

The I.B.A. proposal is summarized on the first page and a half of the attached memo which was prepared by Mr. Vest. It gives a good summary but Mr. Hopkins has some doubts about the comments following on later pages.

4/25/45 Vent

PLAN OF INVESTMENT BANKERS ASSOCIATION FOR ESTABLISHMENT
OF LOCAL INVESTMENT COMPANIES TO AID SMALL BUSINESS

At the hearings before the House Post-War Economic Policy and Planning Committee on April 24, 1945, the Investment Bankers Association presented a plan to provide capital to small businesses through the establishment of local investment companies. The principal features of the plan are the following.

Congress would authorize the Board of Governors of the Federal Reserve System to grant charters to local investment companies in the various Federal Reserve districts, after investigation by the appropriate Federal Reserve Bank of the qualifications of the management and the need for the proposed company in the territory. The company would be required to have a capital stock of not less than \$25,000.

Such a local investment company would be authorized to purchase for investment or resale mortgage bonds, debentures, and preferred and common stocks of business corporations within the Federal Reserve district and to make loans to unincorporated business; but no such loan or purchase of securities could exceed \$100,000. In any case, the borrower would be required to employ "up to" 10 per cent of the proceeds of the transaction, whether a loan or purchase of stock, for the purpose of purchasing stock in the investment company. The actual amount of stock purchased would be determined by negotiations between the company and the borrower.

An investment company could issue debentures which the Federal Reserve Bank of its district would be obligated to purchase up to an amount equal to 3 times the paid-in capital of such company. The existing section 13b fund of \$139,000,000 would be made available to the Federal Reserve Banks for the purchase of such debentures; and consequently no Federal Reserve Bank would be required to purchase such debentures if the aggregate amount of its purchases equals or exceeds the amount originally advanced by it for stock of the Federal Deposit Insurance Corporation. Such debentures would mature in 25 years.

The capital stock of an investment company would be divided into two classes: Class A shares would be issued to original subscribers of the paid-in capital of the company; Class B shares would be issued to borrowers at the time the investment company purchases stocks or makes loans to such borrowers. Both classes of stock would be entitled to receive dividends at the same rate out of net earnings; but upon liquidation Class A shares would be paid off first at their par value.

The plan suggests that an investment company would not always hold the stock and securities purchased by it, but would endeavor to

sell such securities and stock to permanent investors, if possible, thereby releasing its capital for further operations.

The directors of an investment company would serve without compensation, although the permanent staff of the company would be paid compensation subject to the approval of the Federal Reserve Bank.

The investment companies would be authorized to render management service and technical assistance to their customers at moderate fees.

The Federal Reserve Bank would be authorized to make examinations of the books of account of the investment companies in its district as long as it holds debentures of such companies.

Possible Objections to Proposed Plan

1. Saleability of Stock in Investment Companies. - The plan purports to provide for the purchase of small capital issues of a kind which the present investment banking machinery will not handle because such issues have limited markets and afford considerable risk and difficulty to the underwriter, because small concerns frequently have inferior management, and because the cost to an underwriter of handling a small issue of stock is ordinarily about the same as the cost of handling a large issue. The plan indicates that it is intended to supply a source of credit particularly to small and "risky" businesses.

In the circumstances, the question arises whether stock in the proposed local investment companies would readily be purchased by the investing public. At the hearing before the House Post-War Economic Policy and Planning Committee on April 26, 1945, Mr. Folger, President of the Investment Bankers Association, emphasized the fact that there is at present a scarcity of "venture capital", in other words, that the public is slow to invest in any securities other than Government bonds and the safest kinds of corporate securities. If this is true, it seems questionable whether the minimum capital of the proposed investment companies would be promptly subscribed, in view of the fact that these investment companies would be engaged largely in financing small business concerns in the marginal risk area.

2. Further Government Competition. - The plan is based on the theory that aid to small business should not come from the Federal Government and that any plan for direct Government loans or guarantees would be a major threat to the system of private enterprise. Nevertheless, the proposed plan would utilize the appropriated fund of \$139,000,000 under the present provisions of section 13b of the Federal

Reserve Act, since the Federal Reserve Banks would use such fund for the purchase of debentures issued by the local investment companies. In effect, therefore, Government credit would be at the basis of the plan. Moreover, while the investment companies would be privately managed and of a local nature, they would be chartered pursuant to Federal law, and therefore would be somewhat analogous to Federal savings and loan associations, production credit associations, etc., which have been cited by bankers as being in effect Federally chartered institutions which compete with private banks.

Consequently, the adoption of the proposed plan would result in the establishment of still another system of credit institutions operating under Federal law and competing with existing institutions. Such a result seems undesirable, particularly if the objectives of the plan can possibly be accomplished by the use of existing machinery.

Moreover, since the investment companies would be chartered under Federal law, the question would arise whether their securities would be subject to the requirements of the Securities Act of 1933, and also whether the companies would be subject to State laws governing the issuance and sale of securities. If not so subject, such companies would have a further competitive advantage over State institutions which are not exempted from such laws.

3. Knowledge of Merits of Local Enterprises. - One of the arguments advanced for the establishment of local investment companies under the plan is that such companies would be under the management of local business men who would be familiar with the merits of small local enterprises. To some extent this might be true. However, it is unlikely that the officers and directors who might be engaged to manage such investment companies would be any more familiar with local businesses than are the directors and officers of the commercial banks in the particular locality. On the contrary, it is reasonable to suppose that the management of a local bank, with the benefit of long experience in the community, would be much more qualified to assess the financial needs and determine the merits of business concerns in the locality than would the management of newly created institutions.

4. Complexity of the Plan. - The financing visualized by the plan could be effected only with a considerable amount of procedure and red tape. Time would be necessary to organize the investment companies in the various Federal Reserve districts, for the Federal Reserve Bank to investigate the proposed management of such companies and the need for the existence of the companies in the particular communities, for the election of directors, for the establishment of suitable quarters for the companies, and for advertisement and attraction of customers. Even after the perfection of all details connected with the establishment

of the system, individual transactions would involve much more detail and probably consume more time than the usual type of bank loan. A business concern wishing to obtain financing would first have to authorize the issuance of the necessary mortgage bonds or stock and negotiate the sale of such bonds or stock to the investment company. Additional details would be involved in the issuance of debentures by investment companies for sale to the Federal Reserve Bank.

5. Requirement That Borrower Purchase Stock. - Any borrower from one of the proposed investment companies would be required to use up to 10 per cent of the proceeds of the transaction to subscribe to stock in the investment company. In other words, a borrower selling \$100,000 worth of stock to such an investment company might actually receive only \$90,000. This feature of the plan, which increases the financing cost by about 11 per cent, might make the proposed system of financing unacceptable to many small business corporations. Moreover, since the exact amount of stock in the investment company which would have to be purchased by the borrower would be determined by agreement between the company and the borrower, it is possible that such negotiations might tend to prolong the consummation of individual transactions and thus retard the whole program.

6. Limitation on Amount of Financing. - No borrower could obtain financing in excess of \$100,000 under the plan. While this limitation might not be an obstacle in many instances, it is a restriction which would probably prevent the use of such financing by business enterprises requiring larger amounts to finance the purchase of new machinery and plants. In this connection, it is to be borne in mind that the plan purports to provide financing of a long-term nature rather than current working capital.

7. Requirement That Federal Reserve Banks Purchase Debentures. - Under the plan, the Federal Reserve Banks would be obligated to purchase debentures issued by the investment loan companies at any time within 5 years after their issuance. Heretofore, the extent to which the Federal Reserve Banks will extend credit has been, in all cases, within the discretion of the Federal Reserve Banks. The proposed plan would require the Federal Reserve Banks to finance the proposed investment companies apparently without regard to the quality of the management or the financial condition of such companies. This would be an unfortunate precedent.

8. Use of Section 13b Fund. - In theory, the proposed plan is not inconsistent with the adoption at the same time of the proposal for guaranteed loans by the Federal Reserve Banks under the pending Wagner-Spence bill. However, if the proposed plan should be adopted, including the use of the fund of \$139,000,000 as above indicated, the program of guaranteed loans would be impossible since obviously the fund could not be used for both programs.

9. Repayment of Funds Under Section 13b. - The plan states that funds heretofore paid to the Federal Reserve Banks by the Secretary of the Treasury under section 13b of the Federal Reserve Act (about \$27,000,000) would be "returned" to the Secretary of the Treasury. It is difficult to see how such repayment could be made in view of the fact that these funds are in part at least already tied up in outstanding loans and commitments under section 13b, unless it is intended that the Federal Reserve Banks must make the repayment out of their own funds. Such a situation would be a taking of the property of the Federal Reserve Banks to the extent that losses might develop on these loans and obviously would be inconsistent with the intent of present section 13b.

10. Qualifications of Directors. - Under the plan, directors of the investment companies would receive no compensation. In view of the somewhat risky nature of the enterprise, it is doubtful whether a sufficient number of men of superior caliber, particularly investment bankers, could be obtained to serve as directors of such companies.

11. Lack of Supervision. - While the proposed investment companies, as previously indicated, would in effect constitute a system of credit institutions operating under Federal law in competition with commercial banks, the plan contains no provision for adequate supervision and regulation of such companies. It is true that the plan provides that the Federal Reserve Bank may make periodic examinations of the books of account of such companies; but even this limited supervisory authority would apply only so long as the Federal Reserve Bank holds debentures in such an investment company and, furthermore, it is not clear that the Federal Reserve Bank would have any power to require corrections as the result of such examinations.

HHH: jc
4-28-45