Negotiated vs. Competitive Debt Financing

Ralph S. Peterson

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RALPH S. PETERSON *

INTRODUCTION

Competitive bidding is as old as the investment banking business itself. Since the turn of the century this has been the accepted method of financing by municipalities, political subdivisions, and other public instrumentalities. For example, since 1935 the firm of Halsey, Stuart & Co., Inc., alone or with associates, has bid on over 6,500 such issues, ranging in size from less than $100,000 to $300,000,000 each and aggregating a face amount of over $9 billion.

Since 1926, pursuant to the policy then adopted by the Interstate Commerce Commission, several hundred railway equipment trust and terminal issues aggregating over $2 billion in face amount have been sold competitively.

The principle of competitive bidding for municipal, equipment trust, and terminal issues has been so thoroughly tested during war, boom and depression markets, that its advantages are no longer questioned. It was the extension of this principle, however, to public utility securities generally in 1941, and to additional classes of railroad debt securities in 1944 which again aroused organized opposition from the traditional utility and railroad bankers and gave rise to their solemn predictions of the dire consequences which would follow the adoption of competitive bidding for such securities.

It is not possible within the scope of this article to review all the arguments of opponents and proponents on this subject. These arguments have been fully and ably reviewed in the documents cited below.[1] These documents are the result of extensive investigations, hearings, testimony, briefs, etc., and represent some of the most competent evidence obtainable on the subject. During the past seven years, over $8 billion of corporate securities have been sold competitively, and over $3.6 billion have been sold via negotiation. This represents the bulk of all corporate financing in the United States during that time and the writer proposes to examine in some detail the results obtained under the two methods of sale as they affect the borrower, the underwriter and dealer, the regulatory agency and the public interest generally.

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1. SEC (Public Utilities Division), THE PROBLEM OF MAINTAINING ARM'S LENGTH BARGAINING AND COMPETITIVE CONDITIONS IN THE SALE AND DISTRIBUTION OF SECURITIES OF REGISTERED PUBLIC UTILITY HOLDING COMPANIES AND THEIR SUBSIDIARIES. (Dec. 18, 1940)

SEC, Holding Company Act Release No. 2676, April 8, 1941.

ICC, *Ex Parte* 158, In the Matter of Competitive Bidding in the Sale of Securities Under Section 20A of the Interstate Commerce Act (May 8, 1944).

California Railroad Commission Case No. 4761, Decision No. 38614, In the Matter of the Investigation on the Commission's Motion to determine the propriety of requiring public utilities to invite publicly, written sealed bids for the purchase of their securities.

THE DEVELOPMENT OF COMPETITIVE BIDDING UNDER FEDERAL AND STATE REGULATION

Competitive bidding under public regulation has developed in response to public demand for elimination of those abuses which have hampered or prevented arm's-length bargaining between banker and borrower in traditional negotiated financing. Extensive testimony in this respect is available in the verbatim record of investment banking hearings before the Temporary National Economic Committee.[2] Further testimony in this respect is also contained in the transcript of hearings before regulatory bodies previously referred to.[3]

Instead of reviewing such testimony, the writer believes it more appropriate to restate some of the reasons which have impelled various regulatory agencies to require competitive bids for security issues under their jurisdiction.

The fundamental reason for competitive bidding was well stated by the late Commissioner Robert E. Healy, of the Securities and Exchange Commission, in his address of August 28, 1941, before the National Association of Railroad and Utilities Commissioners, shortly after the effective date of that Commission's competitive bidding rule:

> The insistence upon competition in the sale of this particular kind of merchandise follows the traditional American pattern of the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. All of them aim to preserve competition and to keep that competition fair. The laws, backed by both major political parties, are among the foundation stones of our democratic system of capitalism. Let it not be thought that Rule U-50 (competitive biddiug) is merely a matter of business procedure. Ours is a system of free enterprise and when practices are allowed to develop which eliminate or suppress competition, the very fundamentals of that system are endangered. The liberating influence of our competitive bidding rule will foster free enterprise and competition in a field which has long been characterized by concentration of the management and underwriting of new securities in the hands of a few firms.

In adopting its requirement of competitive bidding on railroad debt securities, the Interstate Commerce Commission, in its Decision[4] of May 8, 1944, stated:

> In the exercise of our power to prescribe rates we are directed to give due consideration, among other factors, "to the need, in the public interest, of adequate and efficient railway transportation service *at the lowest cost consistent with the furnishing of such service;* and to the need of revenue sufficient to enable the carriers, under honest, economical, and efficient management to provide such service." We have considered it our duty under the act to investigate and point out, as inconsistent with efficient and economical management, glaring instances of what we consider improvident

2. VERBATIM RECORD OF THE PROCEEDINGS OF TEMPORARY NATIONAL ECONOMIC COMMITTEE, Volume 10, December 12, 1939, to January 13, 1940.
3. Note 1 *supra.*
4. Note 1 *supra.*

and wasteful expenditures, and we have always regarded the supervision of prices at which securities are issued as one of our most important duties in approving the issue of securities under Section 20a.

In 1939, the Federal Communications Commission after completing its extensive investigation of the telephone industry, recommended to the Congress that it be given authority to regulate the issuance of telephone securities, and on the subject of competitive bidding stated:

It would seem fair that, if the cost of bond money is to be a factor in determining interest during construction work in progress and evidence in establishing a fair rate of return, the investment bankers should be given an opportunity to make competitive bids, and the investment market should be allowed to express itself freely as to the rate of return at which it will supply the telephone business with that capital.[5]

While this Commission still lacks authority over the issuance of securities, it is appropriate to note, that The American Telephone & Telegraph Company and subsidiaries since 1941 have voluntarily, as a matter of sound corporate financial policy, offered at competitive bidding over $1½ billion of securities.

One of the pioneers in state legislation dealing with competitive bidding was Massachusetts, where since 1870 its statutes have provided that, with certain exceptions, stocks of electric and gas companies not taken by shareholders pursuant to preemptive rights should be sold by competitive bidding.[6] In 1919, Massachusetts adopted a law (still in effect) requiring that gas and electric utilities in "issuing bonds . . . should invite proposals for the purchase thereof by advertisements in two or more newspapers." [7]

In 1935 the New Hampshire Public Service Commission adopted competitive bidding in Re *Public Service Company of New Hampshire*,[8] saying:

Acting under this grant of authority, and because of our view that, under present conditions, competitive bidding constitutes the best method of disclosing the most favorable terms upon which bonds may be issued and sold by a public utility, our authorization of a recent refunding operation by the petitioner herein required "comparable competitive bids secured in compliance with procedures acceptable to this Commission" as the basis for our supplement order relating to the terms and price of the proposed issue.

The results in that instance appear to justify our insistence upon the use of like procedures in similar cases. Therefore our authorization herein will be subject to the condition that the exact terms be determined after competitive bids have been secured. . . .[9]

5. F.C.C. Report of the Investigation of the Telephone Industry in the U.S. Pursuant to Pub. Res. No. 8, H. Doc. No. 340, 593 (1939).
6. Mass. Gen. Laws c. 164, § 18, 19 (1932); Mass. Acts c. 179 (1870); Mass. Acts c. 382 (1871); Mass. Acts c. 39, 305, 333 (1873); Mass. Acts c. 84 (1878); Mass. Acts c. 90 (1879); Mass. Acts c. 315 (1893); Mass. Acts c. 472 (1894).
7. Mass. Gen. Laws c. 164, § 15 (1932).
8. 12 P.U.R. (N.S.) 408 (1935).
9. *Id.* at 410.

More recently, California and New York; our two most important states (in value of utility assets situated therein) have adopted competitive bidding.

Since 1944 the New York Public Service Commission has followed a policy generally of placing the burden of proof on the applicant to show that the proposed negotiated price is the best obtainable and where such showing was not conclusive, has required competitive bidding. The position of this Commission was demonstrated in its decision in Case No. 11929, denying the petition of Kings County Lighting Company for a proposed negotiated sale of $4,200,000 First Mortgage Bonds and ordering competitive bidding. Commissioner Maltbie's opinion, approved by the Commission on May 22, 1945, stated:

> In recent years, and particularly in 1944 and 1945, the sale of securities through competitive bidding has grown by leaps and bounds, and companies generally have resorted to this method in preference to private sale or agreement without any public offering. This Commission has rejected proposals for private sale because it did not believe the companies had obtained as good terms as they could have secured; and in every instance where the petition has been denied and competitive bidding has been utilized, the company has obtained better terms, particularly in the way of lower interest rates and higher prices, than were proposed in the rejected petition. Whether a private agreement made without any competitive bidding is the best that can be obtained is obviously a matter of opinion until bids have been received; but there is one great advantage of competitive bidding from the standpoint of the Commission and of company officials. We have had so much experience with competitive bidding and the benefits to the companies under our jurisdiction have been so great that there is no longer any question of the practicability of competitive bidding and that this means will obtain better terms than private sale. It may be that if conditions were to change and through some means real competition were to be eliminated, so that it did not represent a free expression of the financial world as to the proper price to be paid for an issue, "competitive bidding" would need to be abandoned. But there is no such condition at present and there seems to be no better way of determining what is the best a company can obtain for the securities it issues than by inviting bids from any source with full publicity and with ample time afforded to submit bids.

In 1945 the California Public Service Commission, on its own motion, conducted an exhaustive investigation [10] into the subject of competitive bidding, and in its Decision No. 38,614 dated Jan. 14, 1946, adopting a competitive bidding rule, the Commission also concluded:

> The record in this case shows that some utilities depend for advice and guidance on the investment banker to whom they intend to sell their securities. Obviously, the banker is an adversary party. It is doubtful whether the utilities should depend upon him for advice. In several instances members of investment banking firms were on the

10. California Railroad Commission, Case No. 4761, Decision No. 38614, In the Matter of the Investigation on the Commission's Motion to determine the propriety of requiring public utilities to invite publicly, written sealed bids for the purchase of their securities.

Board of Directors of the utilities whose securities they purchased. The record lacks convincing evidence that the utilities shopped around to sell their securities. A competitive bidding rule may relieve the utilities from what seems an implied right that bankers have to purchase the securities of certain utilities.

Much is said in this record about the price at which securities were sold. The price of securities is not static. It changes from day to day and varies with the vicissitudes of the business. No underwriter guarantees that the price at which he offers securities will not decline. The testimony shows that neither a negotiated sale nor a competitive bidding sale carries with it an assurance that the price will not rise above or drop below the offering price. That the price is affected by the terms of the securities, as well as by the standing of the issuer, is self-evident. It is in the public interest that utilities sell their securities at the highest price obtainable. We believe this can be achieved more readily when more than one investment banker is offered an opportunity to acquire their securities.

The Record of Negotiated and Competitive Debt Financing Since 1941

In order to obtain comparable statistical data, a study was made of all competitive sales and negotiated public offerings of new, public utility, railroad (equipment trust issues excluded), and industrial debt issues sold during the calendar years 1941 to 1948. The study does not include negotiated private placements, but does include all issues bid for competitively, whether the high bidder was a consumer (bidding as principal for own account or through an agent) or an underwriter bidding with a view to public offering. The facts relating to each issue were obtained from either the prospectus, the offering circular, or related registration or bidding documents.

Because present federal and state competitive bidding rules have uniformly required bids on funded debt issues, and some rules frequently or wholly exempt stocks and small debt issues, this study has been limited to debt issues of $2,000,000 and over.

Also, in order to compare underwriting spread (difference between cost to underwriters and the public offering price) only publicly offered issues have been included. The study begins in January, 1941, in order to observe the full operation of the competitive bidding rule promulgated by the Securities and Exchange Commission and effective on May 7, 1941.

Although industrial corporations are unregulated in the issuance of securities, the record of industrial debt financing has been included in order to compare the results of such traditional negotiated financing with the financing of regulated railroads and public utilities where competitive bidding is now the predominant practice.

In summary, the study covers 504 issues aggregating $11,976,680,000 face amount, of which 217 issues aggregating $3,689,356,000 face amount were sold via negotiation, and 287 issues aggregating $8,287,324,000 face amount were sold competitively.

THE GROWTH OF COMPETITIVE FINANCING SINCE 1941

From the study previously referred to, the following summary has been prepared showing the face amount and percentage of competitive financing in relation to total negotiated and competitive financing for each of the calendar years from 1941 to 1948, and the same figures for the entire seven-year period.

	Public Utility (000)	Railroad (000)	Industrial (000)	Total of 3 Classes (000)
1941—Total Neg. and Comp. Sales	506,495	81,115	317,200	904,810
Total Competitive Sales	197,920	48,697	13,700	260,317
% Competitive Sales	39.1	60.0	4.3	28.8
1942—Total Neg. and Comp. Sales	240,350	9,500	202,200	452,050
Total Competitive Sales	209,350	9,500	None	218,850
% Competitive Sales	87.1	100.0	—	48.4
1943—Total Neg. and Comp. Sales	346,800	60,183	115,994	522,977
Total Competitive Sales	320,800	31,700	None	352,500
% Competitive Sales	92.5	52.7	—	67.4
1944—Total Neg. and Comp. Sales	966,293	430,525	362,050	1,758,868
Total Competitive Sales	665,843	426,025	None	1,091,868
% Competitive Sales	68.9	99.0	—	62.1
1945—Total Neg. and Comp. Sales	1,828,559	1,338,166	521,410	3,688,135
Total Competitive Sales	1,718,793	1,322,666	None	3,041,459
% Competitive Sales	94.0	98.8	—	82.5
1946—Total Neg. and Comp. Sales	1,128,984	552,821	804,810	2,486,615
Total Competitive Sales	935,784	552,821	None	1,488,605
% Competitive Sales	82.9	100.0	—	59.9
1947—Total Neg. and Comp. Sales	1,845,225	26,500	291,500	2,163,225
Total Competitive Sales	1,792,225	26,500	15,000	1,833,725
% Competitive Sales	97.1	100.0	5.1	84.8
1/1/41—Total Neg. and Comp. Sales	6,862,706	2,498,810	2,615.164	11,976,680
to Total Competitive Sales	5,840,715	2,417,909	28,700	8,287,324
1/1/48— % Competitive Sales	85.1	96.8	1.1	69.2

From this summary it is clear that for the seven-year period, competitive bidding has been the method under which 85.1% of all public utility and 96.8% of all railroad debt issues have been sold, even though Rule U-50 of the Securities and Exchange Commission did not become effective until May 7, 1941, and the Interstate Commerce Commission order prescribing competitive bidding for railroad debt securities did not become effective until June 30, 1944. It is also significant that the only industrial debt securities sold competitively during this period were $13,700,000 McKesson & Robbins Debentures in July, 1941 (under Court jurisdiction), and $15,000,000 Cudahy Packing Company First Mortgage Bonds voluntarily offered by the issuer at competitive sale in May, 1947.

Out of almost $12 billion of total financing covered by this study, over

$8¼ billion, or 69%, was sold competitively—a substantial volume affording some useful conclusions regarding this method of sale.

Competitive Bidding Has Not Been Restricted to the Highest Grade Standardized Issues

One of the traditional arguments advanced against competitive bidding was that this method would work only on high-grade standardized issues. The following summary shows the face value distribution according to Standard & Poor's rating assigned to $11,851,262,000 of negotiated and competitive issues rated by this agency from 1941 to 1948.

Distribution of Par Sold According to Standard & Poor's Rating
1-1-41 to 1-1-48

	Public Utility	Railroad	Industrial	Total of 3 Classes
A1+—Negotiated (000)	238,250	—	389,500	627,750
% of Total	23.3	—	15.2	17.1
Competitive (000)	1,265,010	338,816	—	1,603,826
% of Total	21.9	14.3	—	19.6
A1 —Negotiated (000)	301,000	22,418	552,000	875,418
% of Total	29.5	27.7	21.5	23.9
Competitive (000)	2,130,859	325,085	—	2,455,944
% of Total	36.9	13.7	—	30.0
A —Negotiated (000)	359,482	30,483	668,500	1,058,465
% of Total	35.2	37.7	26.1	28.9
Competitive (000)	1,387,100	1,233,508	28,700	2,649,308
% of Total	24.0	51.9	4.3	32.4
B1+ —Negotiated (000)	97,059	21,500	817,414	935,973
% of Total	9.5	26.6	31.9	25.5
Competitive (000)	949,417	478,800	—	1,428,217
% of Total	16.4	20.1	—	17.5
Sub- —Negotiated (000)	26,200	6,500	137,000	169,700
Rated—% of Total	2.5	8.0	5.3	4.6
Competitive (000)	46,661	—	—	46,661
% of Total	.8	—	—	.6
Total Par (000) Rated	6,801,038	2,457,110	2,593,114	11,851,262
Negotiated	1,021,991	80,901	2,564,414	3,667,306
Competitive	5,779,047	2,376,209	28,700	8,183,956

From the above figures it will be seen that out of the total financing for the three classes shown, the proportion of highest grade A1+ issues sold under the two methods was about equal—17.1% being negotiated, as against 19.6% competitive; in the second highest rating of A1, a greater percentage of such issues were sold competitively (30.0%), as against 23.9% negotiated; in the third highest rating of A, competitive sales represented 32.4%, as against 28.9% negotiated, while in the lowest bank quality rating of B1+, negotiated sales accounted for 25.5% and competitive sales 17.5%.

In the sub-rated classification (i.e. ratings assigned to issues where the investment elements do not predominate) the percentage of such issues sold via negotiation (4.6%) when compared to the percentage sold competitively (.6%) does not indicate that negotiated financing is more adaptable to low quality issues than competitive bidding, the difference in volume of sub-rated issues sold amounting to less than $125 million.

Moreover, the 287 issues sold competitively represented a wide variety of mortgage bonds with varying lien provisions; both serial and term debentures as well as notes; coupons ranged from 2½% to 4¼%; the size of the issues ranged from $2,000,000 to $200,000,000; the obligors represented widely diversified activities and the securities offered appealed to a broad variety of institutional and individual investors.

In the light of such facts it cannot be concluded that competitive bidding has worked only in sales of the highest grade, standardized corporate credit.

Average Spread on Competitive Financing About Half of Average Spread on Negotiated Financing

In preparing the following summary, the gross profit or "spread" to the underwriters has been computed as the difference between their cost (price paid to the issuer) and the initial public offering price. Such spread is shown annually as a percentage of each year's face amount sold, and for the seven-year period the total face amount sold, the total dollar spread and the average spread in per cent.

	Public Utility % Average Spread		Railroad % Average Spread		Industrial % Average Spread		Avg. for 3 Classes % Average Spread	
	Negotiated	Competitive	Negotiated	Competitive	Negotiated	Competitive	Negotiated	Competitive
1941	1.788	1.09	1.527	1.357	1.719	1.569	1.742	1.154
1942	3.023	1.253	—	1.168	1.957	—	2.099	1.249
1943	2.012	1.316	1.748	1.375	2.307	—	2.169	1.321
1944	1.189	1.065	1.511	1.043	1.924	—	1.590	1.057
1945	1.367	.682	1.729	1.162	1.975	—	1.866	.888
1946	.973	.628	—	.843	1.175	—	1.136	.707
1947	1.238	.574	—	1.136	1.264	.98	1.26	.585
Total 1/1/41 to 1/1/48								
Face Amt. Sold (000)...	1,021,991	5,751,365	80,901	2,272,645	2,586,464	28,700	3,689,356	8,052,710
Total Spread (000)	14,585	43,346	1,329	24,324	42,071	362	57,985	68,032
Weighted Av.—%	1.428	.754	1.643	1.070	1.627	1.261	1.572	.845

From the above table it is apparent that for the seven-year period the average spread of 1.428% on negotiated public utility financing was about twice the average spread of .754% on competitive utility financing, and that on railroad financing the average negotiated spread of 1.643% was about 1/3 higher than the average competitive spread of 1.07%.

For the three classes of issues combined, the spread averaged 1.572% on $3,689,356,000 face amount of negotiated sales as against average spread of .845% on $8,052,710,000 sold competitively, a difference of .727% lower spread on competitive sales, or a dollar difference on $3,689,356,000 negotiated financing of over $26,821,000. In other words, absence of competition on such negotiated volume either cost the issuers over $26,000,000 because of less proceeds, or the investors paid over $26,000,000 too much underwriting profit.

Any comparison of competitive with negotiated average underwriting spreads amply confirms the fact that competitive bidding produces competition in bankers' gross profits with substantial distribution economies to issuer and investor.

Competitive Bidding Has Reduced or Eliminated the Management Fee Charged Underwriters by Their Representative

A customary practice of the Underwriters' Representative or Manager has been to charge participating underwriters a management fee as compensation for services in forming and managing the underwriting group. The amount of such fee is usually calculated as a percentage of either the face amount of the issue managed or the gross profit payable to participants. The following table compares the amount of such fee on negotiated and competitive financing in relation to the face amount managed.

	Negotiated	Competitive	Total
1) Total Par Sold by Issuer (000)	3,689,356	8,287,324	11,976,680
Public Utility	1,021,991	5,840,715	6,862,706
Railroad	80,901	2,417,909	2,498,810
Industrial	2,586,464	28,700	2,615,164
2) Total Par (000) on which Mgt. Fee Charged	2,502,370	3,993,245	6,495,615
Public Utility	776,916	2,880,082	3,656,998
Railroad	—	1,113,163	1,113,163
Industrial	1,725,454	—	1,725,454
3) Amt. of Mgt. Fee Charged (000)	6,084	1,961	8,045
Public Utility	1,291	1,333	2,624
Railroad	—	628	628
Industrial	4,793	—	4,793
4) % Mgt. Fee of Par on which Charged	.243	.0491	.124
Public Utility	.166	.0463	.0717
Railroad	--	.0564	.0564
Industrial	.277	—	.277

From these computations it will be noted that on total sales of $11,976,-680,000, a record of the amount of management fee was available with respect to issues aggregating $6,495,615,000 face amount, leaving about $5½ billions of sales on which the amount of the management fee (if any) was not disclosed in the prospectus, offering circular, or related documents.

Total management fees of $6,084,000 were charged on $2,502,370,000 face value of negotiated financing, or .243% of such face amount, whereas on $3,993,245,000 of competitive financing the total management fees charged were $1,961,000, or .049% of such amount. In other words, the per cent of management fees charged on negotiated financing was about five times greater than on competitive financing—further evidence that competitive bidding forces competition not only in price but also in underwriting terms.

Range of Bids Demonstrates Independent and Varied Pricing Judgment

The range of bids (difference between highest and lowest bid) offers conclusive evidence that the pricing of securities is not an exact science but is subject to a varying range of investment opinion. The following summary covers 245 issues, or $7,082,826,000 of securities on which the range of bids could be computed, out of the total of 287 issues, or $8,287,324,000 sold competitively. The difference of $1,204,498,000 is represented by 22 issues aggregating $610,138,000 on which only one bid was received, and by 14 issues aggregating $498,900,000 where the high bid was a "basket bid," i.e., a single bid for two or more issues sold simultaneously as a single "package" or unit, and where the proportionate amount of each bid could not be allocated to a single issue. The remainder, or $95,460,000, is represented by six issues where the range could not be computed because the lowest bid received was not a matter of public record.

	% Range			Total of 3 Classes		
	Public Utility	Railroad	Industrial	Par (000) Rec. 2 Bids & Over	Total Range (000)	% Range
1941	1.409	4.718	1.489	247,357	4,679	1.892
1942	1.861	.768	—	59,850	1,010	1.688
1943	1.587	.628	—	293,800	4,424	1.506
1944	.721	1.013	—	849,868	7,043	.829
1945	.694	.963	—	2,570,159	20,351	.792
1946	.70	.448	—	1,322,067	8,097	.612
1947	.538	1.045	—	1,739,725	9,492	.546
Total 1/1/41 to 1/1/48 Par Sold (000)	5,260,677	1,808,449	13,700	7,082,826		
$ Range (000)	38,440	16,452	204		55,096	
% Range....	.731	.910	1.489			.778

From the above table it will be seen that on over $5¼ billion of utility issues the high and low bidders were over $38 million apart in their respective valuations of such issues, or a difference of .731% of the face amount bid for; the range on railroad issues averaged .910% of the face amount bid for, and on the one industrial which received three bids the range was 1.489%, so that on total financing of $7,082,826,000 the difference in price views amounted to over $55 million, or an average of .778% of the face amount.

Such difference in price views makes it imperative that the issuer obtain the broad judgment of the entire market through competitive bids, instead of the more limited views of the traditional banker in a negotiated transaction.

One of the arguments against competitive bidding has been that it leads to over-pricing in a strong or rising market and to under-pricing in a weak or declining one. The weakness of either view is the fact that it is, of necessity, based on hindsight, and it would be a genuine contribution to the pricing art if any underwriter could state, *before the offering date,* the exact price at which a particular security could be successfully sold. The fallacy of the argument can be shown, however, not only by a consideration of pricing technique, but external market factors affecting the price.

The determination of the bid price is a carefully executed procedure designed to explore every element of price opinion represented among the several bidders. Such opinions are obtained by means of price meetings at which the several bidders may appear or file their price views or price limits.

The purpose of these price meetings is to canvass and evaluate the views expressed by all participants and to compare the credit of the issuer with other securities of similar kind and quality. This is done by means of statistical comparisons and other relevant information. All price views are carefully tabulated and, when finally determined, the price which is bid represents the considered judgment of the several bidders and no bidder needs accept a commitment at a price which he believes does not represent a salable value in comparison with other securities of similar type and quality.

Despite the care which is taken to arrive at proper prices and terms, no bidder can say whether an issue is properly priced until its market reception. Even then, no one can guarantee that the offering price will not rise or fall in competition with other securities in a free market, nor can anyone forecast the extent or duration of subsequent market changes. If such determination were possible, there would be no reason for seeking competitive bids, nor would there be any range of bid and asked prices in the billions of dollars of securities now traded in the secondary market.

For these reasons, no underwriter, whether in a negotiated or competitive sale is going to name any price which he does not believe represents a salable value under existing market conditions, inasmuch as all underwriters buy with a view to resale at a profit and not for permanent investment. Furthermore, any tendency to over-bid inflicts its own penalty—any underwriter which has paid more than the market will bear cannot repeat the same mistake too often and still stay in business.

When the traditional banker in a private negotiation prices a security under the market so as to minimize or eliminate the risk of an unsuccessful sale, and the issue then goes to an immediate and substantial premium, absent a concurrent rise in the price of comparable securities, a conclusive presumption exists that the issuer did not get full value received and that the underwriter was compensated for a risk he did not assume.

It has also been argued that in a declining or weak market the highest bid will be lower than the price that would be paid under private negotiation. While this statement is simply unsupported argument it is more logical to say that the traditional banker, under private negotiation, is far more likely to offer a price to the issuer on a basis intended to assure complete safety for himself, than is the bidder who must compete in order to stay in business. Moreover, since competitive bidding subjects each issue to a broader range of market appraisal than is possible in a privately negotiated transaction, the argument in this respect is simply contrary to experience, and this fact has been amply demonstrated by the results obtained under competitive bidding for railroad equipment trust issues during the last 20 years and municipal issues for the past 50 years. Also, this argument becomes meaningless when put to a real test, because under any depression or panic conditions the issuer is reluctant to borrow and the investor to lend. As a consequence, there is no appreciable financing during such periods to test the alleged fortitude of the traditional banker.

In short, competitive bidding results in the best price and terms for the issuer—which is a fact. It subjects the underwriter to some risk—for which he is paid. It requires the investor to pay the market price for his securities—which is what he pays for everything else.

Complexities of Financing Are No Barrier to Competition

Another objection urged against competitive bidding was that such method of sale was not adaptable to complex debt structures, especially railroad mortgages. Opponents have urged in particular that the numerous and technical mortgage provisions relating to the debt structures of American steam railroads required special analytical and customer educational ability and that such issues could not be sold as readily by competitive bidding as by the traditional negotiated route. The fact is that in the last seven years 80 steam railroad issues aggregating over $2.4 billion have been sold competitively. This volume represents 96.8% of all railroad debt financing during that period and the list of issues sold constitutes a veritable who's who of American railroad financing.

Competitive Bidding Has Not Encouraged Irresponsible Bidding

While the argument in this respect does not define irresponsible bidders or bidding, the record during the past seven years fails to disclose rejection of any bids on such grounds.

Today, the business conduct of securities dealers is closely supervised by stock exchanges and local and national dealer organizations. Furthermore, all dealers and underwriters are subject to broad civil and criminal liabilities for violations, particularly of the Securities Act of 1933, the Securities Exchange Act of 1934, and rules and regulations of the Securities and Exchange Commission generally. Any violations of the rules or laws administered by these agencies subjects the offending dealer either to censure, fine, expulsion, revocation of his license, or other penalties designed to rid the industry of any undesirable members. Financial statements of dealers are also readily available to any interested party, and bidders must also qualify themselves in advance of the bidding by means of bidders' questionnaires submitted to the issuer, trustee, and underwriter's representative.

In view of the extensive regulation to which dealers are now subject, it cannot be concluded that competitive bidding has developed irresponsibility in the investment banking industry.

Competitive Bidding Has Worked on Both Small and Large Issues

Another stock argument against competitive bidding has been that this method would not work on small issues because bidders would not spend time studying a small issue without assurance that they would have securities to sell and that large issues would not obtain more than one bid because there was not enough strength in the investment banking business to form more than one large underwriting group. The following summary shows what has happened.

Distribution of Par Value Sold and Number of Bids Per Issue
According to Size of Issue
1-1-41 to 1-1-48

	Public Utility	Railroad	Industrial	Total of 3 Classes
From $2,000,000 up to $25,000,000 each				
Negotiated par sold as % of grand total	32.9	64.8	40.5	39.0
Competitive par sold as % of grand total	21.5	14.9	100.0	19.8
Average number of bids per issue......	5.0	3.6	2.0	4.6
From $25,000,000 up to $50,000,000 each				

Negotiated par sold as % of grand total	20.3	35.2	24.7	23.7
Competitive par sold as % of grand total	31.6	41.4	None	34.3
Average number of bids per issue......	2.8	2.6	—	2.7
From $50,000,000 up to $100,000,000 each				
Negotiated par sold as % of grand total	20.3	None	18.4	18.5
Competitive par sold as % of grand total	23.0	43.7	None	29.0
Average number of bids per issue......	2.1	2.2	—	2.1
$100,000,000 and over				
Negotiated par sold as % of grand total	26.5	None	16.4	18.8
Competitive par sold as % of grand total	23.9	None	None	16.9
Average number of bids per issue......	2.0	—	—	2.0
Grand Total				
Negotiated par sold (000)............	1,021,991	80,901	2,586,464	3,689,356
Number negotiated issues sold......	49	9	159	217
Avg. size of negotiated issues (000)	20,857	8,989	16,267	17,002
Competitive par sold (000)...........	5,840,715	2,417,909	28,700	8,287,324
Number competitive issues sold......	205	80	2	287
Avg. size of competitive issues (000)	28,491	30,224	14,350	28,876
Average number bids per issue......	4.0	2.9	2.0	3.7
% of par receiving 1 bid per issue......	7.0	7.6	52.3	7.4
% of par receiving 2 bids per issue.....	49.9	76.0	—	52.1
% of par receiving 3 bids per issue.....	21.4	19.3	47.7	20.9
% of par receiving 4 bids per issue.....	9.5	12.7	—	10.4
% of par receiving 5 bids per issue.....	6.7	1.1	—	5.0
% of par receiving over 5 bids.........	5.5	1.1	—	4.2

In the smallest size group (issues of $2,000,000 to but not including $25,000,000) it will be seen that the par value of such issues accounted for 39.0% of the total negotiated sales of $3,689,356,000 and that competitive sales accounted for only 19.8% out of total competitive volume of $8,287,-324,000. The heavier concentration of negotiated financing in this size group is due to the inclusion of 127 of the 159 industrial issues sold during this period. These 127 industrial issues averaged $8¼ million each. The average number of bids (4.6) for issues in this group shows, however, that the smaller the issue the greater the average number of bids per issue. For example, one issue ($4,500,000 Madison Gas & Electric Company Bonds) sold in 1946 received 16 bids and one issue ($4,500,000 Metropolitan Edison Company Bonds) sold in 1947 received 11 bids.

While the opposition argument does not define either a small or large issue, the summary shows that the larger issues offer no obstacles to competitive bidding. The 25 to $50 million group accounted for 34.3% of the volume bid for and received an average of 2.7 bids per issue, the next largest group accounted for 29% of the volume bid for and averaged 2.1 bids per issue, whereas issues of $100,000,000 and over accounted for 16.9% of the total volume bid for and received an average of 2 bids per issue. In the latter class, 10 issues were bid for, all utilities, of which two issues were for $200,000,000 each, one for $175,000,000, and one for $160,000,000, and the remainder for lesser amounts. In this connection it will be noted that negotiated issues averaged $17,002,000, whereas competitive issues averaged $28,876,000 each, indicating that competitive sales are generally larger than negotiated sales.

Public utility financing during the period attracted an over-all average of four bids per issue, and railroad financing 2.9 bids per issue. The average of two bids on the industrial competitive financing is inconclusive because only two issues were sold competitively during this period.

The last six lines of the summary show the distribution of bids by face amount bid for. This shows that 7.4% of the $8,287,324,000 bid for received one bid, or conversely that over 92% of such volume received two bids or more, the average for total financing being 3.7 bids per issue.

Competitive Bidding Has Not Restricted Underwriter's Investigation or Eliminated the Small Dealers

The opposition argument here is to the effect that bidders can not afford to make as exhaustive an investigation of a proposed issue as could an underwriter in a negotiated transaction where he was certain of obtaining the issue, and that competitive bidding would eliminate the small dealer.

As to alleged lack of investigation, such argument forgets the fact that the registration statement and related documents now filed with the SEC and other public agencies on utility and industrial companies, contain a most comprehensive disclosure of facts and financial statements relating to their affairs. The same is true of railroads, whose affairs are most thoroughly publicized in annual reports, offering circulars, Interstate Commerce Commission reports, mortgage maps, traffic density services, and other sources of information. As a result, an issuer's affairs are no longer a mystery to anyone, least of all a bidder and the prospectus or offering circular used by an underwriter or dealer today is a marked contrast to the customary one-page president's letter supplied years ago (and usually written by the traditional banker) in the sale of a negotiated issue. The truth of the matter is, that since 1933 the liability provisions of the Securities Act attaching to misrepresentation or omission of any material fact, have placed definite investigatory responsiblities on both underwriters and dealers and such responsibilities are not affected by the method under which an issuer decides to market its securities.

As to elimination of small dealers, the seven-year record shows that competitive bidding has broadened the activities of such dealers, that bidding, underwriting and selected dealer groups have increased in size despite the essentially institutional character of the market for new issues during this period. For example, in the last seven years, 1,054 bids were submitted by

31,809 bidders on 287 issues aggregating $8,287,324,000 face amount. Out of this number, 12,676 of those bidders became underwriters of 274 issues aggregating $8,091,202,000 face amount by virtue of being members of the 274 bidding groups submitting the bid accepted by the issuer. The number and par value of the issues underwritten excludes 13 issues aggregating $186,122,000 also bid for but not underwritten, and where the issue was awarded either to an institutional investor or his agent. This leaves 19,133 unsuccessful bidders (31,809 less 12,676) who also bid for the same par value but whose 747 bids (1,054 less 287) were rejected by the issuer. These unsuccessful bidders acting as prospective underwriters, made the same initial study of the proposed issue and the issuer's credit as did the successful bidder. Such pre-bidding study has produced broader dealer interest and customer education and discussion of a new issue and the practice has also developed under competitive bidding whereby successful bidders in forming selling groups have included unsuccessful bidders as participants in dealer marketing of an issue.

Under competitive bidding any underwriter or dealer is free to join any one of the several bidding groups which may be formed, and indeed there is competition among underwriter's representatives in the formation of strong bidding groups. As a result, decisions affecting membership and size of participation are decided on the basis of underwriting capacity and distributing ability instead of reciprocity and other mutually cozy relationships which frequently dictate such decisions in a negotiated issue.

Some Specific Savings From Competitive Bidding

Since 1941 there have been six issues[11] where the regulatory agency denied a firm negotiated offer and then ordered competitive bidding.

These six issues aggregating $138,700,000 face amount, when sold competitively, produced total savings over the rejected negotiated offers of $6,504,512 on the basis book method of computation and $5,145,864 on the net interest cost method of computation. Expenses on the issues under the negotiated offers would have been $750,546 or 54/100% of their face amount, whereas expenses of public offering were $972,884 or 70/100%—an increase of 16/100% of the face amount of $222,338 to place the issues in salable form for competitive bidding and public offering.

In addition to these dollar savings, there were also intangible advantages

11. Public Service Electric & Gas Corporation (N.J.) $15,000,000 30 Yr. 3% Bonds sold 6-1-42; Kings County Lighting Co. (N.Y.) $4,200,000 30 Yr. 3⅛% Bonds sold 8-6-42; Brooklyn Union Gas Co. (N.Y.) $30,000,000 25 Yr. 3½% Bonds and $12,000,000 25 Yr. 4% Debentures sold 9-20-44; Georgia Power & Light Co. (Ga.) $2,500,000 30 Yr. 3% Bonds sold 5-7-45; Pacific Telephone & Telegraph Co. (Calif.) $75,000,000 40 Yr. 2¾% Debentures sold 12-10-45.

to the issuers on five of these issues which were publicly offered instead of privately placed as contemplated by the negotiated offer. A public offering creates public interest in the issuer and the issue, not only on the part of investors but also dealers and statistical organizations. As a result, the securities are quoted and traded in the secondary market and they become rated by statistical and other advisory services, all of which is helpful in establishing the public credit of the issuer and facilitates subsequent financing or refunding.

Competitive Bidding Aids Public Regulation

An accepted principle of public regulation is that the regulatory body employ the best information available for the discharge of its public obligations. This principle is recurrent in statements on competitive bidding.

The Public Utilities Commission of the District of Columbia, in explaining its requirement of competitive bidding, rested it upon the need "to be informed adequately as to the propriety of any authorization" and that "evidence must be before it on which to base its action." The former Chairman of the District Commission explained that in the absence of competitive bidding, a regulatory body cannot be assured of the correctness of its determination of price. This he believed was due to the fact that the regulatory body could not pretend to be as expert as the banker on market factors, and that it was jockeyed into quick decisions for fear of delaying a proposed issue in the face of market fluctuations, and for other reasons.[12]

Similarly, the New Hampshire Public Service Commission stated that "competitive bidding constitutes the best method of disclosing the most favorable terms upon which bonds may be issued and sold." [13]

The Securities and Exchange Commission, charged with a similar responsibility with respect to the regulation of securities, concluded that it was not in a position to review the fairness of price of proposed utility securities while investment bankers continued to dominate these transactions. As Commissioner Robert E. Healy put it, the Securities and Exchange Commission concluded that "there was no way short of competitive bidding that would afford us satisfactory means of determining the reasonableness of spreads or the fairness of prices, assure disinterested advice in financial matters to the companies concerned and effectively control their dealings and affiliates." [14]

The Interstate Commerce Commission in its report dated May 8, 1944, adopting competitive bidding stated:

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12. Elgen, *Value of Competitive Bidding for Utility Securities,* P.U. Fort. 729 (June 10, 1937).
13. Re Public Service Co. of New Hampshire, 12 P.U.R. (N.S.) 408 (1935).
14. Address before the National Association of Railroad and Utilities Commissioners, August 28, 1941.

> The requirement that railroads resort to competitive bidding in selling equipment trust certificates and certain terminal company bonds has aided us in determining the fairness and adequacy of the price being paid for the securities and the reasonableness of the spreads. A similar requirement in case of other security issues by railroad companies would aid us in discharging our duties under Sec. 20a.

Also the California Public Service Commission in its Decision No. 38614 dated January 15, 1946, promulgating a competitive bidding rule, stated:

> While the Commission has positive authority to fix the price at which a utility may sell its securities, it should do so only upon having before it competent evidence. The bids are a form of evidence helpful in determining the price at which the securities should be sold.

Further, on this point, the New York Public Service Commission in the *Kings County Lighting* decision stated:

> Whether a private agreement made without any competitive bidding is the best that can be obtained is obviously a matter of opinion until bids have been received.

In the absence of competitive bids, the regulatory agency when considering price and terms of sale, obtains only the views of the traditional banker. Such views may be biased in cases where such banker had any difficulty in marketing previous securities of the issuer, or such views may be limited either by reason of a limited underwriting capacity, commitments in other securities, a limited clientele for the particular issue under consideration, or the ever-present non-competitive profit motive.

Under competitive bidding the regulatory agency obtains the benefit of a broader cross section of investment opinion, not only as to price, but also competition among bankers with respect to terms.

Some Practical and Procedural Aspects of Competitive Bidding

Despite the basic advantages inherent in the principle of competitive bidding, no one has contended that this method is practical for every type of financial transaction and security. A study of the rules promulgated by the Securities and Exchange Commission, the Interstate Commerce Commission, and the California Public Service Commission, discloses a general recognition of the following basic exemptions under which certain transactions and issues are excluded from the requirements of each rule.

1) Any security exchanged for outstanding securities where no fee is paid for soliciting such exchange.

   This exemption appears in each of the three rules and permits an issuer to effect exchanges with existing security holders without any payment for soliciting the exchange.

2) Issuance of securities pro rata to existing security holders pursuant to preemptive right.

    This exemption is also recognized by each of the rules and unless the unexchanged portion is to be underwritten, a straight preemptive offer is exempted.

3) Any security issued during reorganization or financial readjustment pursuant to court jurisdiction.

    This exemption also appears in each of the rules cited and merely recognizes the authority of a court to impose such terms as may be appropriate in connection with the issuance of a new security.

4) Short term notes or conditional sales contracts.

    While such financing is exempted in each of the rules referred to, the maturity of such financing varies from a minimum of three years in the I.C.C. rule, to a maximum of ten years in the S.E.C. rule.

    Since the intent is obviously to exempt short term bank financing, it would appear that any maturity over three years raises a question as to whether such a maturity is in fact an appropriate short term commercial bank investment to be exempted from a rule.

5) Common and Preferred stocks. Only the Interstate Commerce Commission exempts railroad equity issues from their competitive bidding requirement. In this connection, the concurring opinion of Chairman Patterson is pertinent.

I concur in the majority report but would also require competitive bidding in the sale of common and preferred stock not sold or otherwise issued to existing holders of securities of the issuing company. I see no good reason for this exception by the majority and the report shows none.

6) Small issues where the aggregate proceeds to be received would be insufficient to justify the expense of registration under the Federal Securities Act in contemplation of a public offering via competitive bidding.

    Here it will be noted that each of the three rules fixes the proceeds to be exempted at $1,000,000, and whether such amount would be appropriate in all cases would depend on the average size and capital requirements of the smaller issuers.

7) It is also noted that each of the three rules referred to contains a general exemption covering any issue as to which the Commission shall find, upon due showing by the applicant, that competitive bidding should not be required.

    This is an important and necessary exemption to take care of any special situations which may arise and where the burden of proof rests on the applicant to convince the Commission that competition in the sale of the proposed security is not practical or feasible.

The Annual Report of the Securities and Exchange Commission covering its fiscal year ended June 30, 1947, contains the following appropriate statement on the subject of exemptions from its competitive bidding rule U-50:

> The past year has seen the first extended period in which the Commission's competitive bidding rule has been called upon to function in a falling market. It has been recognized from the outset, of course, that the competitive bidding procedure is not necessarily adapted to all securities and all market conditions, and exemption provisions were thus made an integral part of rule U-50. However, it has been necessary to grant exemptions in only a few cases even under the relatively unfavorable market conditions of the year just past.
>
> Although the volume of offerings under rule U-50 dropped sharply from the previous year, the total of $466,265,349 for the 12 months ended June 30, 1947, was exceeded only in the 1945 and 1946 fiscal years, when refunding operations were at their height. From the standpoint of equity securities alone, the 1947 volume was surpassed only by that of 1946.

One of the important effects following the adoption of each rule was to shift the burden of proof from each Commission to show affirmative cause for competition, to each applicant to show cause for exemption. That the burden of proof should rest on the applicant and exemption be decided on the merits of each application was recognized in the report of the Interstate Commerce Commission where, in adopting its rule, it stated:

> On the question of why we should adopt a rule or regulations requiring competitive bidding when we have the power to require it in any specific case if it should appear that such a method is appropriate, proponents point out that in recent proceedings while expressing the opinion that the market has not been adequately tested in the particular cases before us, we nevertheless felt constrained to approve arrangements to which the railroad had committed itself in reliance upon the fact that no existing rule required it to solicit bids. They say that the absence of such a rule has thus come to be a persuasively practical argnment for not requiring competitive bidding in particular cases. From this they argue that as the situation stands today, either private negotiation as a practically uniform thing will prevail without shopping around and without competition of any kind, or we must announce a change, if we want that change to take place.

There are also certain procedural provisions which have developed under these rules to assure that all bidders receive fair play and equal opportunity. Some of the more important provisions are:

1) Adequate publicity in calling for bids. This is achieved by newspaper publication of an invitation for bids, stating where copies of the bidding documents may be obtained.
2) Opening and publicizing bids. Another provision is that all bids be

publicly opened at a specified date, hour and place, at which time representatives of the various bidders can be present to examine each bid submitted.

3) If two or more issues are to be bid for at the same sale, and "basket" bids for all issues as a unit are permitted, the basket bidders should also submit separate bids so that the issuer can obtain the best terms by either selecting the best basket bid or that combination of separate bids which will produce the lowest cost to the issuer.
4) How winning bid is to be determined. Whether the lowest interest cost is determined via the basis book or net interest cost method, is immaterial, so long as all bidders know in advance which method will be used.
5) Statement of action taken on each bid. The rules referred to contain a provision under which the applicant files a statement of compliance with the rule, showing all bids received and which bid or bids were accepted or rejected. In this connection it should be noted that neither one of the three rules cited requires the issuer to accept any bid, or even to accept the highest bid. Consequently, if an issuer so chooses; it can reject any or all bids which either do not comply with its specifications governing submission of bids or for any other reason which the issuer decides its valid justification for rejection. The only requirement is that the issuer file a statement of the action it has taken.

Some Comments and Conclusions

The record of competitive bidding for corporate securities amply demonstrates a proved and tested method of sale, whereby either a public or private issuer can most effectively canvass the broadest range of market opinion and obtain binding bids, in accordance with its own specifications, for the marketing of its securities on terms most advantageous to it.

Competitive bidding has effectively eliminated the charges, countercharges and resultant Commission investigations of concentration of underwriting control, bankers' preferential rights, agreements to share or divide business, frozen accounts, proprietary interests, pro rata participations, rotation and swapping of leadership, reciprocity and related pactices which created and perpetuated the traditional negotiated financing relationship. As a result, it has re-established the independence of issuers, underwriters and distributing dealers and created a broader and more wholesome interest in financing by a wider variety of banking houses, with resultant marketing economies.

Such record also supplies complete and conclusive evidence that the traditional banker arguments against competition are basically self-serving and without merit in fact or logic. Their predictions of the drastic consequences which would follow adoption of competitive bidding have simply failed to materialize. This is also attested by the fact that no changes have been made and none are contemplated by the regulatory agencies in their administration of the rules under which most securities of regulated issuers are now sold competitively.

Experience has also shown that sponsorship of an issue by the traditional banker has not endowed such issue with any bench-mark of quality not inherent in the security itself or the credit of the obligor. Issues sold under either method are subject to the same market and economic influences which affect all securities generally and the results in this respect are no different on either negotiated or competitive sales. Neither does the record support the allegation that an issuer needs the exclusive advice of the traditional banker in formulating a financial program. Such argument overlooks the fact, that to an ever-increasing extent, federal and state regulatory agencies are passing judgment on financing proposals and insisting upon stronger capitalization and earning structures, adequate protective provisions in mortgages and charters, conservative accounting procedures and sounder corporate practices. In fact, considerable regulatory activity in recent years has been concentrated on overhauling the financial stuctures and policies of many corporations whose securities had been designed and distributed by their traditional banker in negotiated transactions.

Even the most case-hardened critics of competitive bidding have grudgingly admitted that it produces better prices and lower spreads—sometimes. When the record shows a range of bids amounting to over $55 million on 245 issues coupled with the fact that the traditional banker was the successful bidder on less than one third of those issues, then even the "sometimes" qualification wilts. When the record also shows that over $8 billion of securities were marketed competitively at an average spread of about one half the average spread on some $3.7 billion of negotiated sales, the difference of $26,000,000 is tangible proof that the issuer and/or the investor got a better bargain—not the traditional banker.

The results under competitive bidding for municipal, public utility and railroad securities have contradicted every argument of opponents. This leaves industrial securities as the last stand of the traditional bankers in their attempts to resist extension of competitive bidding to such securities. There is no question that competitive bidding will benefit industrial issuers, stockholders and investors. The only question is—how long can industrial management afford to ignore those benefits?