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of

**SUMNER T. PIKE**

*Commissioner, Securities and Exchange Commission*

before the

MAINE INVESTMENT DEALERS ASSOCIATION

CUMBERLAND CLUB
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In recent months there has been so much heated controversy about some aspects of the securities laws and the S.E.C. that I believe many of us are beginning to lose perspective. A peek at fundamentals might do some good. I have heard a great deal about all the troublesome questions the S.E.C. asks about a new issue of securities to be sold to the public. The other day I went down to the bank and asked them if they'd let me see the questionnaire which they require to be filled out by those seeking loans. I wish I had photostatic copies to pass out among you today. They ask about as many questions as the S.E.C. asks when a corporation wants to sell a hundred million of bonds to tens of thousands of investors. Among the questions which must be answered are those relating to earnings and other income, assets and liabilities, the cost of properties owned, pending litigations against the prospective borrower, and a number of others designed to ascertain the net worth and credit standing of the prospective borrower. Authorization must also be given the bank to obtain such other information as is necessary to verify the facts set forth in the application for a loan. The banks have always asked those questions. They have to, in order to protect themselves and their depositors. It would be foolish business for them to take the position that to answer such a long list of questions is both troublesome and embarrassing to the borrower. They even go so far as to check up on some of the answers. And, of course, if they don't feel that

the answers to the questions are complete and honest, they would be foolish not to insist on accurate corrections. Or they might even turn down the loan because of it. None of us, I am sure, have any doubts about the propriety of that. Of course, I am referring to uncollateralized personal loans. Yet what of the experience of the business man, large or small, who seeks either to borrow from the bank or to sell an issue of securities to insurance companies or savings banks? I am sure that any of you who have participated in any such negotiations know the painstaking care with which the prospective lender -- the banker or the insurance official -- explores the credit standing, the operating costs, the sales volume, the capital structure and even the personal morals of the borrowing company officers before accepting the deal. And I am sure you know the responsibility -- liability, if you will -- which the company officers assume for the accuracy with which they set forth the condition of their company to the prospective creditor in these private deals. And, of course, if the banker doesn't happen to like the looks of the picture when he has seen all the facts, there is no deal and that's all there is to that. The fact that his decision may be capricious, that is, based on nothing more than the fact that he has a bad hangover, doesn't help you because the decision is not appealable. You're through.

Of course, there used to be a very nice theory that what you, the prospective borrower, told the public investor had nothing to do with what you *had* to tell the hard-hearted bankers. The mere fact that both the public investor and banker were supplying you with your life-blood -- capital -- made no difference. In fact, if you could stay away from the banker, so much the better because then you didn't have to tell anybody much of anything. I say "you". Of course, I mean "us". We simply didn't think much about it.

Now that we have thought about it, there are, I am sure, very few of us who don't honestly feel that prospective public investors are entitled to the basic facts about the business together with a reasonable running picture of operations and financial condition. Without disclosure of such facts these investors are in the dark. Now these people aren't contributing mudpies. They are investing money -- often hard-earned life savings. Because it is virtually impossible for each individual public investor to obtain the disclosure which the banker gets, the job of getting those facts has been given to the S.E.C. As I have said, the S.E.C. doesn't ask any more questions than the banker who is considering a loan. And the S.E.C. doesn't have the power under the Securities Act to refuse an issue simply because it's a bad issue. Of course the S.E.C. conceivably might turn you down because its Commissioners

have had bad nights. But if it does, you're much better off than you were with the banker because you can appeal to a court and get the Commission's decision reviewed.

In fact, the more I think of it, the more I can't understand why a S.E.C. hasn't been in existence sixty years rather than six. It is practically unanimously agreed today that the fundamental purposes of the Securities Act are sound and desirable. No prudent person desires a return to the medieval bedlam of the twenty's. Yet, despite all this, it is said that the Securities Act places business in a predicament. Prudent business favors its investors getting all the facts. It has no quarrel with that. But, it is said, securities markets are shifting and changing all the time, and the investment banker can never be sure he's going to be able to sell an issue of securities which must be registered with the S.E.C. The delay of registration, we are told, has dried up the capital markets. Frankly, I must confess that when I went to the S.E.C., I had heard so much about this that I resolved to look into it immediately.

Fortunately, one of the first things that happened after I became a Commissioner was a long series of conferences with the representatives of the investment bankers and securities dealers. Those conferences are still going on. As a matter of fact, the S.E.C. seems to be in endless conference with representatives of one group of businessmen or another. It never seems to do anything without these conferences. I think that I have met more businessmen

at the S.E.C. than I met at the Department of Commerce, which is supposed to be the agency for business in Washington. And I must say, at this point, that I like the S.E.C. way of doing business. It results in fewer mistakes and better understanding of the problems of those who are being regulated.

The conferences with the investment bankers were most enlightening to me. I have done business with investment bankers for a great many years. Naturally, I like them. They're a fine, hard-working group of men. In these conferences, we were talking about the well-known twenty day waiting period which was required before an issue of securities could be sold to the public. We were working out the amendment which Congress has just passed to eliminate a fixed waiting period for most classes of securities. The discussions were, let me say, on a most cordial plane. But the investment bankers made it clear that while they thought the proposed amendment was an improvement, they did not think it did the whole job. They continued to say that the operation of the Securities Act is seriously hindering the flow of capital -- that is, the flow of funds of investors into American industry. And here is where my eyes were opened. It suddenly dawned on me that the investment banker has come to believe that he and the capital markets are identical. He implies that if his business is bad, the capital markets are clogged up. I wish it were that simple, for it would be a great deal easier for us to trace the trends and hence the causes of trends in the capital markets.

Throughout our discussions, it became clear that what the investment bankers were really saying was that because of the 20 day waiting period they are unable to meet the competition of the insurance companies. When, however, the investment bankers said that they couldn't compete with their competitors, the insurance companies, they came much closer to the crux of their difficulties. For the insurance companies, with their vast reservoirs of capital, are an increasingly vital part of the capital markets. And there is no doubt that they are increasingly serious competitors of the investment bankers. Over and over again the investment bankers repeated that corporations were going to insurance companies with their financing problems because the insurance companies could tell them definitely when they could get their money, while the investment banker could not do that. Companies doing their refunding through insurance companies don't have to register their issues and don't have to wait twenty days for registration, they pointed out. In short, their position was that the insurance companies can make a firm commitment to take an issue at a definite price within a definite period while the underwriters cannot do that. And, say the investment bankers, this is all because of the waiting period.

To me the fallacy is pretty clear. The reason the insurance company can make a firm commitment is because it has in hand the money to pay. The reason the underwriter cannot make a firm commitment is because it does not have in hand the money to pay. In other words, the insurance company has got it. The investment banker will undertake to get it. The waiting period under the Securities Act

has little to do with it because tomorrow's public market is just as uncertain as next week's or next month's. Complete elimination of the waiting period would not, in my judgment, affect this situation materially. The underwriter simply has not got enough capital to make a firm commitment. The insurance company is usually buying for keeps - for yield to maturity. It doesn't care much what tomorrow morning's stock market price may be. But to the underwriter, whether his commitment is for twenty days or twenty hours, this is all important - because he must distribute in that market to get the money with which to make good on his commitment. He must price to market as well as to yield and his chance for error is, therefore, just that much greater than that of the insurance company.

The investment banker's fallacy is borne out in the case of public utility bonds. Under the Public Utility Holding Company Act, such bonds must be cleared with the Commission even if they are going to be placed privately and even though they are exempt from registration under the Securities Act. In this situation, although Holding Company Act clearance may take all of twenty days, and involves the filing and sifting of more extensive financial data than under the Securities Act, the insurance company can agree to take the issue at a fixed price, subject to clearance in Washington - and it may make this agreement long before the issue is even brought to Washington. Why? Again, because it is not interested in day-to-day prices. It is interested in yield, and a bond will yield 3.1 percent to maturity just as well whether it is bought this month or next month.

Suppose there weren't any Securities Act. Could an investment banker make such a commitment? Of course not. Now that situation is actual. It isn't imaginary or hypothetical. Moreover, there are other advantages entailed in private financing. For instance, direct sale to insurance companies makes possible reduction of expenses ordinarily incurred in public distribution. Thus, underwriting commissions are saved. Although so-called finders' fees may be paid in connection with private placements, these fees are normally far less than any comparable underwriting fees. Add to this the fact that the large insurance companies have tremendous resources which enable them to buy up large security issues and that these overflowing reservoirs of capital compel them to find satisfactory investment outlets continuously. To me, it proves beyond doubt that there isn't very much to the charge that the waiting period has caused the predicament in which the investment bankers find themselves as a result of insurance company competition.

But let's look further into the picture. The charge is made that because of the waiting period, the flow of capital isn't what it should be. But the public utility company got its money. And whose money was it? It was the savings which the American people invested in life insurance - reinvested by the life insurance companies in the bonds of the utility company. If the sale of those bonds through the investment banking machinery would have put men to work in the utility company, certainly the sale of the bonds

direct to the insurance companies puts just as many men to work. I don't see how that can be denied. If the proceeds of those bonds are to be used to build a new generating plant, what difference does it make whether the bonds are sold to the insurance companies or to the public through underwriters? Plant construction will take place in either case.

So, in a nutshell, it seems to me that we have the fact that although the investment bankers are in a predicament, they are raising a false issue when they blame their predicament on the waiting period of the Securities Act. The waiting period provision, of course, is not the whole story. It has been said that the public offering method is handicapped and discriminated against by the regulation provided by the Securities Act. That is, the time and expense and trouble of registering, the fear of liabilities set forth in the Act, - these are said to be imposed only upon public offerings under the Act. Consequently, private offerings, often called private placements, are popularized, it is said. Yet there are regulations, registration provisions, time lags and liabilities under the Holding Company Act which are equally applicable to both public offerings and private placements. Apparently these have not deterred private placement of utility securities.

The history of private placements under the Securities Act is not very long. When the Securities Act of 1933 was passed, several corporation officials were naturally concerned over many of its unfamiliar provisions. They felt that registration would be very burdensome and many of them believed that once the S.E.C.

got a registration statement it would use the statement as an entering wedge and attempt to control their management policies. As a result these corporation officials looked around for some way to finance without going through the process of registration. They turned to the already familiar practice of private placements. The Securities Act exempts from registration transactions by an issuer not involving any public offering. In the early days of the administration of the Securities Act by the Federal Trade Commission, the position was taken that under ordinary circumstances, an offering to less than 25 people would probably be a private offering. Later, the General Counsel's Office of the S.E.C. indicated that the test of a definite number of offerees was to be dropped and all surrounding facts of the issue are now examined to ascertain whether the transaction is, in fact, a private or public offering. No single test governs this determination. But, of course, securities offered only to a small group of insurance companies are generally considered to be exempt. The exemption, however, is not available if the insurance companies do not take the securities for investment but purchase with a present intent to distribute them to the public subsequently. Prior to 1934, the bulk of new securities purchased by life insurance companies had been publicly offered. Thereafter life insurance companies expanded the practice of buying securities directly from the issuers. Of course, private placements had

taken place prior to the Securities Act, but it is undoubtedly true that the Act gave some impetus to the growth in this direction.

To date the Commission has not taken any public position on the causes and meaning of private placements to our financial order. However, it has been steadily gathering data helpful in keeping abreast of the trend. The staff of the S.E.C. has compiled elaborate statistics concerning private placement financing. In addition, members of the staff have interviewed numerous insurance company officials, investment bankers and issuers. Sometimes these interviews have been general, sometimes they have been quite specific, involving access to all papers connected with a particular private placement and detailed discussion with company executives who participated in working out the deal. Furthermore, the Commission has asked the National Association of Securities Dealers and the Investment Bankers Association to submit any materials and suggestions they have relating to the subject.

Although the great growth of private placement financing has taken place during the operation of the Securities Act, I think it is erroneous to conclude that the securities legislation is responsible for private placements. The Securities Act is merely one factor. If you had the experience, as I have had most intimately, of going over the reports of the S.E.C. staff to the T.N.E.C. on life insurance companies, you would realize that private placement financing springs from far deeper developments in our financial system. I refer to the increasing concentration of huge funds of capital in the hands of insurance companies and other so-called institutional investors.

These funds must be invested -- and principally in high grade securities. The concentration of high grade securities in the hands of a few gigantic institutional purchasers must be examined from the point of view of the public interest and the general welfare of the American investor and American industry. The relative competitive abilities of investment bankers and insurance companies must be ascertained. The effect of substantial private placements upon our capital markets should be probed further. These matters, and more too, must be considered in dealing with the problem of private placements. It seems to me the Commission's function is to gather the facts upon which a constructive view can be based, and be ready to assist Congress when the problem comes up for discussion by making its experts available to the Congressional committees and by submitting the results of its factual inquiries. This is what it is doing.

I hope that I have not given you the idea that I don't think we have a serious problem here. I do. The insatiable appetite of the life insurance companies for bonds may, in addition to being a headache for the investment bankers, turn out to be a real headache for American business. First of all, there is danger that only the largest insurance companies will get the good bonds and that the many smaller insurance companies and other savings mediums like banks and trust funds as well as the general public, colleges, hospitals and other endowed institutions will have to be content with only second rate issues. Right now, there aren't enough good

bonds to go around among the insurance companies, let alone to meet the demands of smaller investors. Yet the insurance companies in most states face the dilemma that they can invest only in senior securities. The T.N.E.C. hearings, as well as the Brookings Institution studies, show that the portfolios of life insurance companies have changed so that there is a substantial decrease in real estate mortgages, thereby increasing the pressure to invest in bonds. Our figures show, for instance, that during the period 1934 to 1939, the principal amount of bonds purchased by life insurance companies was over 2 billion dollars, or 91% of the total amount of bonds privately placed. Most large life insurance companies are not permitted under state laws to buy common stocks. Moreover, life insurance companies have shied away from requesting the right to invest in stocks because they didn't want to become involved in the management of industry. Yet already in too many instances they have found themselves thrust into that very position because one of their bond issues went sour and the issuer had to be reorganized and they, as creditors and members of bondholders' protective committees, took active part in the management of that industry during reorganization. Some insurance company executives are now advocating that present restrictions on insurance company investments must be changed so that their companies are not limited to mortgages and bonds and perhaps a little preferred stock.

According to testimony before the T.N.E.C., however, most insurance executives have not yet reached the point where they are willing to recognize that their investment programs may be creating for themselves a vicious downward spiral of safety. I say this because I think that there is merit to the proposition that if

American industry piles up a top-heavy capital structure -- that is, too many bonds in relation to stocks -- the chances of widespread disaster during a period of severe economic reaction are increased. It has been well said that the history of the railroad industry is strewn with the wrecks of companies whose debt structures were unbearably high. There is elasticity in a capital structure made up largely of common stock. A capital structure which does not call for heavy annual fixed charges seems better fitted to absorb the shocks of economic crisis.

Some have suggested that the size of the larger insurance companies is so great that the investment problem of each is approaching the impossible. Others have insisted that insurance companies must come to invest in carefully selected common stock issues. If the insurance companies were smaller, it is asserted by some that the investment banker might find himself in the more equitable position of facing numerous competitors of more moderate resources rather than a handful of large ones with overwhelming billions of dollars at their disposal. If the insurance companies were permitted to invest in common stocks, it is maintained by some that the whole market for common stocks would be almost certain to open up and the investment banker might be in a position to claim a very large share. Insurance officials, as well as others, however, maintain that for certain types of securities issues private financing has definitely supplanted public distribution, and that the existence of investment banking cannot justifiably depend on the underwriting

of issues of those types. These persons contend, in other words, that one large segment of the underwriting business has already disappeared. Hence, these persons say, there is no reason to try to promote competition in a field where underwriting is unnecessary.

Whatever may be the answer to these problems, it is obvious that the investment banker must do some clear, constructive thinking. Name calling will not bring him business. He must be bold and imaginative. For one thing, the investment banker is in a good position if he works hard to take advantage of the business which should come from the reshufflings and regroupings of utility companies under the integration program now in progress pursuant to the Holding Company Act. For another, I believe that the field of small or moderate sized business challenges his imagination today. This is a field which has been comparatively neglected by the investment banker. The machinery of investment banking is not presently available to small enterprise or is available only at underwriting costs - not ascribable to the Securities Act - which are excessive in proportion to the amounts involved. Although the Commercial bank traditionally has been the major source of credit to local small enterprise, that channel of credit has been seriously obstructed during the depression years. Consequently many small businesses are in great need of funds today, particularly "venture or equity capital". Here then lies a fertile field of business for investment bankers if they would adjust their procedures to this end. But when investment bankers talk about pursuing this kind of business, they always seem to contend that there's no profit for them in small deals. And when you begin inquiring why there is no profit, you generally end up surveying formidable overhead expenses. Even the S.E.C. has generally accepted the proposition

that business overhead prevents investment bankers from touching the really small deals, except at impossible spreads. Now you and I know that there's nothing unchangeable about overhead. And you and I know that a profit's a profit -- whether it comes from a small deal or a big deal. For investment bankers to talk as though small deals were out of their reach is plain defeatism. I, for one, don't think the investment banking business is licked. I believe the Down-East Yankees in the business, not only here at home but all over the country, have the imagination and foresight to make any changes necessary to meet the challenge.

In summary, I feel that the investment bankers would be in hot water today even if there had never been any Securities Act or any other kind of securities regulation. They are up against a competitor greater than they have ever met before -- a competitor with almost endless resources and a compulsion to gobble up the best of the securities which are available. This competitor can put cash on the line. He can give the seller a better price because he doesn't have to pay a commission. He can absorb whole issues no matter how large they are. He can ignore day-to-day trends in the market. He can assume market risks which frighten the investment banker.

The Securities Act may be an irritant to the investment banker in many places. We are working to eliminate as many of those irritants as possible while retaining the basic protections for investors. But the investment banker who believes that the Securities Act or the S.E.C. or the Government is the source of his troubles is simply not seeing beyond his nose. He has far more formidable obstacles in his path on the search for good business.

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