

THE CAPITAL MARKET AND THE
INVESTMENT BANKER

ADDRESS

of

JOHN W. HANES

Commissioner, Securities and Exchange Commission

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I should like to talk to you today on some matters concerning investment banking and the capital market. Because I have been in the business for a good many of my working years, I feel that I can speak to you freely as one who shares with you some understanding of the practical operations and problems of that business. In addition, since I am no longer an active participant in the business, I may be able to give you the benefit of the point of view of an outside observer, an observer who is intensely concerned with the subject as part of his job as a government official.

I propose to raise some problems which you may find disturbing, and to suggest to you certain possible trends in the business. One of my reasons for presenting this point of view is my realization of the importance of investment banking to our national economy. Sometimes we forget that an adequate and well directed flow of capital into industry is absolutely essential for the efficient operation and continued growth of our capitalistic system. Not only is new capital investment required to construct additional plant and to purchase more machinery in order that industry may expand and employ a growing number of workers, but such investment is also necessary to provide for the proper maintenance and modernization of existing plant so that business may be assured of its ability to continue to employ those who are now at work. To put the matter briefly, a certain minimum amount of capital investment is required in a complicated, mechanized industrial structure such as ours, before people can be put to work efficiently and kept working.

Putting labor to work with heavy capital outlay is a characteristic feature of the American system. All history has demonstrated the fundamental wisdom of that method of producing goods. It was discovered almost at the beginning of time that working with machinery (which is invested capital) is far more productive than turning out goods solely by hand. In this fact lies

the strength of this country's productive system -- the use of more tools, more plant, more power -- more capital -- than are employed in other countries. In this fact also lies a large measure of the explanation of our ability to produce, on a gigantic scale, goods which remain relatively inexpensive despite the fact that wages are higher here than anywhere else. Without capital or with insufficient capital, the productivity of our industrial machine would be seriously impaired; costs would become inordinately high, demand would fall off, output decline, and employment be curtailed.

Various estimates of the size of the capital investment necessary to employ one worker have been made, but for our purposes we may take almost anyone of them. Let us therefore take the all-inclusive figure of \$7,000 per person which represents on the average the amount of capital required to provide each worker with the plant facilities, tools, housing, government facilities, etc., necessary to enable him to turn out goods in accordance with the American capitalistic method of production. Incidentally, in connection with all these estimates, please remember that, although I shall use the best figures I can find to make my story clear, I do not pretend to be a statistician.

Although some people are inclined to scoff at private enterprise and at democracy, there is no getting away from the fact that everything we are and everything we have--the myriad of things all around us we call civilization--we owe to the existence of capitalism in a free democracy. In our system, the driving force of individual initiative, despite the restrictions of which many complain, is still less hampered than almost anywhere else on the face of the earth. To help maintain this system, we must provide the \$7,000 per man necessary to give work to the 500,000 or more persons who are added to our employable population each year, and to all those stranded on the relief rolls as a result of the post-war depression. We also need capital investment

if we are to furnish jobs for those who are released for new employment owing to shifts away from old industries or from old techniques of those industries, since the capital investment which has been made in the old industries is practically useless for the purpose of giving these displaced persons new employment. Even more capital is required if, in addition, we are to provide increased security and a higher standard of living for our population.

All these facts indicate the urgent need for capital, the main source of which has always been in the sale of securities. Through the capital markets for which investment banking provides the primary mechanism, savings--the surplus earnings of business concerns and individuals--have been directed into productive industry. Yet despite the fact that our economy can be kept going and expanding only by the injection of new capital, we know that the flow of such funds has been consistently lower in the last four or five years than in the period prior to 1929. It is my impression that one of the causes of this stoppage, at the present time, is the fact that the machinery provided by bankers and dealers throughout the country is not functioning adequately. It is this problem which I should like to discuss with you today.

Let us see first what the people in the investment banking business are expected to do, what functions you are supposed to perform in fulfilling your task of providing channels through which savings can flow into capital investment. A channel conveys the idea of something which is wholly inert, but you and I know that investment bankers have active jobs to perform. The origination of securities, with all the work of finding the issue, investigating it, pricing and setting it up, is no simple matter. The advertising, selling, placing and replacing of an issue are also not the sort of tasks which permit a banker to sit back and rest. But are you doing these jobs today in the same fashion as you used to and as you should if investment banking is to be an economically useful occupation?

In selecting issues, the originating banker is supposed to be discriminating, to distinguish between good and bad risks and to use his judgment in choosing between industries with a future and those which have passed their zenith. Bankers must think in terms of their "economic functions." A banker, who takes the long-run point of view with respect to his own business and its profits, will be more concerned with the future of the company whose issues he is floating than with the immediate market success or failure of the securities. There is some reason, therefore, to expect a banker to examine investment situations not only from the point of view of salability and marketability, but also with an eye to determining the real investment merit of the particular securities. It is this type of examination which has always been thought of as the true function of originating securities. Investment banking of this type means that the banker, taking the long view, makes a genuine contribution to the operation of the economy. He chooses issues with reference to the effect of the contemplated use of proceeds upon national wealth and income, employment and the standard of living, for only where financing will have beneficial results in these directions does it represent a good risk for the long pull. While I realize that nobody can look too far ahead, I think it poor banking, as well as poor economics, to be concerned with the success of an issue solely during the period of its syndication.

Once a banker has determined to his satisfaction that he has discovered a sound investment opportunity, then comes the task of selling the securities to investors. This task of selling will involve, in many cases, the use of the complicated but familiar machinery of selling groups or syndicates, in which firms of a somewhat different type from the originating firm may participate, but which is after all a part of the broad field of investment banking. The investment banking machinery also is expected to stand ready to

take the issue if it is not readily sold, thus carrying a risk. Where the particular issue involves the raising of new capital for a concern which is not established, the potential risk is likely to be considerable.

We all know these facts. I repeat them merely to emphasize that the proper conduct of investment banking for the benefit of the economy, as a whole, requires three things. First, the selection of those situations where capital can be employed productively and profitably over the long run. Second, the assumption of risk in order to facilitate the raising of capital for such concerns. Third, the selling and placing of the securities, a job which is likely to be particularly difficult when the issuer is small or relatively new. Stated thus simply, these three items, to a certain extent represent ideals rather than concrete tasks. Yet they are functions which must be performed, so far as possible, if industry is to receive the funds essential for its continued life and its expansion, that is, if we are going to have effective conversion of savings into capital. If you are interested in my own frank opinion of the situation, it seems to me that the investment banking mechanism is not now hitting on all cylinders.

Has investment banking recently acted to direct the funds of the capital market into those situations where they would be most productively and profitably used? There is no denying that in many instances in the past we were inclined to float the type of issue which suited the particular whim or fancy of the public at the particular time, with little reference to the economic soundness of the issue. Despite this concentration on that which was salable and that which was marketable, however, some of us still did something in the 'twenties towards digging up worthy enterprises and helping industry to raise funds. The same thing cannot be said of the period from 1935 to 1937. On the contrary, we avoided new financing and restricted ourselves almost

entirely to refunding issues which were clearly salable, and which involved little or practically no risk. This fact is evidenced clearly by the statistics available to the SEC. From July 1, 1935, through June 30, 1937, there was a total of \$9,400,000,000 of securities registered under the Securities Act of 1933 which the issuers proposed to sell. Of this total about 70% was for refunding purposes. The remaining 30% was for new capital, but the Commission's research has indicated that investment banking assistance was not available for many of these new money issues, and that there was a rather surprising inability to sell any or a substantial part of such issues registered by firms in the promotional stage. It is safe to say that our investment machinery operated during the recent period of active financing in such a fashion that it raised very small amounts of new funds for industry.

At least a partial cause for this lack of participation in new financing was our unwillingness or inability to take risks. There were of course a few outstanding cases where we did take real risks in connection with underwriting offers to securityholders when new issues were sold by means of rights. However, although these issues bulk large in our minds because of the substantial losses which were attached to some of them, they were only an insignificant part of the total financing of the period. Parenthetically I may add that the losses were due in part to the faulty construction of some of the unsuccessful issues. Offerings by means of rights, which were underwritten, were only 12-1/2% of the total registered securities during 1937. For most of the financing during 1935, 1936 and 1937, we know that risks were generally avoided. As a matter of fact, there crept into our business some rather strange devices for the avoidance of risk even in high grade refunding issues which apparently involved little element of chance in any case. I refer

here to certain types of "market-out" clauses. I realize that circumstances may arise in which these clauses are warranted. But where these provisions, however rarely used or even more rarely exercised, give the underwriter the right to withdraw after the public offering there is, I think you will agree, neither underwriting nor banking. An investment banker in such a case is acting as no more than an investment agent.

However, more important than this contractual hedging against risk is the fact that we avoided the more burdensome risk-taking which is associated with the newer and smaller companies, the type of financing which is essential to a continuance of industrial progress and prosperity. After all it is the acorns of yesterday which are the oaks of today. In former years the enterprising banker often would buy an issue and hold it for a while. He would nurse the corporation along during its early stages. He would buy issues which were relatively unknown to the public and take the risks attached to selling such unknown issues, including the possibility that it might be impossible to dispose of the securities completely within a short period of time. Were it not for such enterprising bankers, we might not have had our present electric power and light industry. But do any of you remember more than one or two of such operations during the last two or three years?

I recall one such instance in an industry related to national defense-- an industry thus of great importance economically and socially. I know the strenuous but vain efforts of the firm which originated this issue to get other bankers to participate in the business. I know the embarrassment of the senior partner when no other firms would aid in the business, and I know how he felt when he had to indicate to his partners that most of the firm's capital would be tied up for thirty or sixty days in this one issue.

In the light of such instances, let me make it clear that I appreciate the general feeling on the part of the industry against assuming excessive

risks. This may not be wholly a matter of choice, but may rather be something which has been forced upon investment bankers by new conditions. I think there is little doubt that the underwriting capital is less extensive today than it was in the 'twenties. There are no more security affiliates. Banks can no longer participate, and the risk-spreading intermediate or banking groups are no longer available. Investment banking firms which used to be able to hold deposits can no longer do so. All investment banking firms went through a depression following 1929 which shrunk their capital, and in recent years, they have received no new capital or very little new capital to counteract these shrinkages.

Risk-taking has also been restricted as a result of governmental influences. I see no reason to close my eyes to that fact, especially as it concerns the operation of our present tax system. Although that system is subject to criticism on several grounds, I should like to refer briefly to that phase of it which apparently has had the effect of driving those with large incomes into tax exempt bonds, thereby greatly curtailing the market for corporate securities, particularly those of junior grade. When persons with large incomes are able to buy relatively riskless tax exempts to yield, say, 3%, it is obvious that non tax-free securities, if they can be made attractive at all, will have to be marketed on a yield basis of 6% or more. These higher yields are necessary to take account of the fact that the prospective wealthy investor is subject to taxes in the upper, say 50%, brackets, as well as to compensate him for the added risk involved. Since it is the wealthy investor who formerly bought corporate securities in large amounts, it is possible that to the extent that he now fails to do so, the effect of the tax-exempt features attached to state and municipal bonds has been not only to put obstacles in the way of the performance of the investment

banking function for industry, but also to throttle new enterprise and to interfere with the expansion of business in general.

However, while I believe that all these forces have combined to weaken the investment banking machinery and to restrain the fullest possible exercise of the risk-taking function, I do not necessarily subscribe to a philosophy of inaction on your part. You cannot afford to sit and wait for changes, ascribing all your difficulties to regulation or taxation, or to both of them. If you want to accomplish changes you must work towards them, in part by first doing your own job. Someone must take risks as part of our mechanism of financing industry. If you decide to "let George do it," you may find that George, and perhaps his Uncle Sam, may be forced to do it by default. Inaction may mean that you will write investment banking off the books--and that course neither you, I am sure, nor anyone whom I know in Washington would welcome.

I assume that I will be telling you nothing new if I give you some statistics on the methods by which insurance companies and other large institutions have recently bought their share of some of the major refunding bond issues. In December 1933, an issue of \$140,000,000 American Telephone and Telegraph Co. Debentures were publicly offered. Poor's Publishing Company has a compilation of purchases and sales of securities by insurance companies which indicates that ten of the largest of those companies purchased over \$48,000,000 principal amount of these bonds, or almost 35% of the total issue. One of the larger insurance companies purchased about \$7,400,000 of these bonds, but in order to acquire that block it had to make separate purchases from 103 different firms. Another large company made purchases from 190 different firms to acquire the \$3,200,000 of bonds which it desired. In other words, the underwriters and dealers instead of distributing the issue widely were, to an astounding degree, all selling to the same few large buyers.

The extreme artificiality of this situation and the wasteful nature of investment banking machinery which operates in this fashion are too obvious to require amplification. The results are plain. Investment bankers, on increasing occasions, are acting merely as order takers for insurance companies and other institutions.

And so we find there has developed a substantial amount of private placing. Investment bankers dislike this trend, because it means a loss of business for them. I have my own doubts as to whether this practice is desirable from the long range public viewpoint, but I am not surprised at the trend which seems to me to flow logically. In such operations, investment bankers may be used on occasion to negotiate the deal, but thereafter their job ceases and a few institutions take all of the issue of a large industrial corporation or public utility without bothering to go through the procedure of syndication and distribution. In more than half of these issues there has not even been an investment banking intermediary. By these means, investment bankers were short-circuited to the extent of some \$1,300,000,000 during the years from 1934 to 1937. The figure is of such proportions as to suggest an alarming trend away from the developed machinery of securities distribution, which has been sanctioned by experience.

These, then, are some of the features of the present situation as I see them. They are actualities which you must face. Whatever the reasons, investment bankers are not doing the job they used to do. Are you collecting the savings of the individual investor to make them available to industry? Are you seeking out productive and nationally useful projects to offer to investors? Are you prepared to take a larger risk so that industry can place reliance upon you as sources of capital? In a word, are you doing your share of providing the power of capital which has, in the past, been the fuel for

the dynamo that is capitalism? If we fail to provide the motive power, there is danger of an eclipse of this system, which, after all, helped to bring out the genius and ingenuity of our people and make this nation great.

I know too well that the inactivity of the capital market is not all your fault. But it is time to study your own situation, to find out just what can be done under present conditions and where changes are required or new machinery necessary. Since the job cannot be left undone, and since the job is yours, it is up to you to start thinking of possible remedies. Nor is this task of self-examination one which I recommend only to the "big city" firms. As Chairman Douglas indicated when he spoke here some weeks ago, the local firms can do much to aid in the financing of deserving small business. Perhaps such local houses cannot themselves fully satisfy the needs of regional financing for small enterprise, but at least they too can think about solutions. Maybe the answer lies in changes in existing machinery, maybe it lies in the addition of new governmental or semi-governmental agencies to assist existing banking and distributing organizations to do *the job which really is theirs.*

For your information I may say that, in view of the growing realization of the acuteness of the problem of reopening the capital markets and the need for speedy action, there have been some preliminary exchanges of views on machinery whereby the government may cooperate with the investment banking fraternity in doing its job. There is a substantial body of informed opinion which seems to favor some sort of cooperative endeavors. As a matter of fact, one Senator recently proposed a bill, aiming at some such cooperative machinery.

As far as I am concerned I do not propose to answer these questions today. I have tried only to present the problems with what may be a new slant to some of you. I have done so because, frankly, I am concerned about this country's future. I wouldn't be in Washington if this were not the case. I think all of us recognize that most of these questions which I have discussed today are vital to the investment banking profession, to industry and to government. Their solution is necessary and must not be too long postponed. I am told that the accumulated deferred capital expenditure since 1930 amounts to many billions of dollars in railroads, construction, public utilities, manufacturing, and other industries. Consequently, we must find solutions and work towards practical ways of reopening the capital market in our capacities as bankers, business men, government officials, and, may I say, patriots. If you cannot reach these solutions, then the government, whatever the party in power, may have to impose them upon you, because a government cannot endure unless it can keep the national economy going. But I do not think that anyone in the government wants to see things go that far. On the contrary, I am confident, if you attempt to work out your own salvation, that the government will work with you. Of my own knowledge, I can only speak about the Securities and Exchange Commission. I know that we will not be adamant against changes in the existing laws and regulations if they are in the public interest. We will not hide ourselves behind red tape and rejoice over your difficulties from the Olympian heights of bureaucracy. On the contrary, we recognize the possibilities of changes, amendments and improvements, and we will work with you. Let me urge you to continue in your efforts towards analysis and solution of the problems at hand in order that investment banking may remain a dynamic profession and continue to supply the life-blood of our industrial machine.