CHAPTER 5

The Business of Banking

Probably, the most important component of Schiff's banking expertise was his ability to assemble and manage syndications. Syndicating loans to groups of institutions and individuals was a primary methodology employed by banks in the late nineteenth and early twentieth centuries to bring to market large bond and stock issues. Kuhn Loeb assembled a syndicate to sell the Japanese loans. The background to and implementation of syndicates are described in this section. They were in large part to be vilified by later investigations. These include the Armstrong Committee report of 1906, which looked at matters of finance in life insurance companies; the report of Governor Hughes on speculation in securities and commodities of 1909; and the Money Trust Investigation of 1913 (more famously known as the Pujo Committee investigation), which looked at the concentration of power in the banking industry. These investigative committees were formed out of concerns that too much power had become vested among too few men in the industry and that some form of corruption existed in the management of major financial institutions.

Notwithstanding the suspicions that prompted the investigations and the restrictive legislative changes that ensued, at the time of the Russo-Japanese War the practices investigated were legal and accepted, and served a critical purpose in the development of the American economy. In an opinion written fifty years later, Harold Medina, US circuit judge in the District Court of the USA for the Southern District of New York, stated that the evolution of the syndicate system was

A. Gower, *Jacob Schiff and the Art of Risk*,
Palgrave Studies in the History of Finance,
https://doi.org/10.1007/978-3-319-90266-1_5

> in no sense a plan or scheme invented by anyone. Its form and development were due entirely to the economic conditions in the midst of which investment bankers functioned. No single underwriter could have borne alone the underwriting risk involved in the purchase and sale of a large security issue. No single underwriter could have effected a successful public distribution of the issue. The various investment bankers combined and formed groups, and pooled their underwriting resources in order to compete for business. These groups of investment bankers were not combinations formed for the purpose of lessening competition. On the contrary, there could have been no competition without them. Unless investment bankers combined and formed such groups there would have been no underwriting and no distribution of new security issues.[1]

In describing the business of Jacob Schiff and his bank Kuhn Loeb in this chapter, I draw upon the various government investigations already mentioned. In each of these investigations, prominent bankers provided verbal evidence that has been transcribed in its entirety and that has provided detailed information. I have also found the works of Vincent Carosso and Susie Pak to be of particular value. In his book *Investment Banking in America: A History*, first published in 1970, Carosso focuses initially on the development of the banking industry in the USA in the period prior to 1914. He explains in detail how the syndicate system evolved and operated, and looks at the roles played by bankers and investors. Susie Pak's analysis in her book *Gentlemen Bankers: The World of J. P. Morgan*, first published in 2013, looks at the nature of the banking business through a detailed analysis of the syndicate books of J. P. Morgan, Kuhn Loeb's closest rival at the time. Morgan's syndicate books have been preserved almost in their entirety, whereas those of Kuhn Loeb have regrettably been destroyed. Syndicate books were records kept by the banks that included detailed accounts of all the investors in an issue, how much each had applied for, how much had been allotted, commissions, profit margins, how much the bank had retained and all other details regarding how an issue had been transacted. Pak's scrupulous analysis of these books sheds light on the way in which business was conducted not only by J. P. Morgan but also by other banks including Kuhn Loeb.

[1] Corrected opinion of Harold R. Medina, US Circuit Judge in United States of America, Plaintiff, V. Henry S. Morgan, Harold Stanley et al., doing business as Morgan Stanley & Co. et al., defendants, filed 4 February 1954, https://babel.hathitrust.org/cgi/pt?id=uc1.b3270652;view=1up;seq=2, accessed 9 July 2016, p. 27.

Background and Definition

Nineteenth-century investment banks (synonymous with merchant banks in Europe) were commonly made up of a small group of partners who contributed their own money to create the initial capital of the bank. New partners may or may not have contributed their own capital, depending on the policy of the bank. Partners would receive returns on their funds commensurate with the returns the firm received. They would share in the profits of the firm, which were calculated in accordance with the firm's policies for how such profits should be split among the partners. Dividends were paid to partners in proportion to their ownership positions in the banks. These dividends might be in the form of a percentage return on the invested capital of the partner, whereby excess profits were retained by the firm in the form of increased capital. Alternatively, dividends totalling the entirety of the firm's profits might be distributed to the partners. Compensation agreements might not be formalized in written contracts and often remained verbal between the partners.[2]

Partners were supported by a staff of clerks. Kidder Peabody's support staff, for example, was low paid, starting at $4 per week for an errand boy, 'the usual starting position'. After two or three years' experience, an errand boy might be promoted to the position of clerk and his pay would be increased to $12 per week. At Kidder Peabody, clerks were not permitted to speculate, though 'the opportunity of being given an interest in the firm compensated, to some extent, for the low stipends and the "years of patient preparation, industry, and self-denial" the partners expected of the clerical staff'.[3] In some cases, clerks might become partners or could move on to positions at affiliate firms. Women were typically employed as stenographers.

A bank's partners made all investment decisions because their personal capital was at risk and they were liable for any debts incurred by the bank. In this regard, they were markedly distinct from joint stock banks—commonly known at the time as clearing banks—which were public companies whose capital came from the shareholding public and which were managed by elected directors. Kuhn Loeb was an investment

[2] *Money Trust Investigation*, pp. 57–80.

[3] Vincent P. Carosso, *More than a Century of Investment Banking: The Kidder, Peabody & Co. Story* (New York: McGraw-Hill, 1979), pp. 34–35.

bank, as was Barings. Parr's Bank and HSBC were joint stock banks managed by salaried directors.

As the American economy expanded after the Civil War, so did the demand for capital. This demand, particularly from the railroad industry, outgrew the fulfilment capacity of individual banks. American investment banks that had networks in Europe, such as Kuhn Loeb, used these connections to raise funds and at the same time started to form alliances with other domestic banks and financial institutions to meet the increasing demand.[4] Towards the end of the nineteenth century, railroad bonds had become the dominant business of the major investment banks. Indeed, 'virtually all the principal railroads in the country and many of the largest industrial corporations looked to the investment banker for their long-term capital requirements. The number of private investment houses and commercial banks capable of meeting the financial needs of these large borrowers was very small, at most no more than a dozen institutions'.[5] Kuhn Loeb was one of the banks capable of such endeavours. By the turn of the century, the bank had financed ten of the largest railroads in America 'including some of the largest systems in the United States', together with their subsidiary lines,[6] and dominated the investment banking industry in America alongside J. P. Morgan.

By 1904, fully one third of all life insurance company assets were invested through investment banks into railroad bonds.[7] Industrial stocks were less traded as they were considered speculative by the banks, and investors had little faith in their value because the underlying entities seldom released financial information about their operations. Kuhn Loeb avoided industrial securities until the end of the nineteenth century, preferring instead to concentrate on its core competency of investing in railroads.[8] Issues made by governments, including the Japanese issues, were viewed as carrying lower risk than those for industrial offerings. As the *Commercial West* commented, a government loan

[4] Corrected opinion of Harold R. Medina, p. 19.

[5] Vincent P. Carosso, *Investment Banking in America: A History* (Cambridge, MA: Harvard University Press, 1970), p. 47.

[6] Ibid., p. 35.

[7] Ibid., p. 48.

[8] Ibid., p. 44.

> is a security whose market is reasonably assured and whose market value can be accurately guessed at in advance. The industrial 'flotations' of 1901 undertook very generally to create a wholly artificial market: to establish and maintain, by sheer brute force of capital and stock exchange manipulation, prices which investors would never otherwise have bid.[9]

It is notable that, while government-issued loans were considered relatively desirable, no bank in America was willing to take up the Japanese offering until Jacob Schiff brought in Kuhn Loeb.

When companies and governments, both local and national, needed funds, they would issue either stocks or bonds to the general public to raise those funds. The difference between stocks and bonds is that stocks offer an ownership share in an issuing entity, whereas bonds are a form of debt to be repaid by the issuing entity. Investors saw bonds as inherently more stable than stocks, preferring to 'own the bonds of corporations rather than to be an outsider in stocks which insiders manipulate'.[10] It was the business of investment banks such as Kuhn Loeb to issue both stocks and bonds on behalf of corporate and government clients.

In addition to issuing stocks and bonds, the investment banks of the early twentieth century were also engaged in 'accepting deposits, trading in foreign exchange, issuing letters of credit, dealing in acceptances and commercial paper, and providing other financial services—as well as participating in the origination, purchase, underwriting, and distribution of new securities'.[11] The extent to which individual banks offered these services was dependent on their specific preferences. At the broadest level, their primary role was 'to channel savings into long-term investments'.[12]

The Pujo Commission of 1913, set up to investigate the concentration of power in the financial industry, described the business of Kuhn Loeb thus: 'It does an international banking business, including especially the issuance of securities. It does not seek general deposits and is not engaged in the general business of accepting deposits against draft,

[9] 'How Great Loans Are Sold', *Commercial West*, Vol. 7 (15 April 1905), p. 25.

[10] *Manual of Statistics: Stock Exchange Handbook*, Vol. 38 (New York: Manual of Statistics Company, 1905), p. 765.

[11] Carosso, *Investment Banking*, p. x.

[12] Ibid., p. xi

though it receives special deposits at times, and the purchase price of securities issued by it is occasionally left with it temporarily'.[13]

Bankers also kept records of bond and share ownership in their client companies as registrars, acted as transfer agents, were the client's bank of deposit, and provided financial advice to corporations. This advice could extend to the 'complete reorganization of the [rail]road's management and financial structure', resulting in a banker becoming the 'dominant influence' in a railroad's affairs.[14] Kuhn Loeb partner Otto Kahn thought of the role of banks in relation to their clients as being that of 'the company's financial doctor'.[15] Once a relationship between a banker and its client had been established, it was seldom interfered with by competing banks. 'Among the big banking-houses, for example, certain ones have affiliations with certain large railroad and industrial interests and may always be counted upon to attend to their financing'.[16]

Building upon the influence they had over their client companies, and in addition to collecting fees for their reorganization services as well as commissions on the bonds they sold,[17] investment banks were 'paid usually in the securities of the companies they underwrite'.[18] This added to the ownership interest banks accumulated in client companies. Similarly, complementing the need to tap into the depository resources of commercial banks in order to be able to manage issues of scale, investment banks took significant stock ownership positions, and in many cases board seats, not only in commercial banks but also in life insurance companies and trust companies.[19]

Indeed, commercial banks were willing participants in developing relationships with private banks. In 1863, nationally chartered commercial banks such as National City Bank and First National Bank were prohibited from opening branches overseas and blocked from participating

[13] *Money Trust Investigation*, p. 78.

[14] Carosso, *Investment Banking*, pp. 33–36.

[15] Ibid., p. 47.

[16] John Terret, 'New York as a Bond Center', *Harper's Weekly*, Vol. 55 (18 November 1911), p. 13.

[17] Carosso, *Investment Banking*, p. 41.

[18] 'Rise of the Syndicate', *New York Times* (4 May 1902), http://query.nytimes.com/mem/archive-free/pdf?res=940CE3D61130E132A25757C0A9639C946397D6CF, accessed 1 August 2016.

[19] *Money Trust Investigation*, pp. 57–80.

in international finance on their own. Consequently, they formed relationships with private banks, combining financial resources (including deposits) and forming cross-directorships. The ties commercial banks created with private banks such as Kuhn Loeb and J. P. Morgan allowed them to 'take advantage of the experience and connections of private banks… which then took advantage of the deposits and reach of its collaborators'.[20] Without a central bank in America until 1913, the commercial banks served as de facto national depositories, and, by accessing these deposits, private banks such as J. P. Morgan and Kuhn Loeb were able to wield considerable financial influence, extending their own formidable resources.[21]

Kuhn Loeb's principals amassed significant stock positions in commercial banks, trust companies, mortgage companies and insurance companies, and, as mentioned, they also held board and directorship positions. These included those at the Fourth National Bank of New York, the Equitable Trust Co. of New York, the National Bank of Commerce of New York and the United States Mortgage and Trust Company of New York. They also held substantial ownership positions without directorships in 'the National Park Bank, the Bank of Manhattan Co., the Merchants National Bank, the Union Exchange National Bank, all of New York, and the First National Bank of Chicago'. The firm was also 'a small stockholder in the Title Guarantee & Trust Co., of New York, of which also Paul M. Warburg [was] a director. The firm [was] a small stockholder in various other banks and trust companies'.[22] Kuhn Loeb's principals also held similarly influential ownership positions and directorships in many of their client companies, most especially the railroads. This pattern of ownership and control was commonplace among the top-tier investment banks.

Schiff personally took board positions across a range of companies and institutions. These were usually related or at least complementary to each other and were generally either directly or indirectly related to his railroad investments. He sat on the board of the Western Union Telegraph Company and was an active member of the board of directors of the National City Bank through an invitation of James Stillman

[20] Pak, *Gentlemen Bankers*, p. 15.

[21] Ibid.

[22] *Money Trust Investigation*, pp. 78–80.

(1850–1918), its head, on 7 February 1899.[23] He was appointed to the board in late 1900 of the Morton Trust Company (eventually merged with the Guaranty Trust Company) through an invitation of Levi Morton, former governor of New York and vice president to President Benjamin Harrison from 1889 to 1893.[24] He was a trustee of the Title Guarantee & Trust Company from 1905 to 1909, and there he also served during the same period on the finance committee. Schiff served as a director of the Bond & Mortgage Guarantee Company from 1892 to 1911, during which time he was also a member of its executive committee.[25] He sat as a director of the Western National Bank until its merger in October 1903 with the National Bank of Commerce in New York, continuing to serve as a director to the successor entity until 1911.[26] Until resigning in 1907, he presided as a director and member of the investment committee of the Industrial Trust Company of Rhode Island.[27] And, until resigning after twelve years in June 1905, he served as a director of the Equitable Life Assurance Society.[28]

In some cases, investment banks wielded their power by retaining as compensation sufficient shares in an issuing company so as to become the largest shareholders. In this way, they could also acquire control of the entity they were financing. They might also wrest control of a company through direct acquisition of that company's common stock. The common stock may have been the lesser portion of the company's capital structure compared to its bonds and preferred stock, but the common stock might represent the only capital with voting privileges. As there were limited, if any, controls regulating the subsequent management of the company, the directors were able to conduct business as they wished.[29]

While shareholders in individual companies had rights of access to company records, they did not have rights of access to those records of other shareholders. Bankers would form holding companies that would

[23] Adler, *Jacob H. Schiff*, Vol. 1, p. 180.

[24] Ibid., p. 182.

[25] Ibid., p. 183.

[26] Ibid.

[27] Ibid., p. 185.

[28] Letter from Schiff to James Alexander (President of the Equitable Life Assurance Society), 5 June 1905, as quoted in Adler, *Jacob H. Schiff*, Vol. 1, p. 188.

[29] Carosso, *More than a Century of Investment Banking*, p. 23.

own majority voting positions in multiple subsidiary companies whose financial performance was consolidated at the level of the holding company. This created structures that masked their activities and effectively eliminated disclosure requirements to shareholders. Schiff, for example, in 1899 participated in the forming of the Amalgamated Copper Company, together with Harriman, Rockefeller and Stillman, as a holding company created 'to control copper supplies and prices in the United States and as much of the rest of the world as possible'.[30] Shares in this trust 'were dealt in on the exchange for many years without the public having any information regarding their affairs'.[31] These structures provided opportunities for bankers to better protect their own investments and those of their syndicates as well as to maximize profits for themselves.

Further ensuring that investments were protected, banks' principals also participated as individuals in their own and other banks' syndicates.[32] This could also be true of insurance companies. For example, the Mutual Life Insurance Company subscribed for $4 million of the second series of 6% Japanese bonds, holding $3 million on its own account. Members of the Mutual's finance subcommittee, tasked with deciding on behalf of the company whether or not to purchase, hold and/or resell the bonds, also invested their own personal funds by making direct contact with the issuer, in this case with Kuhn Loeb, or through other banks in the syndicate. In this way, Mutual insiders profited in three ways: through part ownership of the allocation of bonds made to the Mutual; through profits from the sale of those bonds they elected to distribute to downstream investors; and through purchase on their own personal accounts of bonds directly acquired through the syndicate partners. Investing institutions such as the Mutual might also conduct considerable trade on the open market for bonds that they were investing in through syndications. The practice in this way of trading knowledge not known to the general public was investigated by the Armstrong Committee of 1906.[33]

[30] John Mason Hart, *Empire and Revolution: The Americans in Mexico Since the Civil War* (Berkeley: University of California Press, 2006), p. 149.

[31] *Money Trust Investigation*, p. 37.

[32] Pak, *Gentlemen Bankers*, p. 100.

[33] *Testimony Taken Before the Joint Committee of the State of New York, to Investigate and Examine into the Business and Affairs of Life Insurance Companies, Doing Business in the State of New York* (Albany: J. B. Lyon, 1906), Vol. 1, pp. 198–200. This committee came to be known as the Armstrong Committee after Senator William W. Armstrong, its chairman.

The cooperation between investment and commercial banks together with other financial institutions served two key purposes: the sharing of profit and the mitigation of risk. As the Pujo Committee described it:

> The distinction between the case in which one of the banks or banking houses assumes the relation of any underwriter of an issue of securities made by one of the others and that in which they act in joint account is that in the former case underwriters do not share in the primary bankers' profit, but insure the former against loss, while in the case of a joint account they are partners and as such share in the original risks and profits.[34]

The business of banking at the time of the Russo-Japanese War was very much a cooperative venture.

Syndicates

The syndicate system, 'under which groups of bankers shared selling, profits, and risks, came to serve as the prototype for underwritings of large securities issues'.[35] The financial analyst John Moody stated that the 'aggregation of great sums of money was absolutely essential for the conduct of human affairs… and the head of the syndicate—the man with the resources and temperament capable of conducting them—was about to concentrate the greatest financial power in the history of the world'.[36] Indeed, during the period of the Japanese loans, cooperation through syndication was not just deemed necessary by financial institutions; they held the collective belief that competition created inefficiencies that could stymie growth.[37] It is better to combine resources in a syndicate than to pit them against each other.

The practice of syndicating loans had been developing informally since the mid-nineteenth century during the growth in financing the

[34] *Money Trust Investigation*, p. 90.

[35] Jean Strouse, *Morgan: American Financier* (New York: Random House, 1999), p. 187.

[36] John Moody as quoted in ibid., p. 187.

[37] 'How the Wall Street Syndicates Operate', *New York Times* (25 September 1905), http://query.nytimes.com/mem/archive-free/pdf?res=9E03E0D6173DE733A-25756C2A96F9C946497D6CF, accessed 1 August 2016.

expansion of the railroad, and Kuhn Loeb's modus operandi followed the industry's trend to institutionalize this practice. In addition to consolidating capital to feed the ever-increasing demands of industry, bankers syndicated bond issues because it offered a way to mitigate the risk to their own capital.[38] It also went some way to alleviating the risk that if the investment failed, it could lead to the insolvency of the bank itself.[39] In particular, large single offerings simply could not be handled prudently without syndicating the risk and opportunity to other institutions.[40]

When an investment bank did agree to purchase the entirety of a bond issue from a client, it would

> immediately organize a larger group, composed of a limited number of investment banking firms, which was sometimes called a 'purchase syndicate', whereby it would, in effect, sub-underwrite the risk by selling the securities which it had purchased alone from the issuer to this larger group, at an increase or 'step up' in price. The investment banker who purchased the entire issue directly from the issuer was known as the 'originating banker' or 'house of issue'. The originating banker became a member and the manager of the 'purchase syndicate'.[41]

As the scale of the transactions grew, secondary groups would be formed below the purchase syndicates to acquire from them the bonds on offer, spreading the risk further and lining up profit before any offering to the general public was made. To ensure they had enough time to sell all they had agreed to, syndicates were typically organized to operate for one year with the manager retaining the right to extend the period, sometimes for up to five years or longer.[42]

Investment banks could sell directly to the general public, to each other, to high-net-worth individuals and families, to institutions or to any combination of these options, and they could choose to acquire for

[38] Carosso, *Investment Banking*, p. 32. See also Lewis B. Franklin, 'The Formation of Syndicates', *Magazine of Wall Street*, Vol. 15 (1915), pp. 452–453.

[39] Carosso, *Investment Banking*, p. 55. See also Donham, 'Underwriting Syndicates', p. 177.

[40] Franklin, 'The Formation of Syndicates', pp. 452–453

[41] Corrected opinion of Harold R. Medina, p. 25.

[42] Ibid., pp. 22–23.

their own account. Their overriding modus operandi was to create a '"community of interest", whose purpose was to monopolize credit and dominate financial networks. Economic self-interest was assumed to be the basis for trust and collaboration'.[43]

The effect of these syndications was to mitigate risk almost to zero for the issuing bank by spreading the risk across a broad range of downstream investors until it eventually reached the individual investor. Underwriting banks were motivated to secure 'as many individual subscriptions as possible' because it was with individual investors that profits were made or losses minimized.[44] However, for the major banks such as Kuhn Loeb, actively marketing to individual investors was seldom necessary. The syndicate of institutions they sold to would themselves take responsibility for sales to individual investors. In the Japanese loan issues, however, and as a reaction to the especially large scale of the offering, Schiff actively encouraged individual investors across the USA to buy the bonds. Smaller investors were favoured by the syndicate, with applications up to $500 receiving allocations in full and all others receiving an average of 20% of the amount they subscribed for.[45] Otto Kahn called it a 'great army of small investors'.[46] Schiff understood that this would help to reduce risk because it would create a larger investor base than would normally be associated with an issue.

Investment bank compensation was taken in various ways. For example, the bank might buy the bonds from the issuing entity at a discount to the price sold on to the public. Sometimes, banks were paid a flat commission on the value of the bonds they sold. In some cases, they were paid a combination of both of these. They might take a fee from the issuing client for providing the syndication services, usually in the 0.5–1% range. They could capture a profit from the spread made at each layer of the syndication hierarchy. It was common practice to retain a portion of the offering for themselves. For example, between 1894 and 1914, J. P. Morgan 'retained 32% of all the syndicates it sponsored'.[47]

[43] Pak, *Gentlemen Bankers*, p. 8.

[44] 'How Great Loans Are Sold', p. 25.

[45] Letter from Schiff to Kahn, 25 July 1905, JSP: Reel 676.

[46] Otto Kahn, *The Marketing of American Railroad Securities: Memorandum for the Interstate Commerce Commission* (Kuhn, Loeb & Co., 1922), p. 48.

[47] Pak, *Gentlemen Bankers*, p. 17.

The first level of the syndicate, the managing group, would typically consist of up to five participants, who would cooperate on equal financial terms.[48] In the case of the Japanese bonds in America, there were three participants: Kuhn Loeb, National City Bank and the National Bank of Commerce. The leading bank in a syndicate decided exactly how to distribute the various levels of the offering to the other banks, creating a hierarchy of status for participants depending on the prestige or symbolism of the capital they were offered.[49] The managing group would identify those downstream syndicate members that they were going to invite to participate in any given offering. They might also be responsive to requests from prospective syndicate members to join the syndicate.

Once a definitive share of the offering had been assigned to a prospective member, an invitation would be extended in the form of an allotment letter together with a syndicate agreement or prospectus.[50] Schiff rarely gave participations (allotments) to individuals, the Japanese issues being a notable exception, generally distributing to insurance companies, banking houses, financial institutions, trust companies and foreign correspondents, all of which were expected to place with their clients those underwritten issues that they did not elect to keep themselves. Kuhn Loeb's practice was to select distributing syndicate members from a list of up to 125 investing entities, which often included foreign firms entirely made up of either English or continental houses. 'We make alliances for the occasion', Schiff said. 'We have no standing alliances'.[51]

Being on the lists was considered prestigious, an 'enviable privilege, and to be stricken from a list meant a substantial financial loss'.[52] The lists were categorized according to investors' preferences and, when invited, investors who had gained on prior investments were expected to participate again. These correspondents were permitted to sell at a profit to their own networks of investors any proportion of the allocations from Kuhn Loeb that they did not want. This strategy was in stark contrast

[48] Ibid., p. 16.

[49] Ibid., p. 19.

[50] Franklin, 'The Formation of Syndicates', pp. 452–453.

[51] Schiff as quoted in Carosso, *Investment Banking*, p. 145.

[52] Charles W. Gerstenberg, 'The Underwriting of Securities by Syndicates', *Trust Companies*, Vol. 10, June (1910), p. 328.

with that of J. P. Morgan, who seldom permitted his syndicates to sell on to downstream investors.[53]

Correspondents were not relieved of their duty to buy the allocations Schiff made to them in the event that the general public did not take up an offer, but rather were expected to purchase on a pro rata basis their share of any shortfall the market had delivered. It was a very efficient means of pushing risk away from Kuhn Loeb and on to other syndicate participants, who in turn pushed it further downwards until it reached the individual investor. Louis Brandeis said that 'an invitation from these royal bankers is interpreted as a command. As a result, these great bankers frequently get huge commissions without themselves distributing any of the bonds, or ever having taken any actual risk'. In forming these kinds of syndicates, the bankers relieved 'themselves from all liability'.[54] While there may have been some truth to this, the system only worked if all participants consistently made money, and as Schiff's reputation was based on having established a pattern of successes, he was careful to ensure this success continued with the Japanese bonds.

Once issuing banks had created a syndicate, bonds would ultimately be sold on to 'middlemen or speculators, until, in the course of time, they [found] their way into the boxes of investors'.[55] At the retail level, bonds were advertised to the investing public in periodicals and newspapers in boilerplate format simply stating terms and pricing. They could be issued either at a discount to their face value or at a premium. They would carry with them a maturity date on which the issuing entity would commit to repaying the bond at face value. During the intervening period, the issuer would pay interest on the bonds at predefined intervals. These components of a bond were adjusted by the issuing entity, typically with the advice of its investment banker, to maximize acceptance by the investment community. Bonds were issued with printed coupons that were redeemed whenever an interest payment was due. In some cases, more detailed explanations differentiating the investment

[53] Redlich, *The Molding of American Banking*, Vol. 2, p. 375.

[54] Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (Mansfield Centre, MA: Martino, 2009). First Published 1914, p. 44.

[55] *Report of Governor Hughes' Committee on Speculation in Securities and Commodities* (New York: Committee on Speculation in Securities and Commodities, 1909), https://archive.org/details/reportofgovernor00newyuoft, accessed 9 July 2016, p. 7.

Table 5.1 J. P. Morgan & Co.'s top ten syndicate participants, 1894–1914

Name	*Amount ($ millions, rounded)*
First National Bank of New York	544
National City Bank	495
Kidder, Peabody & Co.	239
Kuhn, Loeb & Co.	210
Lee, Higginson & Co.	119
Harvey Fisk & Sons	92
Baring Bros & Co.	86
Baring Magoun & Co.	56
Deutsche Bank	51
John D. Rockefeller Sr.	50
	1942

Source Data derived from Susie Pak, *Gentlemen Bankers: The World of J. P. Morgan* (Cambridge, MA: Harvard University Press, 2013), p. 18

characteristics of bonds versus stocks might be offered to entice an investor to consider a particular issue.[56]

Banks participating in Kuhn Loeb's syndications would reciprocally allocate participations in their own clients' offerings to Kuhn Loeb. As one trust company principal said, 'participations in syndicates are given for the sake of getting participations in syndicates'.[57] Though they number in the thousands, two examples of this include Kuhn Loeb's taking of a 'considerable interest' in the February 1905 Southern Pacific refunding 4% bonds that were issued by J. P. Morgan[58] and in Morgan's $500,000 position in the first Japanese 6% loan that Schiff issued.[59]

J. P. Morgan managed 352 syndications during the twenty-year period 1894 to 1914 and worked with a total of 1530 syndicate partners. Of these, 'the top ten participants, in terms of the amount allotted, included: commercial banks (three), private firms (six) and one individual (John D. Rockefeller Sr.). The top ten syndicate participants alone accounted for $1.94bn or 55 per cent of the total participations allotted to others'.[60] Kuhn Loeb took over 10% of Morgan's syndications (see Table 5.1), and

[56] 'Some Good Bond Advertising', *Banker's Magazine*, Vol. 74, March (1907), p. 425.

[57] Donham, 'Underwriting Syndicates', p. 177.

[58] Letter from Schiff to Robert Fleming, 25 January 1905, JSP: Reel 325.

[59] Strouse, *Morgan: American Financier*, p. 547.

[60] Pak, *Gentlemen Bankers*, p. 18.

Morgan's share of all syndications offered to it during the same period (1894–1914) was about 8.5%.

It is noteworthy that, in total volume, Kuhn Loeb took a smaller share of J. P. Morgan's syndications than did Kidder Peabody, a smaller bank (see Table 5.1). Susie Pak suggests that social barriers led to this anomaly. Kuhn Loeb was not a 'Yankee bank' and so received a different place on the Morgan hierarchy than it might otherwise have done.[61]

When a security was to be sold, the offering bank would first issue a prospectus. The prospectus' language would be agreed with the issuing entity. It would include some details regarding the background to the issue; the financial terms, including the pricing (whether a discount or a premium to face value); the interest rate to be paid; and the maturity terms. Importantly, it would also prominently feature the name of the investment bank. This provided kudos to the bank and lent credibility to the issue based on the reputation of the bank.

The managing group's invitation to its second group of participants would be at slightly less favourable terms than those the managing group enjoyed. This group of banks would sell on at less favourable terms again to a 'distributing group' that would be made up of 'individuals, banks, trust companies or other types of syndicate participants'.[62] The distributing group would sell to other institutions and to the general public. If an issue was over-subscribed—that is, if the value of applications amounted to more than the total issue called for—then some applications would either be rejected or be scaled back. All parties selling to downstream investors would receive a commission on the bonds they sold. By syndicating these deals in this way, investment banks were able to capture 'very large' commissions with very little risk.[63]

Compensation agreements between partners were seldom if ever committed to formal contracts, nor were there usually contracts between Kuhn Loeb (as the managing member of a syndicate) and its syndicate members, and nor were there usually contracts between banker and client. The ties between a railroad and its banker were described by Otto Kahn as follows: 'Most of the important railroad companies, as well as industrial corporations, make a practice of dealing with a particular

[61] Ibid., p. 100.

[62] Ibid.

[63] Carosso, *More than a Century*, p. 20.

banking house or a particular group of bankers in marketing securities. This relationship rarely rests on formal contract. As a rule, the relationship is informal and tacit in its duration'.[64]

The informally agreed-upon formulae for the distribution of syndicate allocations worked as follows: in the first instance, Kuhn Loeb would inform a participant that it had been allotted a certain number of bonds in an issue and would request confirmation of acceptance by letter. Next would be a call for money, in receipt of which would be sent a participation certificate. Otto Kahn described the business of Kuhn Loeb in relation to how it marketed railroad bonds:

> The railroad, in the first instance, sells the issue to a strong banking firm at a price mutually agreed upon through negotiation. That firm then associates with itself a syndicate consisting of many (usually hundreds) of other banking, brokerage, investment and distributing houses throughout the country, each having its clientele of investment customers… Then begins the laborious process of selling securities to ultimate investors, through advertising, letters and circulars and personal presentation, and in this labor are engaged large numbers of dealers in securities, each with his own clientele. In time, if the issue is a success, the securities are absorbed.[65]

Speaking about the industry prior to World War I, Kahn noted that 'the principal buyers of railroad bonds were wealthy individuals and large corporations, especially insurance companies and savings banks'.[66]

Profits were distributed by the syndicate manager to syndicate members in proportion to each member's contribution.[67] There was no explanation of how the profit distribution was calculated. The only thing a participant would receive would be a check. Participants, including those of Kuhn Loeb's syndications, relied entirely on the integrity of the bank to ensure that the accounting and distributions were accurate. The *New York Times* commented that 'the workings of a modern Wall Street syndicate are enveloped with a kind of mystery which even

[64] Kahn, *The Marketing of American Railroad Securities*, p. 5.

[65] Ibid., pp. 8–9.

[66] Ibid.

[67] *Testimony Taken Before the Joint Committee of the State of New York*, Vol. 1, p. 222.

the subscribers are sometimes unable to penetrate'.[68] Syndicates were not transparent structures and were rarely broadly understood by anyone but those directly involved in them. As late as 1913, the editors of *Bankers' Magazine* saw fit to introduce an article on syndicates by Lewis B. Franklin, vice president of the Guaranty Trust Company of New York, with the message that 'there are certain "inside" things in the financial world about which it's next to impossible to get information from the printed page. The syndicate is one of them'.[69] To ask for a detailed accounting of a distribution would imply distrust and likely lead to the termination of the relationship.[70] The *New York Times* agreed: 'It is bad form for an outside subscriber even to question directly what is being done by the syndicate. The authority of the syndicate managers is absolute, and they are likely to resent such inquiries'.[71]

In this environment of adherence to authority, syndicate subscribers were also expected to take whatever allocations they were allotted. The pressure on them to participate was strongest on issues where the managers had less confidence in the outcome. If a member did not take up a share as offered by the manager, the member would not be invited to participate in future issues.[72]

As they were treated, so did syndicate members treat their downstream investors. In 1899, the *United States Investor* inveighed against the practice:

> This is distinctly an era of blind pools. The Amalgamated Copper Company offers an issue of stock for subscriptions, and there is a mad scramble for it (it is said the subscriptions actually amount to many times the $75,000,000 offered), notwithstanding the fact that the promoters do not consider that there is the slightest need of enlightening the public regarding the present status or the future policy of the concern. It is purely a case of "put

[68] 'Syndicate Ethics: How Subscribers Are Expected to Come in Without Exercising Any Choice—Authority of the Managers Absolute', *New York Times* (24 September 1905), http://query.nytimes.com/mem/archive-free/pdf?res=9E07E0D7103AE733A25757C2A96F9C946497D6CF, accessed 1 August 2016.

[69] Franklin Escher referring to Lewis B. Franklin, 'Syndicates', *Bankers' Magazine*, Vol. 87, December (1913), p. 664.

[70] *Testimony Taken Before the Joint Committee of the State of New York*, Vol. 1, pp. 259–261.

[71] 'Syndicate Ethics'.

[72] Ibid.

> up or shut up". If you don't want to buy the stock on faith, you can let it alone. The Sugar Trust is equally explicit regarding its affairs. You can buy its stock and take the dividends paid on the same, but you must not ask how the company is being run, or what the prospects for the future are.[73]

The same commentator went on say: 'to sum up the situation briefly, the best asset of a new enterprise is not the plant and its earning capacity, but the name of the promoter'.[74]

This was an important factor in ensuring the success of the Japanese loans despite earlier hesitation by the American banks. Where an investor did not know very much about the issuing entity of a bond, he would instead rely upon the credibility of the investment bank as an indicator as to the creditworthiness of the issuer.[75] Consequently, a bank's success was dependent on how it was perceived by both investors and other banks. As a result, banks were careful to protect and enhance their reputations whenever possible, and were diligent in ensuring that the issues they financed were carefully evaluated prior to launch.[76] This applied very much to Schiff and the Japanese loans.

Schiff was sensitive to the importance of protecting his name and that of his bank from the earliest days of his career. In 1871, at the age of 24, Schiff wrote to James Wilson, who was at the time a principal of the firm Winslow and Wilson and with whom he was conducting considerable business financing railroads. Schiff asked Wilson about one of the railroads seeking finance: 'do you know who the directors are, whether they are reliable Railroad men? I wish you would inform me fully and tell me openly whether it will be safe to lend our name to the sale of the bonds'.[77] By the time of the Russo-Japanese War, Schiff's success was in part due to the care he had taken in building a reputation that was highly regarded by the investment community. Sale of securities to individual investors among the general public was possible 'largely on account of the confidence which the investor has in the selling house; not primarily on account of the value of the securities'.[78] Indeed, 'the prestige of

[73] *United States Investor* (6 May 1899), p. 584.

[74] Ibid.

[75] Ziegler, *The Sixth Great Power*, pp. 5–11.

[76] Carosso, *Investment Banking*, p. 38.

[77] Letter from Schiff to Wilson, 7 October 1871, JWP: 1870–1871.

[78] Franklin, 'The Formation of Syndicates', pp. 452–453.

certain banking houses exceeded by far that of most corporations', and investors relied upon the credibility of the banking house more than on the credit of the issuing corporation.[79]

The general public believed that investment banks such as Kuhn Loeb would have conducted exhaustive investigations of the issuing corporations, making it 'safe to buy' the securities on offer.[80] This factor goes some way to explaining why the Japanese offering was as successful as it was. Before Schiff decided to take on the loans, other banks were reticent to have their name associated with the issue because they considered it too high risk. Having Kuhn Loeb's name on the issue changed their perception of risk and at the same time won the confidence of the individual investor. In combination with the high relative yield, this made for a compelling investment and drove demand beyond expectations.

Exchange Listing

Once securities had been distributed through the syndicate system, they were usually listed on the New York Stock Exchange, the primary market for securities in the USA at the time, in order to increase the market of potential buyers as well as to better determine accurate pricing at any one time.[81] Participation on the exchange required membership. Memberships could be purchased in the event of a vacancy or acquired from an existing member subject to exchange committee approval. In 1909, there were 1100 members of which 700 or so were active. Memberships were sold at the time for around $80,000.[82] Though originally the exchange membership was populated by brokers and agents only, by 1909 many members were also principals trading on their own accounts as well as on behalf of their clients. The average annual turnover of shares on the exchange from 1902 to 1912 was $15.5 billion, and the figure for bonds for the same period was $800 million.[83] The scale of the self-regulated exchange was a cause for concern in a 1909 New York State Commission finding that considered

[79] Carosso, *Investment Banking*, p. 54.

[80] Donham, 'Underwriting Syndicates', p. 175.

[81] *Money Trust Investigation*, p. 33.

[82] *Report of Governor Hughes' Committee*, p. 4.

[83] Ibid., p. 5.

it to have so large an impact on the 'financial and credit interests of the country… that its proper regulation is a matter of transcendent importance'.[84]

Quotation on the stock exchange provided investors with a market through which they could buy and sell the securities they found of interest. Securities listed on the exchange were examined by an exchange committee. The committee did 'not guarantee the character of any securities, or affirm that the statements filed by the promoters [were] true', but it certified 'that due diligence and caution [had] been used by experienced men in examining them'.[85] There was no requirement for listed companies to file statements of their financial condition either at listing or at any other time. There was no requirement for the capital structure of a listed company to be disclosed, nor for the commission paid to entities marketing and selling the company's securities to be reported.[86]

The exchanges also contributed to a mechanism by which investment banks could borrow from commercial banks on a short-term basis to carry securities during an issue. The market price of a security was considered a sufficiently definitive statement of underlying value that banks would use it to determine their worth as collateral for lending. Standard lending practice was to discount a share price by 10% and then lend 80% of the remaining value.[87] Lending on the floor of the exchange, collateralized by the securities being traded, was dominated by six banks, of which Kuhn Loeb was one.[88]

There was also an unlisted department on the stock exchange that was populated with shares in companies that supplied no meaningful information about their business. There was little distinction on the tabulated listings of companies on the exchange other than that unlisted securities were designated by a star. This blurred the lines between the listed and the unlisted by making any overt distinction difficult to notice. Unlisted companies were consequently more speculative from an investor's

[84] Ibid., p. 5.

[85] Ibid., p. 9.

[86] Ibid.

[87] *Money Trust Investigation*, p. 36.

[88] The other five lenders were the Chase National Bank, the Hanover National Bank, J. P. Morgan, the National Bank of Commerce and the National City Bank.

perspective than listed companies and more controllable from a management perspective.[89]

As bankers became directors of major corporations, such as the railroad companies, this in part afforded them the ability to control stock prices as well as to control the strategic direction of these companies. By the beginning of the twentieth century, this form of 'active' investing had become commonplace, and alliances between railroads and their bankers had developed.[90] Investment bankers operated 'in a virtual regulatory vacuum'.[91] Directors were able to manipulate pricing to their own benefit by increasing a stock's price through issuing an 'unexpected dividend or depress it by passing an expected one'.[92] They could issue new shares with 'no proportionate addition to the productive assets of the company, or load it with indebtedness, putting an unexpected lien on the shareholders' property'.[93] To boost market demand, brokers would be hired by the underwriters to trade on the underwriters' own stock, buying and selling in balanced transactions and executing external orders when they came in. This helped to create the appearance of activity even if none actually existed, drawing speculators in who would only be attracted by active trading while allowing pricing to be set and protecting the interests of the underwriter and its syndicate. There was no duty to inform shareholders of such actions,[94] and manipulation of the buying and selling processes of the exchange 'to make a profit as the result of fluctuations which have been planned in advance' was commonplace.[95]

In 1914, Louis Brandeis wrote a scathing indictment of these processes, criticizing them as being anti-competitive, illegitimate and market distorting. At the time of the Russo-Japanese War, they were just another risk-mitigation strategy and were considered essential.[96]

[89] *Money Trust Investigation*, p. 37.

[90] Carosso, *Investment Banking*, p. 29.

[91] Ibid.

[92] *Report of Governor Hughes' Committee*, p. 12.

[93] Ibid.

[94] Ibid.

[95] Ibid., p. 7.

[96] Redlich, *The Molding of American Banking*, Vol. 2, p. 375.

Motivating Syndicate Participants

Various means to motivate participants were employed to ensure that all interests in a syndicate were aligned so as to maximize profits. The Mutual Life Insurance Company was a major participant in the critical first Japanese issue, subscribing for £1 million at 89% of face value plus interest, fully 20% of the total issue in America.[97] Its role as a member of Kuhn Loeb's Japanese bond syndicate provides an illustrative example of how the syndicates operated.

Kuhn Loeb had purchased £5 million at 89% of face value in the first Japanese 6% series and created two sub-syndicates below it to distribute the bonds. These included

> a syndicate to underwrite the issue of the same at 92 1/2 and interest, the issue price to be 93 1/2 and interest, and offered the [Mutual Life Insurance] Company an interest in their purchase of one million pounds at eighty-nine and interest, plus one per cent. commission. They also offered an interest of about eight hundred thousand pounds in the underwriting syndicate at 91 1/2 and interest.[98]

Of the £1 million that the Mutual subscribed for, it held £600,000 to trade on its own account and allotted £180,000 each to the United States Mortgage and Trust Company and the Guarantee Trust Company, and £20,000 each to the Fifth Avenue Trust Company and the Morristown Trust Company. These companies were in the Mutual's downstream syndicate because it held large stock ownerships in them. As a consequence, it took profit in the downstream sale and shared in the profit of the trust companies it had in turn sold to. This all occurred in the week before the issue went on sale to the general public.[99]

It was not only institutions that profited at a substantially reduced risk. Individuals too could benefit personally from the system. People employed by the syndicate participants who were privy to the workings of the syndicates would also trade on the knowledge they had. In some cases, such as during the first Japanese 6% series, neither individual nor institutions would have to put up any money because the bonds they

[97] *Testimony Taken Before the Joint Committee of the State of New York*, Vol. 1, p. 442.

[98] Ibid., p. 567.

[99] Ibid., pp. 442–443.

were allotted were sold further downstream before the call for money was made to them.

Allocating shares to syndicate members (individuals) who could themselves affect the resale of their own allocations through related organizations was common practice. Creating structures by which this phenomenon was possible enhanced the efficiency of the system. One case in point is as follows. On 6 May 1904 (only one business day after Schiff's announcement in London that he would participate in the loan, and six days before the 12 May public issue), Kuhn Loeb allotted to James H. Hyde and Associates approximately $2,000,000 of the $25,000,000 first 6% series loan. Also on 6 May, the Equitable Life Assurance Society gave the authority to decide to subscribe for these same bonds on its behalf to its officers James Alexander (1839–1915) and George Squire.

James Hyde (1876–1959) was also a director of the Equitable Society alongside Alexander and Squire. Before any cash call was placed by Kuhn Loeb to Hyde and Associates, the Equitable Society elected to acquire the allotment from them. This action yielded immediate profit to the individuals within James Hyde and Associates, who themselves were directors and trustees of the Equitable Society, whose money they had used to affect the transaction.[100]

The profits on the Japanese bonds were particularly large in comparison with other offerings around the same time, especially to insiders at the syndication companies. This process of rewarding individuals contributed to motivating them to promote an offering because it was in their best interest to do so. It enhanced the likelihood that an issue would be a success. For example, the Mutual Life Society's treasurer, Frederic Cromwell (1843–1914), had his own personal investments in the various issues in which the Mutual was a participant.

The Mutual, though it purchased Japanese bonds through various syndicate channels, also purchased at 'the issue price on the public offering and thus contributed to the profits which would be available for distribution among the members of the syndicate'.[101] In his capacity as

[100] F. Hendricks, 'Superintendent Hendricks' Report on the Equitable Life: A Detailed Record of Systematic Graft', *Underwriters' Review*, Vol. 15 (10 January 1905), p. 273. See also *Testimony Taken Before the Joint Committee of the State of New York*, Vol. 1, pp. 884–885.

[101] *Testimony Taken Before the Joint Committee of the State of New York*, Vol. 1, p. 449.

its treasurer, Cromwell authorized the Mutual to buy on the open market at a higher price the bonds he had himself sold downstream. In this way, Cromwell added substantial demand for the bonds and in so doing ensured that his own personal investments were guaranteed to be safe and profitable.

Cromwell often benefited from his position in this manner, investing in issues that he subsequently authorized the insurance company he oversaw to invest in. The Japanese loans were significantly more lucrative for Cromwell (and presumably for others similarly situated to him in the syndicate) than many other investments he made (see Table 5.2).

As a percentage of the investment Cromwell made, the returns he received on the Japanese bonds ranged from almost 10% to almost 16% (see Table 5.2). These were significantly higher returns than anything else he invested in. This was the result of a combination of the yield on the bonds themselves, the discount to face value, the profits Cromwell made buying into the two sub-syndicates that Kuhn Loeb set up and his proportionate profit from ownership in the downstream trust companies he sold to. Here too, Cromwell as well as others did not at any time have to advance funds to acquire the bonds because the bonds had in their entirety been sold to individual investors before the call for funds was made by Kuhn Loeb.[102]

The bankers were unsure before the launch of the issue whether there was sufficient demand that the entire offering would be bought. However, Kuhn Loeb put in place a syndication mechanism that all but guaranteed the demand would be there by deploying the vast financial resources of the syndicate members. The Mutual company directors and trustees were allotted bonds to their own personal accounts by the managing group of the syndicate. They in turn ensured that the Mutual would sell to trust companies in which they had significant ownership interests. The Mutual bought on the public market at non-discounted pricing. The existing public demand was consequently inflated by the purchasing power of the Mutual. Only discounted allocations were taken up by the syndicate members. The general public together with the Mutual and other related entities bought at market rates and ensured that the timing of their purchases meant that no cash call was required for the bonds purchased by the individuals who stood to make the most money creating the system that created the demand.

[102] Ibid., pp. 441–448.

Table 5.2 Frederick Cromwell, Mutual Life Insurance Company's treasurer: Investments and returns

Syndicate	*Participation ($)*	*Profits ($)*	*Profit (%)*	*Managers*
Republic of cuba, 40 year 5% bond, original syndicate	100,000	3450.63	3.45	Strong, Sturgis & Co.
Ditto syndicate	50,000	2422.49	4.84	Ditto
Southern Pacific 1st refunding 4% bonds	150,000	3726.56	2.48	Kuhn, Loeb & Co. and Speyer & Co.
US of Mexico 4% bonds	100,000	3001.03	3.00	Speyer & Co.
Atchison, Topeka & Santa Fe Conv. bonds	50,000	802.50	1.61	Kuhn, Loeb & Co.
Pennsylvania railroad shares	100,000	1546.90	1.55	Speyer & Co.
Oregon short line 4% refunding purchase	75,000	1502.84	2.00	Kuhn, Loeb & Co.
Ditto 4% and participating	50,000	1333.17	2.67	Kuhn, Loeb & Co.
Imperial Japanese 6% bonds, 1st series	10,000	976.00	9.76	Kuhn, Loeb & Co.
Ditto 2nd series	10,000	1570.38	15.70	Ditto
Ditto 4.5% bonds, 1st series	15,000	1886.55	12.58	Ditto
Atchison, Topeka & Santa Fe, East Okla. Div. 4% purchase	50,000	866.03	1.73	Strong, Sturgis & Co.
Chicago, Burlington & Quincy purchase	60,000	1746.27	2.91	J. P. Morgan & Co.
Third avenue railroad consolidated bonds	100,000	1522.17	1.52	Kuhn, Loeb & Co.
Imperial Japanese 4.5% 2nd series	15,000	–	–	Kuhn, Loeb & Co.

Source Reproduced from exhibit 55, in *Testimony Taken Before the Joint Committee of the State of New York, to Investigate and Examine into the Business and Affairs of Life Insurance Companies, Doing Business in the State of New York* (Albany: J. B. Lyon, 1906), Vol. 8, p. 120

Writing about the general practice that institutions and insiders captured profits before issues were sold on the open market, one commentator noted that 'the stockholders did not participate in any of the juicy portions of [the] financial vegetable. They got the rind'.[103] The *New York Times* described the practice as follows: 'The position of the insurance policy holder whose money has been used to force up the security that he wants to buy is something like that of the Democratic policy holder whose premiums have been turned over to Republican campaign funds'.[104] Kuhn Loeb recognized that expertise in assembling these kinds of syndicates was in large part the reason it was known that its offerings were likely to be a success.

Ultimately what underpinned all offerings was the extent to which individual investors bought them. In his 1909 report to the New York State Committee on Speculation in Securities and Commodities, Governor Hughes described the individual investor at the bottom rung of the investment ladder as follows: 'Inexperienced persons, who act on interested advice, tips, advertisements in newspapers, or circulars sent by mail, or take flyers in absolute ignorance, and with blind confidence in their luck. Almost without exception they eventually lose'.[105] If individual investors did not buy into an offering, the responsibility for buying the bonds fell back on the syndicate partners. It was in the investment banks' best interest to ensure that its downstream investors made money. Schiff had to make sure that the individual investor base was substantial enough to prop up the entire syndicate, especially for the Japanese issues, because of the enormity of their scale.

This was not normal business practice for Kuhn Loeb. There were only five or so investment banks that had national distribution networks in America. Kuhn Loeb tended to focus primarily on the New York investment community, making the national syndication and distribution network for the Japanese bonds that Schiff engineered particularly noteworthy.[106] Schiff ensured that as broad a swath of the general

[103] Richard D. Wyckoff, 'The Old vs. the New Idea in Capitalizing an Enterprise', *Magazine of Wall Street*, Vol. 15, No. 2 (1914), p. 93.

[104] 'How the Wall Street Syndicates Operate'.

[105] *Report of Governor Hughes' Committee*, p. 5.

[106] Corrected opinion of Harold R. Medina, p. 22.

public took a share in the offering as possible. He did this by not only expanding the syndicate membership nationwide but also favouring smaller investors over the larger ones. 'It may be said without exaggeration that no similar security ever enjoyed the same degree of popularity in the financial markets of this country', extolled the *New York Times* of the first Japanese 4.5% issue. As the issues were so widely held, they were widely traded on the markets. In the week to 18 June 1905, for example, the Japanese 4.5% bonds accounted for over 50% of all bond sales on the New York Stock Exchange.[107]

No system existed for consolidating the results, so no precise measure of how many people actually took part in the issue is available. However, the *New York Times* estimated the total number of original subscribers to be in excess of 15,000 and stated that as a result of the subsequent trading activity likely 'upward of 20,000 different individuals or interests have bought some of the bonds'. Further underscoring the success of the offering was the speed at which the issue was taken up by the markets. 'All this', the *New York Times* continued, 'before the actual bonds are issued, the trading up to this time being in the temporary certificates, which are provided with one interest coupon, to be paid through Kuhn, Loeb & Co. in case the actual bonds are not out by the date when the first interest falls due'.[108]

The result of favouring the smaller investor was not without its administrative inconveniences. Kuhn Loeb's policy, for example, was that only a partner could act on behalf of the firm in issuing a bond, meaning that to be valid every bond had to be signed by a partner. As a consequence, the partners, Schiff included, were tasked with the arduous duty of hand signing every bond purchased by each of the 15,000–20,000 original subscribers.[109] Such was the work of ensuring success.

[107] 'Handling Japan's Loans: Tremendous Tasks Involved in So Large an Issue, 20,000 Individual Holders', *New York Times* (18 June 1905), http://query.nytimes.com/mem/archive-free/pdf?res=9900EFD7133EE733A2575BC1A9609C946497D6CF, accessed 1 August 2016.

[108] Ibid.

[109] Ibid. See also letter from Jacob H. Schiff to Mortimer Schiff, 13 July 1905, JSP: Reel 688.

Market Conditions and Relative Pricing

Compared to the prior three years, the New York stock exchange enjoyed a considerably higher bond sale volume in 1904. Sales exceeded $1 billion of bonds that year, compared to only $684 million in 1903 and approximately the same amounts in 1902 and 1901. Despite what amounted to a 50% increase in the supply of bonds during 1904, there was no shortage of demand, and competition for the resulting limited supply contributed to upward pressure on pricing.[110] One factor that drove up pricing for bonds was rebound from a panic that had afflicted the markets in 1901. In the immediate aftermath of the 1901 downturn, bond issuers had been driven to borrow with short-term maturities in anticipation of better pricing once the markets had rebounded. By late 1904 that rebound was fully underway, longer-term borrowing was back, market confidence had recovered, and liquidity had returned.[111]

Earlier in 1904, Schiff bemoaned the paucity of what he considered investment-grade opportunities available on the markets. 'Money is quite worthless', he said in a letter to Kahn on 2 June 1904, 'being offered for three months at 2½% and for six months at 3½%, and the bond and share market is also devoid of activity'.[112] He understood that by pricing the Japanese bonds as favourably as he did, they would be made very attractive in comparison with other options available to investors and would consequently drive up demand. This accentuated the benefit he received from the return of the bull market as the recovery from the downturn of 1901 got underway and from accelerated speculation that began to build from September 1904.

12 September 1904 saw a share volume traded on the New York Stock Exchange of 1,273,623, which was a six-month high following a period of relative quiet. This was the beginning of 'a period of public speculation in securities which has rarely been surpassed in sustained activity of long duration'[113] and was marked by a strong upward trend in

[110] *Manual of Statistics*, p. 765.

[111] 'Extraordinary Demand for Bonds', *Chicago Tribune* (1 February 1905), p. 12.

[112] Letter from Schiff to Otto Kahn, 2 June 1904, JSP: Reel 688.

[113] Algernon Ashburner Osborne, 'Speculation on the New York Stock Exchange, September 1904–March 1907', in *Studies in History Economics and Public Law*, Vol. 56 (New York: Columbia University, 1913), p. 21.

pricing as a result of expanding demand. In fact, the thirty-month period to March 1904, two months before the first Japanese bond issue, was characterized by a decline in trading volume of over 20% and so saw the need for particularly attractive pricing on the Japanese bonds.

However, the thirty-month period from September 1904 saw a 25% increase in volume. This represented a 64% increase in trading volume for the period from the lows of the 1901 downturn.[114] The *Commercial and Financial Chronicle* summarized the overall market in 1904 for bonds as it would have appeared to investors as follows:

> The listings on the New York Stock Exchange during the year 1904, as compiled in our usual form, disclose facts of considerable importance. Among these we note (1) the large increase in the output of bonds for new capital, the total being more than double that for the preceding year, and far in excess of the record of any previous twelve-months; (2) the extraordinary amount of bonds for improvements, and particularly the large sum devoted to railroad terminals at New York, St. Louis, Washington, Jersey City and Baltimore; (3) the entire absence of railroad reorganizations following bankruptcy; (4) the relatively small amount of bonds for refunding, but the very considerable amount replacing floating debt or short-term loans; (5) the small total of the stock additions, although these during the last half of the year were double in amount what they were for the first six months; (6) the further widening of the New York market for securities, as seen in the inclusion of Japanese Government bonds and the securities of the London Underground [rail]road; (7) the complete lack of new industrial consolidations, if we except a single mining proposition; but, on the other hand (8) the very considerable aggregate reached by miscellaneous bond issues, including municipal and Government issues, as well as industrial enterprises, and, lastly (9) the replacement of voting trust certificates to a total of not less than $352,000,000 by share certificates carrying full voting power.[115]

By the beginning of 1905, American investors' appetite for bonds was steadily increasing, driving up pricing,[116] and by mid-1905, Schiff's efforts had led to the extraordinary result that the number of people in

[114] Ibid., p. 18.

[115] *Commercial and Financial Chronicle*, Vol. 80 (21 January 1905), p. 195.

[116] Henry D. Baker, 'The Insatiable Demand for Bonds', *Commercial West* (4 February 1905), p. 11.

Table 5.3 Bond price comparisons, 1904–1905

	Market pricing		*Effective yield*	
	Lowest	*January 21*	*Lowest*	*January 21*
	1904 ($)	*1905 ($)*	*1904 (%)*	*1905 (%)*
Japanese 6s[a]	89.00	97.00	6.74	6.19
US steel 5s[b]	68.75	93.50	7.27	5.35
Atchison adj. 4[c]	87.50	95.25	4.57	4.20
C., B. & Q., joint 4s[d]	90.50	101.50	4.42	3.94
Bal. & Ohio const. 4s[e]	97.00	105.00	4.12	3.81
US 4s conf. 1907[f]	104.50	105.50	3.83	3.79
North Pac., 1st 4s[g]	101.50	105.50	3.94	3.79
Union Pac., const. 4s[h]	99.50	118.50	4.02	3.38

[a]'Japanese 6s' refers to the war issue offered by Kuhn Loeb
[b]'US Steel' was an industrial bond offering
[c]'Atchison adj. 4' was a 4% bond for the Atchison railroad
[d]'C., B. & Q., joint 4s' was the Chicago, Burlington and Quincy railroad 4% bonds
[e]'Bal. & Ohio const. 4s' was a Baltimore and Ohio railroad 4% bond
[f]'US 4s conf. 1907' was a US government 4% bond with a 1907 maturity date
[g]'North Pac., 1st 4s' was a 4% Northern Pacific railroad bond
[h]'Union Pac., const. 4s' was a 4% Union Pacific railroad bond
Source Data derived from Henry D. Baker, 'The Insatiable Demand for Bonds', *Commercial West* (4 February 1905), p. 11

America who held Japanese bonds outstripped the number of those who held American government bonds.[117] An article in *Commercial West* reported: 'The problem of the bond dealers is no longer, as it was a year ago this time [February 1904—three months prior to the first Japanese bond issue], how to sell bonds to an unwilling public, but instead, how to get bonds to sell to a public whose appetite for mortgage investments seems insatiable'.[118] Demand during 1904 for bonds drove up pricing and hence drove down yield (see Table 5.3).

Table 5.3 shows how pricing increased consistently across a basket of railroad, industrial and government bonds from their low points in 1904 to their prices at the beginning of 1905. The table also shows how the bonds compared in terms of yield, which was an important factor to an

[117] Letter from Schiff to Revelstoke, 14 July 1905, JSP: Reel 679.

[118] Baker, 'The Insatiable Demand for Bonds', p. 11.

investor. Yields fell as pricing increased, and for investors, the Japanese bonds offered a compelling return on their investment when compared to domestic options available to them. Other than against US Steel's low point in 1904—which came about anomalously following a precipitous drop at the end of 1903 in net profits for the corporation[119]—the Japanese bond yields were among the most attractive available.

By the beginning of 1905, pricing for the Japanese bonds had risen 8.99%, driving yield down to 6.19%. In comparison with domestic options available to investors, the Japanese bonds were still offering a high relative yield. Pricing on the US Steel bonds had risen a colossal 36%, pushing yield down to 5.35%, below Japanese bond yields. The most stable bond on the market was the US 4% bonds, which only increased in pricing by 0.96% during the period and which consequently delivered a relatively consistent yield, dropping to 3.79% from a low in 1904 of 3.94%.

With an effective yield at launch of 6.74% for the first series of 1904, the Japanese bonds also compared very favourably to other foreign bonds available on the market (see Table 5.4).

The first Japanese 6% series' net yield was higher than that of almost all other foreign options available to investors at the time. The only ones that had higher yields were the less desirable Chinese 1894 Silver bonds, the Greek 1884s and the Venezuelan 1881s. Consequently, compared to other foreign issues, the Japanese bonds offered among the best returns to investors. This helped them to stand out as exceptional investments and translated into high demand. Indeed, *The Economist* noted that the strength of the demand for the Japanese bonds should not be considered remarkable in the light of the high relative yield they offered.[120]

How could Schiff have known that the Japanese debt had been priced at a competitive level relative to its perceived value? Comparing Japanese government bonds against British consols is useful in understanding how the cost of Japanese debt fluctuated against a benchmark indicator. Nathan Sussman and Yishay Yafeh analysed relative currency values by benchmarking them against British consols.[121]

[119] *Manual of Statistics*, p. 765.

[120] 'Foreign Government Securities', *The Economist* (21 May 1904), p. 885. Retrieved from *The Economist Historical Archive, 1843–2011*, Web, accessed 13 November 2015.

[121] Nathan Sussman and Yishay Yafeh, 'Institutions, Reforms, and Country Risk: Lessons from Japanese Government Debt in the Meiji Era', *Journal of Economic History*, Vol. 60, No. 2 (2000).

Table 5.4 Relative pricing of available foreign securities, May 1904

	Price		
	Coupon	*14-May-04*	*Yield*
Argentina (1886–7)	5.00%	102 3/4	4.87%
Brazilian (1889)	4.00%	74 1/4	5.39%
Bulgarian (1892)	6.00%	91	6.59%
Chilian (1895)	4.50%	83	5.42%
Chinese (silver 1894)	7.00%	85	8.24%
Chinese (gold)	5.00%	95 1/2	5.24%
Egyptian (united debt)	4.00%	105	3.81%
French	3.00%	96	3.13%
German Imperial (1891)	3.00%	88 1/2	3.39%
Greek (1884)	4.00%	44	9.09%
Hungarian (gold rentes)	4.00%	100	4.00%
Italian (rentes)	5.00%	102 1/2	4.88%
Japanese (sterling, 1899)	4.00%	70 1/4	5.69%
Japanese (1904)	6.00%	89	6.74%
Russian Ser. II	4.00%	89	4.49%
Spanish	4.00%	82 3/4	4.83%
Turkish (1877)	3.50%	100	3.50%
US (1877)	4.00%	109	3.67%
US (new)	4.00%	132 1/2	3.02%
Uruguay	3.50%	54 1/2	6.42%
Venezuela (1881)	3.00%	30	10.00%

Source Data derived from 'Foreign Government Securities', *The Economist* (21 May 1904), p. 885

Compared to a basket of other foreign country debt traded on the London markets during the period 1870–1913, Japan's credit was relatively strong. At an average spread of 288 basis points as compared to British consols during the period, Japan's debt compared favourably to an average of a 369-basis-point spread of the peer group of foreign debtor nations.[122] Sussman and Yafeh's results are illustrated in Fig. 5.1.

Sussman and Yafeh's analysis shows that the Japanese bond spread against consols spiked to approximately 370 basis points (bps) at the onset of the war with the Kuhn Loeb issues (see Fig. 5.1). This was in part as a result of the market perception that Japan was a weak country unlikely to prevail against Russia. This level gave the Japanese debt a

[122] Toshiki Tomita, 'Japanese Government Bonds 100 Years Ago', *NRI Papers*, No. 90 (1 June 2005), p. 4.

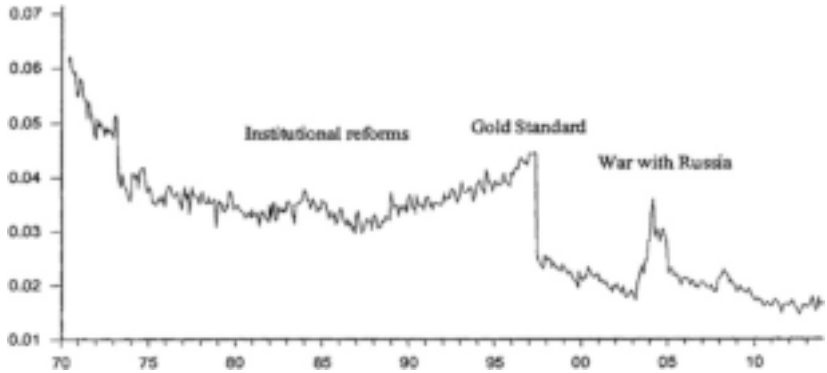

Fig. 5.1 Japanese government debt, interest-rate differential, 1870–1914: Japanese government bonds versus British consols (*Note* The *x*-axis denotes the years 1870–1913; the *y*-axis denotes the interest-rate differential (0.01 equates to a 1% differential). *Source* Reproduced from Nathan Sussman and Yishay Yafeh, 'Institutions, Reforms, and Country Risk: Lessons from Japanese Government Debt in the Meiji Era', *Journal of Economic History*, Vol. 60, No. 2 (2000), pp. 442–467)

higher return than the average Chinese (310 bps) and Argentinian (309 bps) debt, but lower than Turkey (1030bps), Greece (877 bps), Mexico (720bps), Uruguay (650bps) and Portugal (447 bps). Alongside the kudos accompanying the bond issues brought about by being associated with Kuhn Loeb and the additional layers of collateral being offered to mitigate risk, the Japanese issues benefited from being priced competitively against weaker alternatives and were consequently positioned well to command solid demand.[123]

In their analysis of the movement of bond yields, Sussman and Yafeh compare factors as diverse as the qualitative nature of media coverage of Japan in England to structural changes resulting from Japan's industrialization. The biggest impact, they note, resulted from the implementation of the gold standard in 1897 (as clearly illustrated in Fig. 5.1), which dramatically reduced the relative cost of borrowing for the Japanese government. The next pivotal moment came during the Russo-Japanese

[123]Tomita, 'Japanese Government Bonds 100 Years Ago', p. 4.

Table 5.5 Changes in issue conditions of Japanese government bonds in London, 1870–1910

	Coupon (%)	*Issue price*	*Issue amount (£ millions)*	*Maturity (years)*	*Issue interest rate (%)*	*Consol interest rate (%)*	*IJG bond yield as multiple of consol yield*
April 1870	9.0	98.0	1.0	13	9.2	3.20	2.88
January 1873	7.0	92.5	2.4	25	7.6	3.26	2.33
June 1897	5.0	101.5	4.4	53	4.9	2.44	2.01
June 1899	4.0	90.0	10.0	55	4.4	2.54	1.73
October 1902	5.0	100.0	5.1	55	5.0	2.96	1.69
May 1904	6.0	93.5	5.0	7	6.4	2.78	2.30
November 1904	6.0	90.5	6.0	7	6.6	2.84	2.32
March 1905	4.5	90.0	15.0	25	5.0	2.74	1.82
July 1905	4.5	90.0	10.0	25	5.0	2.77	1.81
November 1905	4.0	90.0	6.5	25	4.4	2.82	1.56
March 1907	5.0	99.5	11.5	40	5.0	2.92	1.71
May 1910	4.0	95.0	11.0	60	4.2	3.08	1.36

Source Data derived from Toshiki Tomita, 'Japanese Government Bonds 100 Years Ago', *NRI Papers*, No. 90 (1 June 2005), p. 16

War, in which there was a significant spike in the cost of debt for Japan. By way of explanation, Sussman and Yafeh state simply that Japan was seen to be the underdog.[124] Examining the historical trajectory of the pricing of the Japanese bonds against consols shows how the pricing spiked during the war (see Table 5.5).

Table 5.5 shows the issue interest rates of Japanese government bonds alongside the price of British consols. As Japan first started to emerge onto the international markets, the price of its bonds was set at almost three times that of consols in order to compensate

[124] Sussman and Yafeh, 'Institutions, Reforms, and Country Risk', p. 459.

investors for their perceived risk. As confidence and familiarity with Japan improved, the relative pricing of its bonds declined to a low of 1.69 times the price of the consols in 1902. The Russo-Japanese War pricing saw a spike to over twice the yield of the consols to compensate for perceived Japanese weakness in the face of powerful Russian aggression and in order to drive demand. After the war, as confidence in Japan's creditworthiness improved again, the pricing of its bonds reached a new low in 1910, against British consols of only 1.36 times the relative yield.

At the time the first 6% series was issued to the market in early May 1904, Japanese government bonds were enjoying an increase in pricing and consequent reduction in yield as news started to come in of military triumphs. Between 12 April and 10 May, Japan's 1899 4% bonds, which had been trading in London at 63.75% of face value, increased in price to 70.50%. In contrast, Russian 4% bonds dropped in price from 95% to 89.5%. Compared to other foreign government options, at the time the first Japanese 6% series was issued, it offered higher returns and stronger collateral.[125]

The motivations of retail bond investors changed as the war progressed, and the strong demand for the second two offerings (at 4.5%) reflected these different demand characteristics.

> The excessive subscriptions for the American allotments of the Japanese loans – bearing interest at the rate of 4½ per cent. and sold far below par – pointed to the features which now appealed to large numbers of prospective investors. The latter either had ceased to lay so much stress on security alone as they had formerly done, regardless of the rate of income return; or else they thought that, in this new economic era, security could be taken for granted and income return might be constituted the chief object of their attention.[126]

Investors were reassured that their confidence in the Japanese bonds had been well placed and as a consequence were willing to accept higher prices and lower yields as the war progressed.

[125] Tomita, 'Japanese Government Bonds 100 Years Ago', p. 17.

[126] Osborne, 'Speculation on the New York Stock Exchange', p. 44.

Scale of the Japanese Loans in Perspective

In 1904, there was a total of $535,081,600 in new bond issues for investors to choose from on the New York Stock Exchange. Of these, over 67% were railroad-related bonds that averaged totals per issue of only $3,078,261 for the year. Of the non-railroad 'miscellaneous bonds' listed that year, comprising $119,925,100 (not including the Japanese issues), the average total size of each issue was $9,225,008—three times the average railroad offering. Second only to New York City Corp. stock, the single biggest aggregate issue for the year was the Japanese bonds, at a total of $55,000,000—over sixteen times the average railroad issue size and almost six times the average non-railroad issue size. In short, the Japanese bonds stood out for their sheer scale compared to American domestic bond offerings that year.[127]

They also set a record at the time for being the largest foreign issue ever to have occurred on the American markets.[128] *Commercial West* compared the $55 million total of the first two Japanese loans on the American markets to the next two largest issues previously attempted: the $35 million Cuban loan of 1903 and a Mexican $25 million offering in America in 1899.[129] Even for Japan, the scale was colossal. The value of the bonds raised in London and New York was double the Japanese government's revenues at the time.[130]

For Schiff also, in a market where a $15 million bond issue was considered large and a $25 million issue considered huge, underwriting approximately $180 million of the $400 million or so of the overall Japanese bond issue was a monumental undertaking.[131] Comparing the scale of the Japanese loans to total syndicate volumes of the major investment banks at the time provides insight into how significant this undertaking was for Kuhn Loeb (see Table 5.6).

Although Kuhn Loeb's syndicate books have been lost, Susie Pak's analysis of J. P. Morgan's records goes some way to helping us to understand the relative scale of the Japanese loans for Schiff. As shown in

[127] *Commercial and Financial Chronicle*, Vol. 80 (21 January 1905), p. 194.

[128] 'How Great Loans Are Sold', p. 25.

[129] Ibid.

[130] Metzler, *Lever of Empire*, p. 48.

[131] 'Jacob H. Schiff: The Pioneer of American Foreign Financing', pp. 452–454.

Table 5.6 Comparative syndication volume, 1894–1914

Name of managing bank, syndications 1894–1914	*Total syndication value ($ millions, rounded)*
J. P. Morgan	3800
Kuhn, Loeb & Co.	1440
National City Bank	694
First National Bank (New York)	223
Lee, Higginson & Co.	120
Kidder, Peabody & Co.	90
Harvey, Fisk & Sons	88

Source Reproduced from Susie K. Pak, Gentlemen *Bankers: The World of J. P. Morgan* (Cambridge, MA: Harvard University Press, 2013) and referenced there as being Table 9 from J. P. Morgan & Co. syndicate books, ARC 108-ARC 119, Pierpont Morgan library

Table 5.6, as a proportion of the total syndication volume between 1894 and 1914, Kuhn Loeb's $1440 million represented approximately 38% of J. P. Morgan's $3800 million. Of this $1440 million, the Japanese war loans accounted for $180 million, or fully one eighth of Kuhn Loeb's total loan volume over the period. They accounted for almost a quarter of the entire transactional volume of Kuhn Loeb for the period 1897–1906.[132] In short, the Japanese bonds were as significant in their size for Schiff as they were also for the markets themselves.

[132] Redlich, *The Molding of American Banking*, Vol. 2, p. 387.