THE SECURITIES ACT AND ITS EFFECT UPON THE INSTITUTIONAL INVESTOR

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I

The institutional investor—comprised largely of insurance companies and banks—is one of the most important classes of securities purchasers. Many of these organizations throughout the country were asked the general summarizing question: "Do you see any marked difference between conditions now as compared with pre-Securities Exchange Commission times in their effect upon your own investment policies and programs?" The answer was an almost unanimous "No!"

Such a broad categorical statement, however, needs some qualification. The question and answer could easily dismiss the subject as to the *net* effect upon institutional investment policies, but some attention must be given to both the favorable and unfavorable features whose sum total appears to be not far from zero.

It has been the writer's experience—and likewise that of most of those in a similar capacity with whom this problem has been discussed—that little has been accomplished to alter in any noticeable degree the investment status of institutions as a whole. Rather, paths smoothed out in the approach to the investment problem have been offset by the rocky roads left open in the changed course that must now be pursued.

Greater Information Available

Foremost among the benefits of the Securities Act of 1933, as amended, and of the Securities Exchange Act of 1934, is the accessibility of more information with respect to companies whose securities are presently outstanding or about to be issued. There can be no doubt of the great advantages gained. Here the accomplishment has been specific, helping all classes of investors. Whether complete advantage is taken of this opportunity by the smaller institutions is beside the point. At least it is there for their use.

To institutions whose investment analysis is more painstaking, the information

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The author wishes to point out that this paper is purposely confined to the subject expressed in the title. No attempt has been made to give any institutional view of the securities legislation from a broader economic, political or social angle—he has rigidly refrained from treading upon ground which is to be covered in other sections of this publication.

now given on new issues in regard to affiliations, contracts, litigation, investment accounts, contingent liabilities, stock ownership, etc., is of tremendous importance. Moreover, the knowledge that there is slight possibility of misrepresentation or omission of material facts is not only a comfort but a distinct aid in the elimination of much research work.

This dissemination of more detailed information is a progressive step in setting up improved standards of investment practice. The provisions of the Acts calling for this have developed and should continue to develop a greater spirit of co-operation in disclosing necessary data, not because of the requirements of the law alone, but as a tradition and a custom. It is already spreading into channels affecting securities of companies which have not raised any capital since the inauguration of the new federal securities legislation. Witness the gradual broadening and delineation of facts in interim and annual reports. Witness the increased endeavors on the part of the New York Stock Exchange to obtain in listing statements such information as was formerly considered sacred.

To the larger institutions the effect of the new form of publicity of data has been somewhat overrated. The invested assets of these institutions comprise well over two-thirds of the total of all such institutional invested assets. Their security buyers are trained and sophisticated; they usually have experienced assistance in performing necessary investigational work; they know what they want and what to look for and where to go to get it. Even with the information made available under the new legislation, there is still much research work to be done on matters not disclosed in a registration statement of a new issue or of an issue listed on a national exchange. With all the information now provided, the responsibility for getting the answers to problems not covered in the form of publicity presently required cannot be avoided. This may again be considered as beside the point, but it indicates that the value of this aspect of the legislation is entirely relative.

Evils Eliminated

Of importance are the restraints now imposed upon corporations and investment bankers foisting new issues upon institutions and individual investors with a paucity of information. The gullibility of a certain section of the smaller institutional investors can probably never be appeased, but the chances are slight of their being imposed upon to the extent they formerly were. The only practical offset to this is the fact that with the extreme care now necessary for sellers, and with distributing profits cut, the smaller institutions receive much less attention. In a great many cases they are eliminated entirely with no chance whatsoever to purchase new issues. On the other hand, the Securities Act tends to lessen the danger of smaller institutions becoming overloaded with securities of a non-institutional character through high pressure salesmanship.

While still a matter of opinion, it is unlikely that a gigantic fraud such as International Match could again be perpetrated upon investors. No apologies are needed for the institutions who purchased Mr. Kreuger's securities, but under the new Act they will probably not be caught again. Further, irregularities exposed in recent years in Simmons Co., Gillette and other companies would undoubtedly have been prevented in their inception. By hindsight, the advantages would have been obvious.

Of no little importance, also, is the fact that the information now available under the Securities Act tends to reduce the spread between offering price to the public and the price received by the issuer. A price spread of 3½ points is a rarity today, whereas prior to the Act this spread was more often near the minimum range.[1] It may be said that the combination of high-grade refunding financing and low money rates with the plethora of funds seeking investment would have brought this result in any event, but it appears that the new legislation is the real motivating factor. The benefits to both issuer and buyer are apparent.

Protective Measure Improved

Two of the finest pieces of work done by the Securities and Exchange Commission to date, and of particular advantage to institutions, are (1) that of attempting to define trustees' functions more clearly, and (2) steps taken to eliminate the protective committee racketeer.[2]

In regard to the former, institutions have deplored the looseness of indenture provisions regarding trustees' powers and the mockery of remedies offered. In numerous cases they have refused to buy certain issues for that very reason. Any tightening of these provisions as a result of the Commission's activity—and the work done so far should have some helpful effect even if it is carried no further—is a definite gain.

The protective committee racket has been a thorn in the side of institutions. In most major instances, institutional representatives are and have been the leaders in serving the interests of security-holders when difficulties arise. The minority committees, frequently formed in the past with some ulterior motive, should now be largely eliminated.

The Securities Act Not Responsible for Lack of New Capital Financing

The Securities Act often has been accused of being an obstacle to new capital financing and of having eliminated a large source of investment for institutional funds. There is an almost complete unanimity of opinion among institutions that this criticism is unjustified and that other economic factors are in reality the cause. Without attempting any elaborate proof of the soundness of this position, two facts alone will provide ample evidence.

[1] For a table presenting spreads on issues before and after the Act, see Gourrich, *supra*, p. 69.

[2] The Commission is conducting a broad investigation of the "Work, Activities, Personnel and Functions of Protective and Reorganization Committees," the results of which have been published in part. Specific recommendations are made to Congress for legislation which will strengthen weaknesses that exist. Although no definite action has been taken as yet, the publicity accorded these studies and resulting recommendations for legislation has had an immediate effect in transforming trustees' inertia into action and in curbing protective committee excesses. With regard to the latter, the necessity for registration with the Securities and Exchange Commission upon issuance of reorganization securities is also a check on improper practices.

First, railroads are exempt from registration under the Act. The absence of new capital financing by the rails cannot, therefore, be laid at its door. Second, financing for refunding purposes has been prolific in all types of industries. With all the attendant disadvantages of cost, etc., corporations have not refrained from undergoing the painful process of meeting registration requirements under the Act, where real savings or other advantages accrue. After all, those registration requirements for refunding purposes are precisely the same as they would be for new capital purposes—ergo, if new capital were needed, it would be obtained! From this viewpoint, institutions appear to have suffered no harm as a result of the Securities Act.

"Beating the Gun"

Of all the controversial questions that arouse a storm of discussion with regard to new security issues, "beating the gun" has received more attention than it deserves. So little harm could result from a liberal interpretation of this section of the 1933 Act and so little could be gained from its strictest enforcement that the entire matter is considerably over-emphasized. It becomes a nice question as to which side is the real winner in either event. As usual, attempts to regulate and control human behavior cause great ruptures in the body politic and great infractions of the rules. In this case, the expected result is seen—the condition is now as bad as or worse than it was before the Act was passed.

In the trade, "beating the gun" means making commitments for sale *or purchase* of new issues before the effective date of a registration statement. Despite all attempts to stop this practice, it has persisted, with institutions being largely in the supposedly "favored" class of buyers. No one will deny that institutions as a class make up the backbone of the new issues market. Without them, capital could be raised only with great difficulty and at a much higher cost. Their role in our financial system of accumulating funds to provide capital is integral—they represent the public in the form of depositors, policy-holders, *et al.* Why, then, can there be any complaint about their receiving favored treatment, if such it be?

But the subject strikes deeper than this somewhat specious reasoning. While most institutional buyers are attempting to obey the law (they are as culpable as the seller if they make a definite purchase commitment before the effective date), those who are meticulous are injuring themselves the most. To follow the law to the letter means to work blindly. If, for example, after proper study, an institution decides to invest $1,000,000 in a forthcoming issue, it may eventually be able to obtain only $10,000 to $25,000 at the offering price under present conditions. This is hardly intelligent investing. It could formerly plan exactly and purchase its requirements directly from the underwriting syndicate or banking group members. Now it must scramble with every individual one-bond buyer and perhaps purchase from as many as 200 different dealers scattered throughout the country, nonetheless not getting all it desires. The waste and added costs are self-evident.[3] The stimula-

[3] Institutions frequently complain of the number of prospectuses received describing a single new issue. Some of the larger institutional investors receive as many as 250 prospectuses, with an actual need for but two or three. While not required under the law, most underwriting firms request acknowledgments

tion to "free riders" has been enormous under present market conditions, and will eventually hurt the establishment of free markets under less favorable money and market circumstances.

This is not the procedure followed by large sellers and buyers of commodities or manufactured articles. Why should there be any difference with respect to securities? It is difficult to see where harm can be done by making initial offerings to large buyers. Certainly it is less expensive to the underwriters and therefore less costly to issuer and buyer. In these days of excessive cash funds, the larger institutions suffer because of their inability to put this cash to work—partly for the reason already given.

To attempt to draw a line of demarcation and define when submission of data on a new issue is or is not an offering is nothing but legal acrobatics—it would be classed by a practical man as pure nonsense. No one is fooled—buyer and seller both know what each is after, and a commitment can be made by a mere meeting of minds without a mention of the fact. Institutions are heartily sick of these silly subterfuges and thin disguises. They don't want "beating the gun" stopped!

Enforcement of this section of the 1933 Act is as useless as King Canute's efforts to stem the tide. It should be altered and modified to allow free and open discussion of new issues with potential buyers without this sophistic bush-beating and the creation of stealthy law violators. In all fairness it should be said that the Securities and Exchange Commission is not unaware of the situation the law has created and is cognizant of the difficulties in interpreting it. This has been shown in certain of its releases and in the mild charges brought against a group of underwriters on this score in June 1936. It is to be hoped that, in the absence of any change in the law, the Commission will continue to devote its attention to other more important matters.

Private Placements

Because of excessive costs, or for other internal reasons, many corporations have avoided registration under the Act and have sold their securities privately. The larger institutions, in general, have been the principal purchasers of such issues. This trend has shown a tendency to increase since the establishment of the Securities Act. According to the *Commercial and Financial Chronicle,* a total of over $212,000,000 was privately placed in the first seven months of 1936, or more than 7% of all corporate financing during that period.[4] Occasionally, an issue may be registered subsequent to its having been privately sold. This took place before the enactment of the 1933 Act, both in complete private placements and in the sense that a large part of major new issues may have been sold to institutions before being offered to the public—usually the latter. As contrasted with the situation existing before the Act, the present procedure now holds some definite disadvantages.

of prospectuses for their own protection under Section 5 of the Securities Act of 1933. It is not feasible for institutions to cooperate in this regard.

[4] For tables presenting data on private placements since the adoption of the Act, see Gourrich, *Investment Banking Methods Prior to and Since the Securities Act of 1933,* Table V, *supra,* p. 64, and Goldschmidt, *Registration Under the Securities Act of 1933,* Table I, *supra,* p. 21.

In the old days, it was often the case that underwriters discussed features of a proposed offering with institutional buyers. This was helpful to them and also to the institutions since they frequently were responsible for tightening various indenture provisions and for improving the terms in some instances. Their judgment was valuable to the banker and lessened his burden of attempting to serve the interests of the issuer and the public—extremely opposing viewpoints. The efforts of institutions to strengthen the investment status of a new issue for their own purposes were safeguards to the public who likewise purchased the new securities. These institutions now are able to dictate terms on private placings with them, but, since there can be no subsequent partial sale to the public, the public loses those benefits. Means should be found to restore this form of protection to smaller institutions and non-institutional investors.

The growth of private placings excludes the smaller institutions and individuals and eliminates a source of employment of their funds. This is true both in original offering and in the lack of a subsequent open market in which to buy. Most private placings, whether later registered or not, are closely held and unlikely to be redistributed.[5]

This matter ties in closely with the law aimed at "beating the gun." There now can be no pre-public offering to institutions—a new issue must be placed privately as a whole or offered to institutions and the public simultaneously. The Securities and Exchange Commission can do nothing about this without an amendment to the Act, the need for which is readily apparent. A return in this respect to conditions ante-dating the Securities Act, with open dealings permissible after *filing* date rather than *effective* date, would be salutary.

Thin Markets

Although governmental control of markets is accomplished under the Securities Exchange Act rather than under the 1933 Act, legislative regulation of markets is mentioned here because of its importance to institutions. Many institutions invest in common and preferred stocks, essentially on a long term growth basis and as a precautionary measure against changes in dollar purchasing power. Despite protestations to the contrary and whatever other advantages may accrue, it is the consensus of opinion among trained security buyers that regulations on specialists, floor traders and professional non-member traders, psychological limitations on short sellers and legitimate speculators, high margin requirements and rulings pertaining thereto, publication of purchases and sales of officers, directors and large owners, etc., have a restrictive effect upon markets outweighing the benefits gained. The result is exaggerated price movements in both directions, particularly on the decline. Unfortunately (in a sense), this opinion has not been tested as yet. Beyond temporary and sporadic periods of liquidation, the trend of all security markets has been consistently upward since the enactment of the Securities Exchange Act.[6]

[5] While having no present application, there exists the possibility that a growth in private placements might reduce the liquidity of institutional portfolios.

[6] This fact must temper all criticisms of the 1933 and 1934 Acts and the Securities and Exchange

If the current prophecy of virtual demoralization of the market during a marked downtrend turns out to be true, the effect on institutions will be pronounced. Bonds other than high grades will follow the same general pattern. A restricted or frozen position together with painful and perhaps deadly shrinkage in assets may result and could have disastrous consequences. While efforts to prevent manipulation are laudable, shackling the law of demand and supply usually proves ineffective and harmful. Framers of the 1934 Act and those who administer it may well keep in mind that artificial impediments seeking to check the normal functioning of a natural law might have a twin boomerang effect upon the public through the difficulties caused institutions.

State, County and Municipal Securities

As a class, no type of security is more involved, more subject to political factors, and less susceptible to continued analysis and the application of judgment, than obligations of political subdivisions. Sins of omission and commission have occurred in this field as flagrantly as in any other. There have been many cases of deliberate misrepresentations and misstatements and others of veiled and concealed facts. In the spring of this year, for example, there was offered to the public an issue of a Southern municipality, carrying the name of that city (which made it tax exempt), but which, in reality, was not an obligation of the city at all. It was supported, principal and interest, by the income received from the lease of a certain property to a railroad—nothing else. Stripped of technicalities and red tape, its strength depended upon the credit of a common carrier and not of a taxing authority. What could this be called but a thinly disguised misrepresentation?

Frequent changes in administration, the lack of incentive as in business, the prevalent tendency to blame predecessors in office for misdeeds without assuming responsibility for their correction, omission of periodic condition reports, etc., all contribute to the need for regulation. Much could be said in its favor from the view point of helping to prevent municipalities from again overburdening themselves with debt and getting into a hopeless financial morass.

Why not have federal regulation of such securities? It is true that state legislatures have passed many acts in recent years in an attempt to solve the municipal finance problem, but these are primarily in the interest of the municipality rather than the investor. Constitutional and state rights are involved, but in these days they are no insurmountable barriers. Institutions, as large holders of state, county and municipal securities, would welcome regulation of municipal bond issues—at least to the extent of filing registration statements that contain needed data.

Broker-Dealer Segregation

The study, authorized under the Securities Exchange Act, of broker-dealer segregation which has been undertaken by the Commission and which is incomplete as

Commission. The Commission has been in office during one-half of a long term cycle only—not until we have gone through the remaining half of the cycle under the new securities legislation will we know its faults and its virtues.

yet, deserves some mention. If any legislation results, circumscribing the activities of brokers and dealers in their present dual capacity, the effect will be felt acutely by institutions.

The Commission's first report on this subject, dated June 30, 1936, is an admirably calm and sane approach to the problem, although in the writer's opinion somewhat tinged with a pre-conceived idea of the desirability of segregation. Are not dual relationships extant in most businesses? Can every such relationship be delineated, carefully plucked apart and regulated by law? This is dangerous ground.

The report says "Undoubtedly, abuses incident to these multiple relationships are held in check by the standards of business conduct prevailing among reputable commission brokers. Practices on the part of a commission house which are detrimental to the interests of its brokerage customers would appear, in the final analysis, to be opposed to the dictates of enlightened self-interest. Nevertheless, such abuses have not been uncommon in the past." Is any business relationship perfect?

Any disruption of this dual function would make institutional buying and selling a much less efficient and more difficult operation; it would largely eliminate a source of valuable investment information now available by virtue of that multiple capacity; it would bring into play a prejudiced attitude on the part of security houses toward their institutional customers. All this would have exaggerated effects upon institutions outside the New York metropolitan area. Much could be added as to the probable derangement of our entire system of sale and distribution of securities—it has been made hard enough for institutions as it is.

In the securities business, temptations and opportunities for dishonesty abound in a measure greater than in almost any other field. It is generally admitted by those familiar with security operations and by the Commission itself, that standards of conduct in the business are high. Is it necessary to overthrow the entire system upon discovery of abuses, or is it wiser to set up means of preventing their recurrence without destroying a business that has proved its worth?

II

To institutions, nothing can take the place of experience and judgment in the selection of investment media. No legislation can replace those safeguards. Aside from the very small banks, insurance companies, etc., (which, for purposes of this article, must be classed as individual investors) most institutions know what they want to buy—they are seldom "sold" anything. If they are, that very act is conducive to the research and analysis which they are prepared to make.

From an institutional viewpoint, the purpose of the Securities Act is primarily to protect the small investor—institutions did not need such protection. From the setting up of those safeguards for the small buyer without making any distinctions, the large investors gain relatively little. An institution which purchases $1,000,000 of a new bond issue is put on the same level as the individual who buys $1,000 of the same issue—and incidentally both pay the same price.[7] For the protection

[7] Quantity discounts and concessions to institutions were discontinued by underwriters themselves shortly

which may now be afforded the little fellow, the institution pays a penalty and is placed in no better position if anything goes wrong.

As an illustration, penalties imposed in the Acts for infractions of the law are virtually meaningless to financial institutions. As a practical matter, they cannot sue—they must assume responsibility and suffer for their own mistakes. And as essentially long term investors, the one to three year limitation on actions to recover damages, good though this may be, restricts further the value of these remedies. Why apply these penalties to transactions with institutions when they cannot take advantage of them? There have been but a negligible number of instances prior to the enactment of the securities legislation where these penalties would have prevented trouble for institutions. It would be far better to discriminate and allow a restoration of the old institution-underwriter relationship. Whatever evils may have existed then, the present furtive and clandestine atmosphere that shrouds many transactions encourages as many, if not more, devious practices. Too much regulation often defeats its own ends—with all of its benefits, the securities legislation has certainly made investment operations more difficult for institutions.

Desire for improved standards of practice is universal. Like a new broom, a new agency feels that it must sweep clean, but there is no single rule that can cover a heterogeneity of circumstances.

III

Specifically, institutions would welcome changes in the law and in the administration of it as follows:

First. Amend Section 5 of the Securities Act of 1933, exempting therefrom institutions and professional buyers, and allowing free and open discussion with, and offerings of new securities, to institutions and professional buyers prior to effective date.

Second. Relax restrictions imposed under the Securities Exchange Act of 1934 which have resulted in a large-scale elimination of the legitimate speculator and a consequent thinning of the market.

Third. Amend the 1933 Act to include issues of states, counties and municipalities.

Fourth. Demand public disclosure by underwriting syndicates of terms of new offerings two or three days prior to effective date.

Fifth. Remedy conditions under which institutions are now forced to purchase surreptitiously foreign internal securities not registered with the Commission. In many cases such issues are necessary holdings in conjunction with business done in those countries. Now they must be bought under cover and sneaked into this country.

Sixth. Reduce substantially the cost of securing from the Commission copies of registration statements, corporation reports, publications, etc.

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prior to and during N. R. A. days. Neither the 1933 Act nor any regulations issued by the Commission contain any prohibition against this practice. Institutions feel that, in simple justice and on a pure business basis, they are entitled to discounts on large purchases.