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Reprinted from FINANCIAL WORLD, February 2, 1944

INVESTMENT BANKING—COMPETITION, OR DECADENCE?

The foremost exponent of competitive bidding in investment banking sees need for revival of courage in corporate financing

By Cyrus Eaton

Finfoto

CYRUS EATON

Shall we have a revival of honest competition in private finance or will we persist in our present ways until the Government takes over all of the banking business in America?

That, as I see it, is the crux of the current controversy over competitive bidding for new security issues and of the related struggle over regional finance.

The Government is already obliged to be loaning $27 billion to American business and agriculture, through thirty or more lending agencies. So obviously there is something wrong with private finance, and federal domination of the banking field is not just an idle threat.

WHAT AILS PRIVATE BANKING?

My diagnosis of the ills of the private banking business—without pretending to be complete—is that creative force is at a low ebb in the money markets, and willingness to take risks has practically disappeared. This, I think, is especially the case with the self-styled banking leadership in New York, where the big commercial banks have become hardly more than morgues for government bonds and cash, while the half dozen or so investment banking houses that euphemistically call themselves the "majors" have developed a positive phobia about taking normal business risks with the timid money—most of it is closely akin to trust funds—that forms their capital.

Another reason for the pusillanimity of the so-called "majors," in addition to the cautious nature of their capital, is the dearth of powerful personalities among them. Their business is largely inherited, but the capital, the courage and the brains of the financial giants who originally secured the business have not been an equally prominent part of the heritage.

LAWYERS' INFLUENCE

The trepidation of the "majors" is also attributable, in no small measure, to their dependence on the big New York law firms to supply the ingenuity in which they, themselves, are lacking. The lawyers, for all their wisdom and their skill in their own profession, are poor tutors for the investment banking business. Their counsel invariably favors caution over courage, and their training and experience naturally incline them to the distorted view that the intrinsic worth of an issue of securities rests more on obscure and restrictive legal documents than on the ability of the management of the issuing company to conduct its business successfully.

Parenthetically, it should be added that the influence of the lawyers not only on the "majors," but on the entire security business, has been greatly heightened in recent years by the growing legal complexities of doing business under the ever-increasing mass of federal and state regulatory laws. By the same token, those other highly respectable, but equally parasitical, professions of accounting and engineering have come to enjoy an unprecedented position of importance in the investment banking world, although no audit or engineer's report ever increased the intrinsic value of any stock or bond issue one jot or iota.

In recognition of their own weakness, the "majors" have banded together in an effort to preserve their inherited business, and it is from this phenomenon that investment banking, as carried on today, gets its markedly non-competitive character. Thus the pattern for practically all high grade corporate financing, excepting such

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The Author

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utility and railroad issues as are sold at competitive bidding, is the same: One of the "majors" manages the underwriting, while the others are automatically assigned to their usual places in the top brackets, and the rest of the issue is divided up in small amounts among a hundred or more of the faithful smaller houses.

Underwriting participations of houses both large and small follow practically the same percentages from issue to issue; the house that is dissatisfied with the size of its participation knows better than to register more than a mild protest if it wants to be included in future financing. The selling group, usually including several hundred other securities dealers in addition to the underwriters, is organized in the same automatic way, each house submissively accepting the "majors'" estimate of its capacity.

NO RISKS FOR THE "MAJORS"

After an issue has been set up, if market conditions look propitious for a perfectly risk-free transaction, then the "majors" will proceed with the public offering. But let the slightest upset occur in the markets or even let the big institutional investors look a little coolly on the proposed securities, and the "majors," despite the wide division of liability in the underwriting group, will wait weeks, months and sometimes years before bringing out an issue—or will abandon it completely, regardless of the financial hardship that delay or abandonment may work on the issuing corporation.

Where this happens to an issuing company, especially to one of the substantial number with whose directors and management the "majors" enjoy pleasant social relations, the resulting financial embarrassment must be stoically endured by the company's existing security holders unless the Government comes to the rescue. Theoretically, of course, an issuing company in dire straits can take its banking to other underwriters—and there are independent bankers of capacity and courage—but, as the issuer and everyone else concerned know, the "majors" have the rank and file of the Investment Bankers Association and the National Association of Securities Dealers so well regimented that dealer reception of an issue turned down by the "majors" is poor, and the flotation of a large issue without active dealer support is almost an impossibility.

All of this is in sharp contrast with the time not so many years ago when, even in unsettled markets, a single house would by itself take the first responsibility for the terms, the conditions and the liability of a large piece of financing, and wait until firm agreement had been reached with the issuing company before seeking other underwriters. In this way, for instance, one house handled the issuance of $60 million of preferred stock and $13 million of common for the Firestone Tire & Rubber Company in October, 1929, $60 million of preferred for the Republic Steel Corporation on its formation in April, 1930, and $30 million of debentures for the B. F. Goodrich Company in May, 1930.

PRIVATE VS. GOVT. BANKING

The choice that now faces the investment banking fraternity, to my mind, is a return to that kind of banking, with plenty of competition among houses, or complete abdication to the government. By this I do not mean, however, that formal competitive bidding should be, or could be, universally applied to the flotation of securities of ordinary industrial companies, although I do believe that competitive bidding is indispensable to such regulated corporations as the utilities, the railroads and the communications companies. Certainly venture money is needed, and industry is determined to get it, from the Government if necessary, as witness Henry Kaiser's recent suggestion for the post-war organization of a $500 million risk-capital corporation in which the Government would be invited to participate with various private groups and which would be empowered to invest in industrial stocks and bonds. If private underwriting is going to continue to consist for the most part of refundings of high grade bonds from higher to lower coupons, then some such suggestion as Mr. Kaiser's will have to be adopted.

My own notion is, however, that risk money can again be supplied to industry by private banking, as it was in the past, without bringing the Government any further into the banking business except on a temporary basis. The problem is to get more capital into the investment banking business, for, even when eastern underwriting capital is taken into consideration, there is insufficient money in the business, and has been ever since the commercial banks were required by law to give up their underwriting activities after the bank panic of the early nineteen-thirties.

Each region of the United States ought to have underwriting capital adequate to its own needs, and could have, if the Reconstruction Finance Corporation or some other Government agency would agree to take preferred stock in investment banking houses, just as it once bought the preferred stock of banks around the country. Another helpful step would be to have the Federal Reserve Banks in the twelve Federal Reserve districts grant liberal rediscount privileges to investment bankers. Then, Government could gradually withdraw from much of the banking it is now doing and, at the same time, security underwriters would soon find themselves in a position to retire the preferred stock held by the RFC.

EFFECTS ON STOCKS

With the strengthening of the regional financial centers, stocks generally should recover from their present abnormally low prices—many are selling for half their net quick assets—and the individual investor should at last emerge from the cyclone cellar where he has been languishing since the devastating debacle that began in 1929.

There was a time when every man in every town in the United States wanted to own some shares in the railroads, the utilities, the industrial companies and the banks of America, and that time will come again when the emphasis is shifted from riskless refundings designed for easy sale to the big insurance companies back to the constructive and creative finance that once made a major contribution to our industrial progress.