will get no publicity other than what they pick up themselves.

Mr. Connely: If the Chairman wanted to release this as a basis of discussion --

Commissioner Pike: That is what it is, a basis of discussion.

The Chairman: What do you think of this suggestion, that until we advise you to the contrary we won't put it in the record. We will advise you when we do.

Mr. Stewart: Right.

Mr. Connely: All right.

Mr. Stewart: And we on our part will not give it any publicity until you do.

Commissioner Healy: There is a great disadvantage in giving it in this form, that since you have shown yourself willing to discuss changes and suggestions and that means your written proposal does not stand as written, and that might be embarrassing.

Mr. Ford: We put it in for N. A. S. D. solely for the purpose of discussion.

The Chairman: We will let you know when we put it in the record.

Mr. Stewart: I wish to say again that we are not suggesting our proposal as a definitive rule but merely as a basis for discussion. We recognize that it is not a finished, perfect product but merely a basis for an approach to the problem.

As to the "affiliate" question, let me emphasize that we are prepared to accept the strongest kind of definition in the present tense that you want to make, but we are not disposed to a retroactive rule.

The Chairman: Thank you very much, gentlemen.

(Whereupon, at 12:45 p. m. the discussion was concluded.)