

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION

**PURSUANT TO SECTION 30 OF
THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935**

PART THREE

CHAPTER VII

Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies



WASHINGTON, D. C.

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PART THREE CHAPTER VII Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies



WASHINGTON, D. C.

COMMISSIONERS

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SECURITIES AND EXCHANGE COMMISSION,
Washington, February 24, 1941.

SIR: I have the honor to transmit herewith Chapter VII (the final chapter) of Part Three of the Commission's over-all report on the study of investment trusts and investment companies made pursuant to Section 30 of the Public Utility Holding Company Act of 1935. Chapter VII deals primarily with the problems in connection with the management of assets and the pyramiding of investment companies.

The study and report were under the general supervision of Commissioner Robert E. Healy, with Paul P. Gourrich, former technical adviser to the Commission, as director of the study; the late William R. Spratt, Jr., as chief of the study; David Schenker as counsel; and L. M. C. Smith as associate counsel. Mr. Justice Douglas, former Chairman of the Commission, whose resignation from the Commission was submitted on April 14, 1939; Paul P. Gourrich, former director of the study, whose resignation from the Commission was submitted on March 31, 1939; and William R. Spratt, Jr., former chief of the study, whose death occurred on June 20, 1938, did not participate in the preparation or consideration of Part Three. Chairman Frank and Commissioner Henderson were not able to participate in the consideration and approval of Chapter VII of Part Three.

Chapter VII was prepared under the supervision of Harry S. Carver, Harry Heller, and Rella Resnick Shwartz.

By direction of the Commission,

ROBERT E. HEALY,
Acting Chairman.

THE PRESIDENT OF THE SENATE,
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES,
Washington, D. C.

LIST OF REPORTS SUBMITTED

Part One, Part Two, and Chapters I to VI, inclusive, of Part Three of the over-all report have heretofore been transmitted by the Commission to the Congress. Part One, which was transmitted by the Commission to the 75th Congress on June 10, 1938, consists of a discussion of the nature, classification, and origins of investment trusts and investment companies, and has been printed as House Document No. 707, 75th Congress. Part Two, the transmission of which to the 76th Congress was completed on March 10, 1939, consists of a statistical survey of investment trusts and investment companies and has been printed as House Document No. 70, 76th Congress. Chapter VII, herewith transmitted to the 77th Congress, completes Part Three, which deals with the abuses and deficiencies in the organization and operation of investment trusts and investment companies. Part Three is printed as two House documents, Chapters I-VI as House Document No. 279, 76th Congress, Chapter VII as House Document No. 136, 77th Congress.

The Commission has also transmitted to the Congress six supplemental reports, namely: Investment Trusts in Great Britain, transmitted on June 26, 1939, and printed as House Document No. 380, 76th Congress; Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, transmitted on August 17, 1939, and printed as House Document No. 477, 76th Congress; Commingled and Common Trust Funds Administered by Banks and Trust Companies, transmitted on August 30, 1939, and printed as House Document No. 476, 76th Congress; Companies Sponsoring Installment Investment Plans, transmitted on September 22, 1939, and printed as House Document No. 482, 76th Congress; Fixed and Semifixed Investment Trusts, transmitted on January 15, 1940, and printed as House Document No. 567, 76th Congress; and Companies Issuing Face Amount Installment Certificates, transmitted on March 13, 1940, and printed as House Document No. 659, 76th Congress.

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PART THREE

CHAPTER VII

PROBLEMS IN CONNECTION WITH
MANAGEMENT OF ASSETS OF INVESTMENT
TRUSTS AND INVESTMENT COMPANIES

I. INTRODUCTION

A. Description of Subject Matter

1. COVERAGE OF CHAPTER

This chapter discusses the various abuses and problems in connection with the management and portfolio activities of investment companies.

The matters discussed include the benefits of sponsorship, purchase and sale of portfolio securities, joint ventures with sponsors, loans, underwriting participations, trading activities, and portfolio practices generally.

2. LOSSES TO INVESTORS

Previous parts of this report have indicated the extent of the losses suffered by the public investors in investment companies. It has been computed that, as at the end of 1935, the capital shrinkage of investment companies was approximately \$2,900,000,000, or approximately 37% of a total capital investment of approximately \$7,900,000,000. However, allowing full credit for dividends, interest, and other payments to stockholders the shrinkage was approximately \$1,750,000,000, or approximately 22% of the amount invested.¹ This figure does not reflect the entire shrinkage because it does not include the losses sustained by certain companies which had become defunct and as to which no information was directly available.²

¹ Report on Investment Trusts and Investment Companies, Pt. Two, Ch. VII, Table 155, p. 504.

² Of the total of approximately \$7,900,000,000 contributed capital, \$1,000,000,000 represented an investment in senior securities. This latter amount represents over two-fifths of the total capital raised by leverage management investment companies proper and over one-fourth of the total for all management investment companies proper (closed-end and open-end). If intercompany transactions were excluded both from total capital raised and from senior securities, the proportion of total capital raised through the sale of senior securities might be as high as 50% for leverage management companies proper, and 35% for all management investment companies proper. (Report on Investment Trusts and Investment Companies, Pt. Three, Ch. V, p. 1579.) Since the loss of senior capital was not large the greater part of the loss sustained in the capital investment was sustained by the common stockholders.

Of course, a large part of these losses may be traced to the drastic general market declines in security prices and to other causes. However, a very substantial portion of these tremendous losses resulted from mismanagement of one kind or another.

3. FLUIDITY OF INVESTMENT COMPANY ASSETS

One of the significant attributes of investment companies is that their assets are almost invariably fluid. Unlike industrial companies, the assets of investment companies do not consist of tangible physical properties employed in productive activity but, instead, usually consist of securities evidencing claims upon or participations in such productive properties. The character of these assets is constantly shifting, through investment and reinvestment, from the time the funds are received from the public throughout the existence of the company.³ These assets have, in the main, an ascertainable market value which can be readily realized. The ownership of these assets, because they are frequently in bearer form or the practical equivalent (*i. e.*, stock certificates endorsed in blank), is frequently not disclosed by the securities themselves.

4. SPONSORSHIP OF INVESTMENT COMPANIES

Investment bankers, securities dealers, and brokers have predominated in the organization and sponsorship of investment companies. In a large measure these types of sponsorship were attributed to the ease with which the funds of such companies might be used to enhance the business of such sponsors. Frequently investment companies have been treated by their sponsors merely as adjuncts or instrumentalities of the sponsors rather than as independent business ventures. Consequently, in the investment companies field, the fiduciary concepts historically applicable to the management of the funds of others have not been always observed. Persons in control of investment companies have not only been found acting where they represented conflicting interests but also where their own interests conflicted with the interest of the companies they managed. These conflicts have been particularly apparent—and particularly detrimental to public investors—in connection with portfolio activities of investment companies. For example, the sponsors would adopt devices at, or prior to, the organization of an investment company which would insure to such sponsors absolute control of the enterprise without any appreciable personal investment. Thereafter many sponsoring groups managed the funds of the investment company in such ways as their particular type of self-interest dictated.

The outstanding features of the management policies of many investment companies reveal a consistent relationship to the private business interests of the sponsor. Investment companies sponsored by brokers frequently show active trading in portfolio securities; companies sponsored by investment bankers show portfolios heavily weighted with security issues underwritten by the sponsors and a large proportion of underwritings shared with sponsors; companies spon-

³ The security portfolio of the average investment company turns over completely at least once every two years. (Pt. Two, Ch. VIII, pp. 632-4.)

sored by industrial promoters show portfolios favoring large blocks of securities—available as instrumentalities of control—in various industrial enterprises in which the sponsors were interested.

B. Circumstances Surrounding Organization of Investment Companies

1. EASE OF ORGANIZATION

From their very inception investment companies have lent themselves to promotion by persons who possessed a means of marketing the securities of such organizations. The original sponsors determined the authorized purposes and powers, the size of the undertaking, the capital structure, and the identity, tenure, and responsibilities of the management of the enterprise. The various opportunities and emoluments flowing from control could be and were, in many cases, established before there was a single public investor to protest the favored position which the organizers accorded themselves or the vulnerable position in which the investor was likely to find himself.⁴ The necessary organization expenses were frequently charged against the capital subscribed, and, when borne by the sponsors, it was so arranged that distribution or management fees would be adequate to absorb the outlay. Too, such costs were but a small percentage of the total capital raised and the investment company became an ideal instrument for the professional promoter.⁵

Technical training and experience were not regarded as a requirement for the organization and operation of an investment company, as was evidenced by the variety of inexperienced and untrained sponsors.⁶

⁴ Public Examination, Tri-Continental Corporation, at 18520-1. The complete discretion enjoyed by the sponsors of investment companies at the time of organization was conceded by Earle Bailie, chairman of the board of directors of Tri-Continental Corporation and a member of the sponsoring firm of J. & W. Seligman & Co. Mr. Bailie testified:

Q. Just briefly, you decided on what should go into the charter, didn't you?

A. Yes.

Q. That is Seligman, is it?

A. That is J. & W. Seligman & Company. They formed the company.

Q. Anyway, Seligman & Company decided on the underlying spread?

A. They decided on the help, they decided on everything preliminary to the issue.

Q. They selected the directors preliminary to the issue?

A. Correct.

⁵ For example, Incorporated Investors, an open-end investment company which eventually grew to a fund of over \$77,000,000 required a cash outlay at the beginning of less than \$10,000. (Pt. One, p. 103 [House Document No. 707, 75th Congress].) The cost of organizing United States & International Securities Corporation in the fall of 1928, with net paid-in assets of \$58,000,000 was only \$19,600 (Reply to Commission's questionnaire for United States & International Securities Corporation, Pt. I), while in January 1929 Petroleum Corporation of America was formed with paid-in assets of \$100,979,880 and its organization and listing expenses were \$77,711.43 (Reply to Commission's questionnaire for Petroleum Corporation of America, Pt. I).

⁶ See also Pt. Three, Ch. I, p. 3. Because there were no legal standards with which promoters, officers, or directors of investment companies were required to comply, many incompetent and dishonest individuals have organized such companies and managed their assets. Persons with little or no experience in the investment field came actively in control of investment companies. Former automobile salesmen, brewers, butchers, dentists, engineers, furniture dealers, insurance salesmen, laundry salesmen, lawyers, manufacturers of drugs, shoes, and other articles, oil promoters, public utility promoters, radio dealers, real estate promoters, and small-loan brokers are among the persons who, without other experience, sponsored, or were affiliated with the management of investment companies. Persons with previous convictions for criminal offenses involving dishonesty have been sponsors of investment companies.

In some cases, the principle of diversification was relied upon to offset unsuccessful management. This concept is disclosed by a letter dated February 1, 1933, to participants in The Alexander Fund, reading, in part, as follows:⁷

Your manager has often told you that human judgment in the selection is not worth much, and after forty years in the market we still believe that, aside from government bonds and a few others of low yield, the greatest safety in investment lies in diversified securities; hence the most important of the Fund's basic rules.

Default in the earning power of gilt-edged investments proves pretty conclusively that the average financial adviser is a myth.

* * * * *

Sponsors could merely place the funds in so-called "blue-chips" or "market leaders" and ride along with the market averages with little fear of criticism, or could hire others to advise them. Because of this attitude the management facilities possessed by many investment companies were extremely limited. The offices of the investment company were often located at the offices of the bankers, brokers, lawyers, and other sponsors who undertook to manage them as part time undertakings, while such functions as bookkeeping, custodianship, statistical analyses, and other similar functions were sometimes assigned to agencies which specialized in such services.⁸ John F. McKay, a laundry salesman who was an employee of First Income Trading Corporation, described the office facilities of that investment company as follows:⁹

Q. Where was the office of First Income?

A. Twenty-five Broadway.

Q. The same place where the Trans-Atlantic office was?

A. Yes.

Q. In the same room?

A. Yes, sir.

Q. How many desks did you have there?

A. Well, they had three desks there.

Eastern Utilities Investing Corporation, an investment company possessing assets of approximately \$80,000,000 in 1929, was operated as a subsidiary of Associated Gas and Electric Company and had no independent offices, clerical staff, or management of its own.¹⁰ Its taxes were paid and its security holdings were acquired through companies in the Associated Gas and Electric Company system¹¹ while all the management services, including the furnishing of officers and directors, were supplied by H. C. Hopson and Company, which rendered like services to affiliated companies.¹² The complete identity of facilities represented by this situation was disclosed in the testimony of Franklin Bowman, a partner of Haskins & Sells, the auditors for Eastern Utilities Investing Corporation:¹³

Q. Could you go to any one place and say that that room was the office of Eastern Utilities Investing Corporation and not the office of any other company?

⁷ Public Examination, The Alexander Fund, at 19059.

⁸ Public Examination, Incorporated Investors, at 2529-30.

⁹ Public Examination, First Income Trading Corporation et al., at 403.

¹⁰ Report on Investment Trusts and Investment Companies, Pt. Three, Ch. II, p. 633.

¹¹ Public Examination, Eastern Utilities Investing Corporation, at 24328-9.

¹² Id., at 24763, 24788.

¹³ Id., at 24328-7.

A. No; I think their office was in the Associated [Gas and Electric] System.

Q. That is, the employees who would work on Eastern Utilities Investing Corporation matters were employees of Hopson Service companies or other companies in the Associated System?

A. That is right.

Q. You think there may have been one man who devoted all of his time to Eastern Utilities Investing Company affairs?

A. I think there may have been.

Q. Are you sure of that?

A. No.

The facilities originally possessed by Prudential Investors, Inc., an investment company organized January 15, 1929, were similarly limited, according to the testimony of its president, J. M. Miller:¹⁴

Q. The corporation had no lease for separate office space at the outset? Is that so?

A. Not that I know.

Q. So that its office would be perhaps more or less between Schrodgers and Tucker Anthony? That is to say, there is no independent office space, and its records were with Schrodgers, and the clerical work was done by them?

A. No; I think their records were kept at their office, 15 Exchange Place, Jersey City.

Q. At the outset, or was that at some time subsequent?

A. I imagine it was at some subsequent time.

Q. I mean, it wasn't the impression at the outset to take on expensive independent offices.

A. No.

Q. When was the Jersey City office opened?—Approximately—

A. I should imagine in 1930.

And further on:¹⁵

Q. What is the size of the corporation's staff?

A. Well, the routine job is done, of course, by Schrodgers and there is no staff really. The research staff consists of myself and a statistician, who is also an officer of the corporation.

Q. And you devote your entire time to the work of this company?

A. That is right.

Q. Do you find that that staff is large enough to handle this job involving the management of some \$13,000,000 of assets?

A. I think it is hard work.

2. SIZE OF INVESTMENT COMPANIES

The size of investment companies may constitute a problem of considerable importance to their investors. An investment company which is too small may not be able to operate efficiently. An investment company which is too large may present difficulties in connection

¹⁴ Public Examination, Prudential Investors, Inc., at 5899.

¹⁵ Id., at 5932, 5933.

with the management of the investment funds and liquidation of portfolio securities.¹⁶

At the end of 1935, the assets of the investment company industry were concentrated in the larger companies. At least 94 of 120 closed-end management investment companies proper possessed assets of less than \$10,000,000 each.¹⁷ Similarly, 33 out of 39 open-end management investment companies possessed assets of less than \$10,000,000 each.¹⁸ In other words, 78% of the closed-end management investment companies proper in the group at that time possessed 29% of the entire assets of the group while 85% of the total number of open-end management investment companies possessed only about 27% of the total assets of that group.

a. Minimum Size

The experience of investment companies has indicated certain minimum capital needs for economic and efficient operation.

(1) MANAGEMENT SERVICE

A company of small size may not be able to pay for satisfactory management service. William T. Gardiner, chairman of the board of directors of Incorporated Investors, testified:¹⁹

Q. And you don't think you could manage a fund of \$25,000,000 adequately on \$125,000 a year?

A. I don't want to change your question, but will you put it this way to me: If you come to me and say, "I am about to start a trust that is going to be \$25,000,000, with one-half of one percent management fee, limited to that amount for eternity. Will you go and get me a group of responsible men to take the responsibility as their life work in managing that trust, get me a board of directors who will assume the responsibility connected with serving on that board, and a research office, bookkeeping, legal, and accounting departments," I would hesitate to do it.

Mr. Gardiner stated a desirable ultimate range would be between forty and one hundred million dollars.²⁰ In any event, the facilities

¹⁶ Public Examination, Tri-Continental Corporation, at 18843-4. Earle Baillie, of Tri-Continental Corporation, discussing size of investment companies testified:

* * * That means an independent trust must be of considerable size if it is going to have its entire management under its own roof and all paid for. It means a small company not connected with any organization that has this facility to research and to have this knowledge of markets is, I should say, at a disadvantage so great as to make their successful existence almost impossible. Of course, you will have the independent agency or the individual agency come out and prove me a liar by a sensational performance with a slide rule or some other method of working. But I am talking about average people, not geniuses.

On the top side there certainly is a place where investment companies can have too many funds to handle to make it workable and easy for them to do their task. I don't know exactly what that size is * * *

¹⁷ Pt. Two, Ch. II, Table 21, p. 119 (House Document No. 70, 76th Congress).

¹⁸ Pt. Two, Ch. II, Table 22, p. 120 (House Doc. No. 70, 76th Congress). Small beginnings have been the uniform practice with open-end management investment companies because they customarily make no single or original offering but engage in making continuous offerings. The assets invested in these companies following the market crash of 1929 grew primarily as the result of successes in marketing the securities of open-end management investment companies already in existence. (Pt. Two, Ch. II, Table 43, p. 168 and Table 45, p. 162 (House Doc. No. 70, 76th Congress).)

¹⁹ Public Examination, Incorporated Investors, at 2616.

²⁰ Id., at 2617.

which could be supported by a fund possessing \$500,000 or less were very limited.

Moreover, it was indicated that without an adequate research organization it may be mechanically impractical to police more than a limited number of securities. Lehman Corporation engaged the services of about 55 employees in the various aspects of managing assets totaling more than \$75,000,000, the over-all salaries running around \$275,000 a year.²¹ Arthur H. Bunker, vice president in charge of operations, testified that a sizeable staff was needed to manage any fund which justifies diversification:²²

Q. Do you think that there is any ratio or any minimum number of statisticians in a force that an investment trust should have in relation to the total assets? Have you ever thought of personnel in terms of relation to total quantity of assets under your control?

A. Yes, I have. I have thought a great deal about it.

Q. Have you arrived at any yardstick or [method] of determining it?

A. I would rather not give it in number of men. It seems to me the problem is this; whether a man has ten million dollars or a hundred million dollars that he is responsible for investing wisely, even the smaller sum mentioned is quite large enough to necessitate diversification, and that, of course, necessitates diversified knowledge.

You have to know something about the utilities, the oils, the rails, building securities, merchandising securities, and so forth. You certainly should attempt to know as much as possible for a man to know about general economic conditions. He should certainly have people who are devoting their time to weighing new influences which come, possible legislation which may take place, and which often quite widely affects given branches of industry.

I have not been able to see how an organization would not really feel short of information unless it covered all of those general fields, fields of well known investment, and covered them rather thoroughly.

Mr. Bunker considered that there were about 15 fields of investment to be considered and that one man should not be expected to be an expert in more than one such field.²³

(2) ECONOMY OF OPERATION

Investment companies, like most other business enterprises, are in a position to enjoy certain economies by having adequate resources over which to spread their fixed charges. Economy of operation was an important consideration in determining the size of Federated Capital Corporation. William J. Thorold of that company testified:²⁴

Q. The expenses in connection with the overhead, and the statistical research, and organization expenses, which is approximately the same, whether you have half a million dollars trust, or a \$5,000,000 trust, isn't that so?

A. To a great extent, of course, the greater capital the less the overhead in percentage.

Q. Would you have undertaken to operate this investment trust, if you had the feeling that you couldn't raise more than a million or two million dollars?

A. I don't think that I would.

²¹ Public Examination, Lehman Corporation, at 5686.

²² Id., at 5692-3.

²³ Id., at 5693-4.

²⁴ Public Examination, Federated Capital Corporation, at 14435-6.

The sponsors of General American Investors Company, Inc. raised a capital of \$9,078,750. This capital was considered inadequate by Raymond D. McGrath, who testified:²⁵

Q. Did you feel that the size of the initial trust was too small to make it economically a feasible unit to operate?

A. We thought that it was too small, that if it was larger it could be operated more economically, and also we needed the prestige of a larger trust. I mean, the trust going out, and making contacts, was handicapped by the fact that it was so small.

The following table gives average percentage ratios of operating expenses to net assets at market and the average percentage ratios of operating expenses to ordinary income, in different size groups for 139 management investment companies proper in 1935:²⁶

Net assets at market (total assets minus current liabilities) \$000	Percent of operating expenses to net assets	Percent of operating expenses to ordinary income	Number of companies
(1)	(2)	(3)	(4)
500- 750	1.98	57.31	19
750- 1,000	1.97	57.38	9
1,000- 2,000	1.17	41.22	20
2,000- 3,000	1.18	47.46	15
3,000- 4,000	.78	41.17	10
4,000- 5,000	.80	27.91	10
5,000- 7,500	.57	30.92	15
7,500-10,000	.82	24.90	13
10,000-25,000	.72	28.95	14
25,000-50,000	.62	21.11	11
Over 50,000	.70	30.23	3

Half of these investment companies had ratios of operating expenses to net assets exceeding 0.80% and half had ratios of operating expenses to ordinary income exceeding 24.73%. Although comparable figures were not compiled for investment companies possessing net assets of less than \$500,000,²⁷ relatively high operating expenses are seen to have persisted in investment companies with assets up to \$1,000,000, where such expenses amounted to almost 2% of net assets and over 57% of ordinary income. While it was customary to express management fees at $\frac{1}{2}$ of 1% of total assets, the items of operating expenses thereby covered were by no means uniform. Obviously, $\frac{1}{2}$ of 1% of \$500,000, or \$2,500, would not even pay the salary of an executive officer. Yet the practice of permitting the investment company to bear a variety of such expenses in addition to the management fee provided the appearances of low operating costs when the aggregate costs were in fact considerably higher.

²⁵ Public Examination, General American Investors Co., Inc., at 5734.

²⁶ Compiled from information contained in Part II of the replies to the questionnaire supplied the Commission for the respective investment companies. Net assets at market consists of assets minus current liabilities while operating expenses exclude brokerage and other expenses of management that do not appear in the income account.

²⁷ The questionnaire from which such information was available was directed only to management investment companies possessing assets at December 31, 1935, amounting to \$500,000 or more.

The declines in these expenses in the larger size groups were greater as percentages of assets than they were as percentages of income. In both comparisons, however, each increase in assets provided marked savings in the operating costs chargeable against the dollar invested. The extent to which size should be increased in order to obtain such savings is discussed hereafter.²⁸

(3) ACQUISITIONS AND LIQUIDATIONS OF SMALL INVESTMENT COMPANIES

The large losses and declining asset values experienced during the period following 1929 combined to deplete the resources of many investment companies to the point where it was considered no longer possible to operate them profitably or efficiently. This situation encouraged the inauguration of acquisition and merger programs in the course of which 163 investment companies were merged or consolidated with other investment companies in the seven years ending with December 31, 1936.²⁹

Among the leaders in such acquisition activities was Atlas Corporation which by October 1936 had taken over 21 investment companies with aggregate resources of approximately \$172,000,000.³⁰ In the course of this program a letter dated February 11, 1931, was sent to the shareholders of Selected Stocks, Inc., and signed by its president, advising as follows:³¹

Your Board has for some time past considered that your corporation is insufficiently capitalized for efficient and successful operation as an investment trust. Two alternatives were therefore presented, the first to raise additional capital through the sale of securities, and the second to negotiate for the taking over of the affairs of your Corporation by a large successfully managed trust. After careful consideration your board has concluded that in the present times and conditions the first alternative is impractical and, with the second alternative in view, have negotiated with Atlas Utilities Corporation, with the result that an offer has been made to acquire your holdings. * * *

Selected Stocks, Inc., had assets of approximately \$600,000 at that time.³²

Another instance of this character was provided by Exide Securities Corporation (later Allied Atlas Corporation) whose stockholders received a letter dated July 16, 1930, recommending the acceptance of an exchange offer of Atlas Utilities Corporation:³³

When the capital stock of Exide Securities Corporation, together with subscription warrants, was distributed to stockholders of The Electric Storage Battery Company, it was expected by your Board of Directors that your corporation would, upon the exercise of the subscription warrants, have a capital of approximately \$18,000,000 but owing to the drastic readjustment of the stock market, more than half of the stockholders of Exide Securities Corporation exercised the option to receive cash for their shares and warrants. The total

²⁸ See *infra*.

²⁹ Pt. Two, Ch. II, Table 16, p. 111 (House Doc. No. 70, 76th Congress).

³⁰ Pt. Three, Ch. IV, Table 16, pp. 1064-5.

³¹ Public Examination, Atlas Corporation, Id., Commission's Exhibit No. 1970.

³² Id., Commission's Exhibit No. 2033.

³³ Id., Commission's Exhibit No. 1970.

capital of your Corporation, therefore, after the exercise of subscription warrants, amounts to but approximately \$6,000,000, which your Board considers too small for the successful operation of an investment trust. Your Board was therefore of opinion that the best interests of stockholders would be served by having the affairs of your Corporation taken over by a large, successfully managed trust, and with this in view, has negotiated with representatives of the Atlas Utilities Corporation, with the result that an offer has been made to acquire your holdings. * * *

It is interesting to observe that in this instance even \$6,000,000 of assets were considered inadequate.

A size grouping of a sample of so-called "defunct" companies, consisting of management investment companies no longer in operation or in the process of liquidation, is given below. While the average amount of net capital contributed to the 107 investment companies in this group was \$5,915,000, the concentration in the small-size groups is apparent and the median investment company possessed assets of only about \$1,200,000. Furthermore, it was difficult for this Commission to ascertain the existence of "defunct" investment companies unless their capital at some time was sufficient to induce their listing in one of the financial manuals.

Net capital contributed to companies which become defunct (\$000)	Number of companies
0-500.....	31
500-1,000.....	15
1,000-2,500.....	32
2,500-5,000.....	14
5,000-7,500.....	6
7,500-10,000.....	2
Over 10,000.....	7
Total..	107

Although a requirement of minimum capitalization would not insure against such contractions of assets it might permit an honestly operated investment company with a reasonable structure to continue to operate and thereby recoup losses suffered during a period of severe market declines. Obviously investment companies of the small sizes which the majority of them possessed offered no such opportunity, even if other conditions were favorable.

b. Maximum Size ³⁴

The size of investment trusts and investment companies, as they have grown up in the United States, has been governed primarily by

³⁴The almost universal limitation on size of corporations which prevailed in earlier days is pointed out by Mr. Justice Brandeis in his dissenting opinion in *Liggett Co. v. Lee*, 283 U. S. 517, 550, where he said:

"Limitation upon the amount of the authorized capital of business corporations was long universal. The maximum limit frequently varied with the kinds of business to be carried on, being dependent apparently upon the supposed requirements of the efficient unit. Although the statutory limits were changed from time to time this principle of limitation was long retained. Thus in New York the limit was at first \$100,000 for some businesses and as little as \$50,000 for others. Until 1881

the receptivity of the market and the ambitions of the promoters.³⁵ Thus, instead of planning the public offerings to meet the asset needs of prospective investment companies, the tendency has been to adjust the operations of investment companies to the capital which they have been able to acquire. Such practices have been encouraged by the broad range in the amounts of operating capital with which investment companies have been permitted to commence business.

The importance of the market factor was admitted by Fred Y. Presley, the guiding spirit of National Investors Corporation, when he testified:³⁶

Q. It is pretty much the fact that the size of these offerings was determined by what the best judgment of the underwriters thought that the market could absorb.

A. Yes.

Q. And it was the maximum which they thought that the market could absorb at that time.

A. Yes.

Similarly, after raising some \$75,000,000 by the formation of The Chicago Corporation and Chicago Investors' Corporation, the firm of Field, Glore and Company, sponsors of the two investment companies, joined with Continental Illinois Company (the security affiliate of the Continental Illinois National Bank and Trust Co. of Chicago) to organize another investment company known as Continental Chicago Corporation because the market was deemed receptive to such a company. The new financing, which represented an

the maximum for business corporations in New York was \$2,000,000; and until 1890, \$5,000,000. In Massachusetts the limit was at first \$200,000 for some businesses and as little as \$5,000 for others. Until 1871 the maximum for mechanical and manufacturing corporations was \$500,000; and until 1899, \$1,000,000. The limit of \$100,000 was retained for some businesses until 1903.

In many other States, including the leading ones in some industries, the removal of the limitations upon size was more recent. Pennsylvania did not remove the limits until 1905. * * * Vermont limited the maximum to \$1,000,000 until 1911, when no amount over \$10,000,000 was authorized if, in the opinion of a judge of the Supreme Court, such a capitalization would tend to create a monopoly or result in restraining competition in trade. * * * New Hampshire did not remove the maximum limit until 1919. It had been \$1,000,000 until 1907, when it was increased to \$5,000,000. Michigan did not remove the maximum limit until 1921. The maximum, at first \$100,000, had been gradually increased until in 1903 it became \$10,000,000 for some corporations and \$25,000,000 for others; and in 1917 became \$50,000,000. Indiana did not remove until 1921 the maximum limit of \$2,000,000 for petroleum and natural-gas corporations. Missouri did not remove its maximum limit until 1927. Texas still has such a limit for certain corporations."

"In fact, when investment trusts and investment companies first indicated their potential importance, the possible haphazard and undirected withdrawal of large resources from their usual channels was a matter of some concern to the New York Stock Exchange, as testified by E. E. MacCrone, one of the sponsors of the American Capital Corporation group of investment companies (Public Examination, American Capital Corporation, at 7012):

The Stock Exchange said that if the investment-trust movement started in the United States that it would assumedly absorb all of the free securities and defeat the purpose of the New York Stock Exchange in its maintenance of a free and open market for the securities of the United States.

Similarly, the State of Michigan was reluctant to let Mr. MacCrone and his associates conduct the affairs of American Capital Corporation in that state as "presumably an institution of this kind would absorb all of the investment capital in the state and it would be injurious to the development of industries within the state. (Id., at 7013.)

Some investment companies reached very large size. Central States Electric Corporation raised a total capital of \$650,000,000. The United Founders Corporation Group raised over \$500,000,000 and The Goldman Sachs Trading Corporation raised \$350,000,000.

"Public Examination, National Investors Corporation, at 4312.

additional \$63,750,000, bore no relation to the needs of the community. Charles F. Glore testified:³⁷

Q. What was the purpose in forming that company?

A. Identical with the formation of Chicago Corporation.

Q. Would you say the experience of the Chicago Corporation formed in February, from February to September, for the purpose it was organized, would warrant the organization of another corporation for that purpose?

A. I don't think Chicago Corporation had any experience during that period.

Q. So if it had sufficient capital to furnish the facilities in the City of Chicago at that time there might be some question for the need of another corporation of that size in the same field?

A. Yes, sir.

Q. Did you all discuss it at that time to determine what the need was for an additional company with substantial resources?

A. I don't recall, didn't see there was need for another company.

It was testified by some sponsors that they might have hesitated to undertake the management of investment funds beyond certain size limits, but that the tremendous demand by their clients and customers for such securities sometimes served to influence their judgment. Thus, when National Bond and Share Corporation was organized on February 21, 1929 by the New York brokerage firm of Dominick & Dominick, the size was determined in large measure by the demands of the customers of that sponsor.³⁸ Gayer Dominick, a member of the sponsor firm, testified in this regard:³⁹

Q. About what size was suggested at that time?

A. \$25,000,000 was suggested at that time. So I gave my vacation up and came up North and went over the demand that there was from our customers. I was rather inclined to a \$5,000,000 trust. It became rather apparent that if we reduced it to that size, that it would be almost impossible to take care of the demand in any form of reasonableness at all, or satisfaction to the clients, so we finally compromised on a \$10,000,000 trust.

Q. And that became the size of the trust?

A. That became the size of the trust.

It was testified that the original offering, which was but half of the total authorized by the charter, was oversubscribed through unsolicited demands by the sponsor's customers to a total demand in the sum of \$28,000,000.⁴⁰

(1) MANAGEMENT COSTS

While it is essential to the efficient and economic operation of investment companies that they possess assets sufficient to pay for adequate management facilities there is a definite reluctance on the part of management to reduce the rate of compensation when that point is passed. As indicated by table above,⁴¹ operating expenses as percentages of net assets and of ordinary income in 1935 varied in inverse ratio to the amounts of assets possessed, in the cases of 139 management in-

³⁷ Public Examination, The Chicago Corporation, at 9683-4.

³⁸ Public Examination, National Bond and Share Corporation, at 2147-8.

³⁹ *Ibid.*

⁴⁰ *Id.*, at 2150-1.

⁴¹ See *supra*, p. 2492.

vestment companies proper. However, an analysis of this table indicates that the greatest decline in operating expenses as a percentage of net assets existed between the investment company groups possessing assets of less than \$1,000,000 and the group possessing assets from that amount up to \$2,000,000 and the percentage tended to level out in the groups possessing assets in excess of \$3,000,000. Furthermore, while the decline in operating expenses as a percentage of ordinary income was more regular for the increasing size groups, there was again a leveling out for investment companies possessing assets in excess of \$4,000,000. This leveling out is apparent without regard to the management investment companies proper with assets in excess of \$50,000,000, only three of which supplied the necessary information. It may accordingly be concluded that increased assets, ordinarily providing increased income, have not assured the same rate of savings, if any, when the investment companies attained sizes in excess of \$4,000,000.

While increased assets have probably entailed increased facilities, substantially the same facilities are needed to supervise properly any fund requiring diversification.⁴² The increased dollar expenses, therefore, probably have represented increased compensation to the management group.

(2) INVESTMENT PROBLEMS

As the assets of investment trusts and investment companies mount the investment of such funds may present various problems. At the same time percentage limitations upon the amount of total assets which could be placed in any one situation decreased in significance as the fund grew in size. In other words, a charter provision which limited the investments of an investment company in any one portfolio company to 5% of the former company's total assets might be a significant restriction to a \$1,000,000 company but of little significance to a \$100,000,000 company. Dr. O. M. W. Sprague, a member of the advisory board of Massachusetts Investors Trust, recognized this problem when he testified:⁴³

Q. What are the limitations or disadvantages you may run into—the dangers, if I may say so—if this thing continues to grow?

A. You are almost inevitably limited in the number of companies or enterprises in which you invest.

You may say that if you invest in 50 companies, if you have 50 million, that you might invest in 200 companies, if you have 200 million dollars. But I think that is unlikely to be the case.

Now, if you limit the number of separate companies in which you invest, and have say a hundred million dollars, that means a pretty heavy investment in numbers of those companies, and when you come to sell, if you do, you may find that you have far more than you can possibly dispose of before the market runs away from you.

Q. That is, you tend to be the market in that stock? Isn't that so?

A. Yes; you tend to be the market in that stock.

⁴² See testimony of Arthur S. Bunker, *supra*, p. 2164.

⁴³ Public Examination, Massachusetts Investors Trust, at 2424-5.

Q. And that is entirely aside from the fact that you may be confronted with problems of industrial magnitude? Isn't that so?

A. Well, we have avoided that so far by never having more than—under our indenture—no more than 5 percent, in an industry.

But it also does tend to limit your choice, that you do not feel that you can undertake something that may be very profitable but which also may involve you in a managerial problem in no short period of time.

Q. For example, 5 percent of \$200,000,000 would be a \$10,000,000 investment—

A. Yes.

Q. And it is perfectly conceivable that you could have it in one situation, under the terms of your indenture? Isn't that so?

A. Yes; if you had that amount of money. And I am quite confident that if there is an increase in sales of shares during the next year or two years, at all paralleling that of the last two years, that steps will be taken to limit the size of the trust."

An effort was made by some of the larger closed-end investment trusts and investment companies to meet this problem by distributing their investment over a large number of security issues.⁴⁴ As of December 31, 1936, The Chicago Corporation had investments in 148 separate issues,⁴⁵ Tri-Continental Corporation owned 184 different security issues,⁴⁶ and The Lehman Corporation was invested in 263 issues.⁴⁷

The United Founders Corporation group of investment companies frequently had bylaw provisions requiring investment in a minimum number of companies. This mandatory diversification reached 400 separate issues in International Securities Corporation of America and Second International Securities Corporation.⁴⁸

In view of the relatively limited number of issues deemed desirable for purchase by investment companies, it is apparent that the size of individual investments, rather than the number, must grow after capital assets of the investment company get beyond a certain point. As individual investments grow in size they may lose their mobility, tend to become static, and what has been advertised as a general management fund may in effect become relatively fixed in type. This problem was admitted by Edgar L. Smith, president of the company managing Investment Trust Funds, A, B, and C, as follows:⁴⁹

⁴⁴ Dr. Sprague at the hearings before the Subcommittee of the Committee on Banking and Currency of the United States Senate on S. 3580 (76th Cong., 3rd Sess.), April 18, 1940 (Part 2, p. 561), modified these recommendations by saying that he no longer thought that large size might be a disadvantage in making the best possible investments. The reason he gave for this change of viewpoint was that the very large companies would not be interested in trading profits from merely playing the market but that large companies would rely principally on income from underlying securities.

⁴⁵ Management investment companies proper, exclusive of The Equity Corporation and Atlas Corporation groups, were invested in an average of approximately 70 security issues from 1927 through 1936. (Pt. Two, Ch. VIII, p. 542 (House Doc. No. 70, 76th Cong).)

⁴⁶ Derived from supplementary information supplied the Commission for The Chicago Corporation.

⁴⁷ Derived from supplementary information supplied the Commission for Tri-Continental Corporation.

⁴⁸ Derived from supplementary information supplied the Commission for The Lehman Corporation.

⁴⁹ See Pt. Two, Ch. VIII, pp. 595-6 (House Doc. No. 70, 76th Congress).

⁵⁰ Public Examination, Investment Trust Funds A, B, and C, at 11512-3.

Q. Do you think there ought to be a ceiling?

A. A what?

Q. A ceiling, a maximum.

A. Well, I don't know. Those things change so. I think it is harder to manage a fund where 5 percent of the fund is a large block to attempt to sell in the market. Again, the character of the fund might be changed so they keep in more active securities. There it would change the management problem. I don't say it can't be handled.

Q. Don't you have two problems there? In the first place, it may entail a broader list of investments which will entail more policing—

A. Yes.

Q. And the second observation is, if you elaborate on that list, you will get a concentration which always entails illiquidity?

A. Yes.

The large investment companies now own larger portfolios of common stocks than any other corporations in the United States except holding companies. Their holdings of diversified common stock are larger than those of any other institutions. At the end of 1939, the common stock holdings of Massachusetts Investors Trust amounted to about \$113,000,000, those of The Lehman Corporation to \$54,000,000, of Tri-Continental Corporation, Broad Street Investing Co., Inc., Capital Administration Co., Ltd., General Shareholdings Corporation, and Selected Industries, Inc., together (as they are under the same management) to \$81,000,000, and those of United States and Foreign and of United States and International Securities Corporation together (also under common management) to \$57,000,000.

None of the fire or casualty insurance companies, which are permitted to own common stock, and do hold considerable amounts of common stock, had a portfolio as large as \$100,000,000. Home Insurance Company, probably the largest of any fire insurance company, had a portfolio of common stock at the end of 1938 of \$61,000,000 (\$13,000,000 in common stocks of insurance companies). Hartford Fire Insurance Co., with total stock portfolio of \$86,000,000, held \$40,000,000 of common stocks (\$31,000,000 in insurance companies). Great American Insurance Co. with assets of \$43,000,000, had \$24,000,000 in common stocks (\$12,000,000 in insurance companies). Aetna Insurance Co., with \$43,000,000 of assets, had \$16,000,000 in common stocks (\$8,000,000 in insurance companies). Fidelity-Phenix Insurance Co. had \$45,000,000 and Continental Insurance Co. had \$51,000,000 in common stocks.

It is, of course, true that numerous banks and insurance companies have holdings of bonds and preferred stocks much larger than the stock holdings of any one investment company. These holdings of bonds and preferred stocks, however, are not comparable to the common-stock holdings of investment companies. They are purchased for practically permanent investment. Even the common-stock holdings of these institutions are semi-permanent. For instance, in the year 1938 the 26 largest life insurance companies bought \$18,000,000 and sold \$13,000,000 of stocks, that is, traded only to the extent of \$31,000,000, while their stock portfolios had a value of

slightly over \$525,000,000. Their portfolio turn-over was, therefore, only about 3%, against ratios of between 50% and 100% common for investment companies.⁵¹

(3) VOLUME OF TRADING BY LARGE INVESTMENT COMPANIES

Some of the large investment companies now probably buy and sell more common stock for their own account than any other organization or individual in the United States.

During the year 1939 one large closed-end investment company reported purchases and sales of stock of about \$39,000,000. Two other large closed-end companies under common control had purchases and sales of stock of \$45,000,000. Another group of two affiliated closed-end companies showed purchases and sales of \$45,000,000. Two large open-end companies had stock transactions of about \$18,000,000 each, and two medium-size open-end companies had purchases and sales of \$25,000,000 and \$21,000,000, respectively. The market value of all stock sales on national securities exchanges during 1939 amounted to about \$11,500,000,000; purchases plus sales consequently aggregated about \$23,000,000,000. Thus, several of the large investment companies alone each accounted for nearly one-fourth of 1% of total stock-exchange trading.

(4) INVESTORS' EXPERIENCE WITH LARGE COMPANIES

At the end of 1929 there were five management investment companies proper and nine investment-holding companies, with assets of more than \$100,000,000 each.⁵² In two of these investment-holding companies (Christiana Securities Company and Solvay American Investment Corporation) the public interest was comparatively small and they are, therefore, eliminated from further discussion. Public investment in the five management investment companies proper and in the remaining seven investment-holding companies amounted to about \$2,300,000,000.

At the end of 1939, four of the five management investment companies proper had disappeared as independent entities through merger, and two of the seven investment-holding companies (Continental Shares, Inc. and Chesapeake Corporation) were in receivership. All the 12 companies had shrunk tremendously in size, the market value of their total assets at the end of 1939 or at date of merger aggregating about \$498,000,000 against \$2,320,000,000 at the end of 1929. It is estimated that the shrinkage suffered by investors was about \$1,760,000,000 at the end of 1935 or 67% of the total investment in these 12 very large companies as compared with 32% for all investment companies proper, and 25% for all investment-holding companies (excluding Christiana Securities Company and Solvay American Investment Corporation).

⁵¹ For life insurance figures see "Investigation of Concentration of Economic Power," Hearings before the Temporary National Economic Committee, 76th Congress, Pt. 10A, February 12, 1940, p. 144 et seq. For investment company portfolio turn-over see Pt. 2 of this report, Ch. VIII, p. 632 et seq. (House Doc. No. 70, 76th Congress).

⁵² Report on Investment Trusts and Investment Companies. Part Two, Ch. II, pp. 53, 92.

c. Types of Portfolio Activity

Investment companies employed their publicly contributed funds in a wide variety of ways: participation in underwritings of securities; trading in securities and commodities; dealing in puts and calls, foreign exchange, bankers' acceptances and commercial paper, and oil and gas royalties; short selling; loans to brokers, dealers, and others on securities; granting of options on securities issued by others; dealing in real estate; reorganization of industrial companies, and rendering investment advisory service.⁵³ In other cases investment companies made very substantial investments which resulted in their active management, and operation, or participation in the operation and management of various commercial and industrial enterprises. These management activities were contemplated in some cases when the investment was made, but in some cases were entered upon in order to protect an outstanding investment. Some of the companies were set up for such activities; others were not. Included in the various types of business in which investment companies participated were agriculture, amusements, building and contracting, distilling and beverages, exploration and promotion, financing, food and dairy products, manufacturing, merchandising, mining, publishing, real estate, servicing, transportation, and utilities.

Naturally, it appears that the assets of investment-holding companies⁵⁴ tended to represent investments in one industry—frequently an affiliated group of companies within an industry.⁵⁵ Investment companies proper,⁵⁶ on the other hand, did not confine their investments to single industries, or indeed to one "special situation."⁵⁷

⁵³ The following table based on Item 19 of the replies to the Commission's questionnaire for 182 companies (166 investment companies proper and 16 investment-holding companies) indicates the extent to which the companies in the group engaged in these various activities:

Type of activity:	Number of companies
Underwriting participations.....	33
Trading accounts.....	42
Loans on securities.....	31
Dealings in puts and calls.....	6
Real estate.....	1
Commodity trading.....	5
Foreign exchange.....	5
Bankers' acceptances and commercial paper.....	2
Oil and gas royalties.....	1
Granting options on securities issued by others.....	16
Short selling.....	6
Investment advisory service.....	4
Other activities.....	5

⁵⁴ Investment-holding companies have been previously defined in this report as "organizations the majority of whose assets consists of blocks of stocks of corporations ranging from 10 to 50 percent of the total outstanding shares and sufficient to give the [investing] company actual or potential working control or influence over these corporations." (Pt. One, p. 26.)

⁵⁵ For example the investments of Christiana Securities Co. were almost exclusively in the chemical industry, entirely in companies controlled by the du Pont interests; Alleghany Corporation confined its investments to railroad companies, particularly to the Van Sweringen group; the assets of Central States Electric Corporation were invested largely in companies in or affiliated with the North American Company system.

⁵⁶ Investment companies proper have been previously defined in this report as "organizations which diversified their security holdings and did not exercise any control or influence over their portfolio corporations."

⁵⁷ The Chicago Corporation, at the end of 1935, showed a substantial part of its assets invested in shipbuilding, real estate, oil-drilling equipment, utilities, and hosiery, among

The remainder of this chapter is devoted to a discussion of various types of portfolio activities and the problems in connection therewith. The discussion does not purport to treat exhaustively of all portfolio activities, but instead points out by illustrative cases the major problems in the management of assets which the instant study and investigation has uncovered. The matters discussed include the benefits of sponsorship, purchases and sales of portfolio securities, joint ventures with sponsors, loans, underwriting participations, trading activities, and special situations.

other business interests. Among other examples is Reynolds Investing Company, Inc., in which there were interests in wholesale grocery, a tinfoil business, and a railroad serving the southwest of the United States. Numerous instances of the variety of these special situations can be cited. Phoenix Securities Corporation during 1934 had substantial interests in a pulp-and-paper company, a whiskey distillery, a department store, and a manufacturing plant of brass and copper products. The Goldman Sachs Trading Corporation in 1929 used its assets in the fields of investment banking, insurance companies, department stores located both in New York and on the west coast, frozen-food business, milk products, salmon fisheries, real estate, and banks located in New York, Chicago, and San Francisco.

II. THE BENEFITS OF SPONSORSHIP

It is indisputable that an investment company is the source of very substantial benefit to its sponsor. This is particularly true when the sponsor is an investment banker.

Practically all sources of benefit to sponsors stem either from the distribution of the capital securities of the investment company or the management of its assets. Since distribution practices have been discussed previously in this report,¹ the discussion of the profits and perquisites of sponsorship in this section will be viewed primarily from the management angle. Summaries of the activities of some firms of investment bankers who sponsored investment companies have been selected as illustrative cases.²

A. Hayden, Stone & Co.

1. HISTORY AND DEVELOPMENT OF SPONSORSHIP

The Adams Express Company was the first investment company with which the investment banking firm of Hayden, Stone & Co. became affiliated.³ In 1918, when the financing of The Adams Express Company was shifted from the Guaranty Trust Company of New York to The Chase National Bank of the City of New York, Albert H. Wiggin, who was the head of The Chase National Bank, became a member of the board of directors of The Adams Express Company.⁴ Charles Hayden, of Hayden, Stone & Co., the largest stockholder of record,⁵ at the invitation of Mr. Wiggin became a member of the board of managers of The Adams Express Company.

The Adams Express Company had been organized in 1854 as an express forwarding company and was at that time and still is a joint stock association. As an incident to its association form, its stockholders are subject to unlimited liability and the management of the

¹ Pt. Three, Ch. III (House Doc. No. 279, 76th Congress), Problems in Connection with the Distribution and Repurchase of Shares of Open-End and Closed-End Management Investment Trusts and Investment Companies.

² These firms have been selected solely for illustrative purposes and the discussion does not purport to present analyses or histories of the companies mentioned nor to discuss abuses or defects as such.

³ Hayden, Stone & Co. is a partnership organized in the year 1892. In 1927 when that firm entered the investment company field, it had a seat on the New York, Philadelphia, and Boston Stock Exchanges and the Chicago Board of Trade. Its business consisted of the underwriting and distribution of common and preferred stock and bonds and the performance of brokerage business for commissions. Branch offices were maintained in Springfield, Massachusetts; Boston, Massachusetts; Portland, Maine; and Paris, France. The firm consisted of eleven partners, among whom were Charles Hayden, Richard F. Hoyt, Clarkson Potter, and John R. Dillon. Registration Statement of Hayden, Stone & Co. File No. 8-1. Security Dealers of North America, Midyear, 1930, p. 520.

⁴ Public Examination, The Adams Express Company, at 6855-56.

⁵ The stock of The Adams Express Company standing in the name of Hayden, Stone & Co. did not belong to that firm but to various clients. (Id., at 6825-6.)

company prior to 1930 was vested in a board of managers.⁶ During the World War, The Adams Express Company had transferred practically all of its physical property and its business to American Railway Express Company, in exchange for one-third interest in American Railway Express Company.⁷ In 1919 The Adams Express Company possessed this one-third interest in American Railway Express Company and the Adams Building at 61 Broadway, New York, as well as liquid assets practically all of which were pledged as collateral to secure between \$17,000,000 and \$18,000,000 outstanding bonds.⁸ With the entry of Mr. Hayden into The Adams Express Company, the new management was vested largely in Mr. Wiggin and Mr. Hayden.⁹ From 1919 to 1927 the management occupied itself primarily with retiring the collateral trust bonds of the company with the proceeds of the sale of securities and the Adams Building. By 1927 the bonded indebtedness had been reduced by \$8,000,000.¹⁰

a. Hayden, Stone & Co. and Hallgarten & Co. form Haygart Corporation

Hayden, Stone & Co. after becoming associated with The Adams Express Company then participated with Hallgarten & Co., another investment banking firm, in the organization of Haygart Corporation, the second investment company to come under the influence of Hayden, Stone & Co.¹¹ Haygart Corporation was organized in November 1928. The charter of Haygart authorized the issue of common stock.¹² The original board consisted of five directors, two of whom represented Hayden, Stone & Co., two represented Hallgarten & Company, and a Mr. Schlessinger, member of the law firm of Chadbourne, Stanchfield & Levy, counsel for Hayden, Stone & Co. and The Adams Express Company.¹³

The joint sponsors, Hayden, Stone & Co. and Hallgarten & Company, were in complete control of this investment company throughout its existence, by virtue of direct holdings of stock,¹⁴ through options on additional issues of stock and by domination of the board of directors.

The original prospectus of Haygart Corporation, after stating that Hayden, Stone & Co. and Hallgarten & Company had caused Haygart Corporation to be organized under the laws of the State of Delaware, specifically announced that the "Corporation will also take part in the underwriting of security issues, thus offering to its stockholders a

⁶ *Id.*, at 6828, 6861.

The articles of association of The Adams Express Company, as amended in 1929, provide that beginning in the year 1930 annual meetings of the common stockholders shall be held to elect the board of managers of the company. (*Id.*, Commission's Exhibit No. 663, p. 24.)

⁷ *Id.*, at 6931.

⁸ *Id.*, at 6832.

⁹ *Id.*, at 6838.

¹⁰ *Ibid.*

¹¹ *Id.*, at 6892.

¹² Reply to the Commission's questionnaire for Haygart Corporation, Part I, Exhibit 12.

¹³ *Id.*, at 6892; 6890-1.

¹⁴ *Id.*, at 6883.

means of participating indirectly in its financial operations which would not ordinarily be available to them as individuals."¹⁵

The initial issue of 250,000 shares of common stock, no par value, was sold to Hayden, Stone & Co. and Hallgarten & Co. at a price of \$40.50 per share and was redistributed to the public at \$12 per share. Hayden, Stone & Co. thus received \$187,500, one-half of the total gross selling commission of \$375,000, for financing the distribution of that issue.¹⁶

Hayden, Stone & Co., as one of the sponsors, also received profitable option rights.¹⁷

In April 1929, Hayden, Stone & Co. and Hallgarten & Co. underwrote a second issue consisting of 140,000 shares of common stock offered to existing stockholders at \$60 per share.¹⁸ Hayden, Stone & Co.'s gross commission on this issue was \$125,000."

b. Merger of Haygart Corporation and The Adams Express Company

Up to the end of 1929, Haygart Corporation was a separate firm under the control of Hayden, Stone & Co. On December 31, 1929, Haygart Corporation was absorbed by The Adams Express Company through an exchange of The Adams Express Company's stock for all of the assets of Haygart Corporation which amounted to approximately \$20,000,000.¹⁹

c. Control by Hayden, Stone & Co. Through The Adams Express Company of American Railway Express Company

As has been indicated, The Adams Express Company in 1918 had received one-third of the stock of American Railway Express Company in return for the express forwarding business of The Adams Express Company which had been absorbed by American Railway Express Company. In the spring of 1929 American Railway Express Company sold its properties to the railroads for approximately \$42,000,000.²⁰

In April 1929 The Adams Express Company, possessing about forty percent of the stock of American Railway Express Company, bought up another thirty-five percent of the stock of that company for \$16,500,000 and thus increased its ownership of American Railway Express Company to approximately seventy-five percent of the existing common stock.²¹ To buy this additional stock of American Railway Express Company The Adams Express Company borrowed

¹⁵ Id., at 6892-3.

¹⁶ Id., at 6913; reply to the Commission's questionnaire for Haygart Corporation, Part I, Exhibit 11.

¹⁷ Id., at 6921. The pecuniary profits accruing to Hayden, Stone & Co. will be discussed *infra*.

¹⁸ Id., at 6917-8; reply to the Commission's questionnaire for Haygart Corporation, Part V.

¹⁹ Id., at 6920.

²⁰ Id., at 6878-6882.

²¹ Id., at 6864.

²² Id., at 6867-8.

\$16,565,850 from The Chase National Bank,²³ of which A. H. Wiggin, a director of The Adams Express Company, was president, and immediately thereafter proceeded to make a public offering of The Adams Express Company securities to raise money to pay off the indebtedness to The Chase National Bank.²⁴

The Adams Express Company raised \$9,931,350 in gross proceeds by a public offering to its then stockholders of units consisting of two shares of preferred and one share of common at \$600 per unit. The issue was underwritten by Hayden, Stone & Co., which received \$248,280, or a two and one-half percent commission on the entire offering.²⁵

d. Hayden, Stone & Co. Converts American Railway Express Company Into an Investment Company

Immediately upon the acquisition by The Adams Express Company of the seventy-five percent ownership of American Railway Express Company stock, Hayden, Stone & Co. caused a complete revision of the charter of American Railway Express Company to be made, changing the latter into a general investment company and the name to Railway and Express Company.²⁶ A board of directors of nine members was elected, eight of whom were members of the board of managers of The Adams Express Company, to wit: Charles Hayden, Richard F. Hoyt, Steele Mitchell (all being affiliated with Hayden, Stone & Co.), William M. Barrett, William T. Hoops, Eugene W. Leake, Albert H. Wiggin, and W. Hinckle Smith.²⁷ The ninth and only member not on the board of directors of The Adams Express Company was Clarkson Potter, who was also affiliated with Hayden, Stone & Co. Thus by April 1929 Hayden, Stone & Co. had established a position of control in three investment companies; namely, The Adams Express Company, Haygart Corporation, and Railway and Express Company, with each firm maintaining an independent portfolio.

Railway and Express Company, however, had a short-lived history as an investment company with independent identity, for in November 1929 The Adams Express Company acquired all the assets (including the portfolio) of Railway and Express Company in exchange for The Adams Express Company common stock.²⁸ The net assets belonging to the minority stockholders of Railway and Express Company at the time of the transfer of its assets to The Adams Express Company aggregated \$11,140,000.²⁹

The stockholders of Railway and Express Company were thus successively: first, investors in an industrial company having \$42,000,000 assets, then common stockholders of a \$42,000,000 invest-

²³ *Id.*, at 6858.

²⁴ *Id.*, at 6863-4.

²⁵ *Ibid.* Reply to the Commission's questionnaire for The Adams Express Company, Pt. V, Table 9.

²⁶ *Id.*, at 6868-69.

²⁷ *Id.*, at 6870-71 and Commission's Exhibit No. 632.

²⁸ *Id.*, at 6873.

²⁹ Reply to the Commission's questionnaire for The Adams Express Company (supplemental information).

ment company having only a single class of stock, and then common stockholders of a larger investment company with leverage.

e. Affiliations of Hayden, Stone & Co. with Sterling Securities Corporation

In May 1929 while Hayden, Stone & Co. had controlling influence in three investment companies, it assumed a significant role in the affairs of a fourth investment company, Sterling Securities Corporation.

Sterling Securities Corporation had been organized as an investment company of the general management type in February 1928³⁰ by a group consisting of Sterling Pile, president of Insuranshares Corporation of New York; Edward B. Twombly, a member of the law firm of Putnam, Twombly and Hall, counsel for Insuranshares Corporation of New York; Insuranshares Corporation of New York itself; Scudder, Stevens and Clark, investment counsel; Harold A. Fortington and Walter B. Wolf.³¹ In May 1929 this group still held the controlling interest in Sterling Securities Corporation by virtue of their ownership of class B common stock, which possessed a cumulative voting privilege, and through their influence as directors of the board.³²

In May 1929, Sterling Securities Corporation desired to float an issue of convertible first preferred stock in the amount of \$15,000,000 and at the same time to list its convertible first preferred stock, its preference stock, and its common A stock on the New York Stock Exchange.³³ Mr. Twombly effected a contact with Charles Hayden for the purpose of securing the aid of Hayden, Stone & Co. in obtaining listing on the New York Stock Exchange and in the marketing of an issue of Sterling Securities Corporation first convertible preferred stock,³⁴ since that Corporation did not have "a wide enough avenue of distribution for that first preferred stock."³⁵ In consideration of the commitment of Hayden, Stone & Co. to aid Sterling Securities Corporation in these respects, Sterling Securities Corporation, in addition to electing Steele Mitchell and Charles Hayden to the board and putting the former on the executive and financial committees, sold to Hayden, Stone & Co. 100,000 shares of its authorized but unissued class A common (voting) stock at \$12 per share and 25,000 shares of its authorized but unissued class B (cumulative voting) stock at a price of 50¢ per share.³⁶ The asset value of the A stock was \$15 per share at that time and the market value between a high of \$28 $\frac{3}{8}$ and a low of \$25 $\frac{3}{8}$. Hence Hayden, Stone & Co. thus received 100,000 shares of A stock at a price \$300,000 below the current asset value and \$1,300,000 below the current market value.³⁷

³⁰ Public Examination, Atlas Corporation, at 14627-28.

³¹ *Id.*, at 14666.

³² *Id.*, at 14671, and Commission's Exhibit No. 1498.

³³ *Id.*, at 14670.

³⁴ *Id.*, at 14668. As a result of this contact, the corporation sold \$15,000,000 of first preferred stock of which Hayden, Stone & Co. sold at retail about \$1,000,000 and received \$48,000 gross selling commissions. (*Id.*, at 14674, 14678.)

³⁵ Public Examination, The Adams Express Company, at 6972.

³⁶ Public Examination, Atlas Corporation, at 14671, and Commission's Exhibit No. 1498.

³⁷ *Id.*, at 14671-3.

The advent of Hayden, Stone & Co. into the management of Sterling Securities Corporation was opposed by Paul C. Cabot, the representative of the portfolio manager, Scudder, Stevens and Clark, who objected to the injection into the corporate management of investment bankers and further characterized the sale of stock to Hayden, Stone & Co. as an "excessive" price for securing Hayden, Stone & Co. participation.³⁸ Hayden, Stone & Co. immediately proceeded to sell shares of the A and B stock of Sterling Securities Corporation at a large profit³⁹ despite an understanding, claimed by the directors of the corporation, that the firm was acquiring the securities of the corporation for permanent investment.⁴⁰

Hayden, Stone & Co. availed itself of The Adams Express Company, which it then sponsored, as a market for the security, for 50% of the Sterling Securities Corporation class A shares costing \$600,000 were sold by Hayden, Stone & Co. to Adams Express at a profit of \$200,000⁴¹ without, however, Hayden, Stone & Co. losing the attendant control factors incidental to the stock sold.⁴²

From 1929 to 1931 when Atlas Corporation acquired control of Sterling Securities Corporation, Hayden, Stone & Co. received substantial brokerage commissions from Sterling Securities Corporation.⁴³

Hayden, Stone & Co. did not render the important service apparently anticipated by Sterling Securities Corporation in the distribution of the new issue of first preferred stock. Of this issue, \$14,000,000 was distributed by Insuranshares Corporation of New York while Hayden, Stone & Co. distributed less than \$1,000,000 receiving \$48,000 in selling commissions.⁴⁴

While Hayden, Stone & Co. did not at any time own enough stock to wield a major voting influence over Sterling Securities Corporation, it played a significant role in effecting the transfer of control of Sterling Securities Corporation to Atlas Corporation. On June 30, 1931, Hayden, Stone & Co. sold to Atlas Corporation 3,000 shares of B stock at a price of \$3.00 per share thus making a profit of \$7,500. On the same date, The Adams Express Company, controlled by Hayden, Stone & Co., sold the Atlas Corporation 17,300 shares of B stock at \$4.00 per share and The Adams Express Company received thereby a profit of \$60,550.⁴⁵ Including these purchases, Atlas Corporation's holding of class B stock reached the total of 61,763 shares in July 1931 or 21% of the total amount of B stock outstanding.⁴⁶ The existing management of Sterling Securities Corporation, at that time, still held 41% of the B stock in addition to 80,000 shares of class A stock (the class A stock had about two-thirds of the entire voting power) so that Atlas Corporation at this time did not have control over the corporation.⁴⁷

³⁸ *Id.*, at 14675-6.

³⁹ Public Examination, Atlas Corporation, at 14674, 14677.

⁴⁰ *Ibid.*

⁴¹ *Id.*, at 14677.

⁴² *Ibid.*

⁴³ *Id.*, at 14678.

⁴⁴ *Id.*, at 14674, 14678.

⁴⁵ *Id.*, at 14678.

⁴⁶ *Id.*, Commission's Exhibit No. 2001 (pp. 261-262).

⁴⁷ *Ibid.*

Hayden, Stone & Co., after or at the time it made its sale to Atlas Corporation, allied itself with the purchaser in a successful effort to induce the remaining sponsors to sell to Atlas Corporation. To induce the sales, Hayden, Stone & Co. made representations that Atlas Corporation had already acquired or would shortly acquire control of Sterling Securities Corporation. In this connection Mr. Twombly, a sponsor of Sterling Securities Corporation, testified to the effectiveness of Mr. Hayden's services on behalf of Atlas Corporation:⁴⁸

Q. Now, with respect to the transfer of control to the Atlas Corporation, do you remember the circumstances under which that transpired?

A. I remember a part of the circumstances.

Q. Will you just tell us?

A. Insofar as they affected me and affected my associates, I was away on my vacation in July, I think it was 1931, and some one of my associates, I don't remember who, called me up and said, "You had better come back to New York," to use a colloquial expression, "Sterling has been sold out from under us." So I returned to New York immediately, met a group of fellow directors in the New York Trust Company, and they said that they had been advised by Mr. Hayden that the control had either been already acquired or was in the process of being acquired by the Atlas Corporation, and that he recommended to them that they sell their holdings to the Atlas Corporation.

Q. That is Hayden recommended to the other directors?

A. That is right, and they said they wanted to include me. I immediately went over to see Mr. Hayden and said, "Is it true that you have sold your 'B' stock?" He said, "Yes." I said, "That was not in accordance with our understanding." He said "Whether it was or not, it has been sold," and I said, "Well, what is the situation?" He said he thought Atlas was probably now in control of the company, if not, it was very close to it. He said "It won't do you any good trying to do anything about it now. You had better join with the other directors and dispose of your securities to them." I said, "I won't do it unless I can include others that I interested in the picture," so I went back and saw these directors and told them I was not prepared to make up my mind until I had gotten in contact with a great many more, and that unless Atlas was willing to include all, that the stock would not be sold, so I spent night and day for about 48 hours getting in contact with individuals who I knew had substantial blocks, most of whom included their blocks in the sale to Atlas, and the whole business was sold out to Atlas within 48 hours.

Largely as a result of these representations by Hayden, Stone & Co., the directors, officers, and management interests of Sterling Securities Corporation sold their holdings to Atlas Corporation so that by December 31, 1931, Atlas Corporation held about one-third of the voting shares of Sterling Securities Corporation⁴⁹ which was sufficient, however, to enable Atlas Corporation to install its own management.⁵⁰

Although Hayden, Stone & Co. had disposed of its holdings of Sterling Securities Corporation's stock, Mr. Hayden continued as a director of Sterling Securities Corporation until 1936⁵¹ and Hayden,

⁴⁸ Id., at 14726-7, 14730.

⁴⁹ Id., Commission's Exhibit No. 2001 (pp. 266-267).

⁵⁰ Id., at 14733.

⁵¹ Moody's Manual of Investments, Banks, etc. (1936), p. 1878.

Stone & Co. continued to receive substantial brokerage fees from Atlas Corporation and its affiliates.⁵²

f. Hayden, Stone & Co. and the Original Financing of Aviation Securities Corporation of New England

Aviation Securities Corporation of New England was incorporated in March 1929, for the purpose of participating in the financing of aviation enterprises. Hayden, Stone & Co. headed the public offering.⁵³ Richard F. Hoyt and Lester Watson, two of the partners of Hayden, Stone & Co., and Haystone Securities Corporation, wholly owned by Hayden, Stone & Co., were separately listed as sponsors of Aviation Securities Corporation of New England.⁵⁴ Haystone Securities Corporation underwrote the sale of the issue of 150,000 shares of common stock by a firm commitment⁵⁵ and received as consideration 100,000 option warrants in addition to commissions as a member of the originating, banking, and selling groups.⁵⁶ Hayden, Stone & Co., Haygart Corporation, and Hallgarten & Co. had a participating interest in the banking syndicate and the selling groups.⁵⁷ Hayden, Stone & Co. has had at least two directors on the board since the formation of the company and a member of the firm has been vice president since March 1929 and Richard F. Hoyt has been president since April 1933.⁵⁸

g. Participation of Hayden, Stone & Co. in the Financing of Additional Investment Companies

Hayden, Stone & Co. participated in the financing of other investment companies in the period of 1928-1929.⁵⁹ In the instances described above, the firm played a major role. In several other instances, Hayden, Stone & Co. had a sizable participation, and in the rest played a minor role. Steele Mitchell testified as follows:⁶⁰

Q. Well, Hayden, Stone—by the way—that is correct, though, there are 41 companies?

A. That is right.

Q. In which cases would you say that there had been substantial underwritings? Most of these are selling groups in which you participated?

A. Right.

Q. Now, in Aviation Securities Corporation, you were in the banking group, is that right?

A. Yes, and a sizable participation there, and also in the banking group of the Chatham Phenix Allied, which was connected with the Chatham Phenix

⁵² Public Examination, Atlas Corporation, Commission's Exhibit No. 2001 (p. 263).

⁵³ American Underwriting Houses and Their Issues, Vol. II, p. 129; Public Examination, The Adams Express Company, Exhibit No. 652.

⁵⁴ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. I.

⁵⁵ Id., Pt. I, Exhibit F; Public Examination, The Adams Express Company, at 6970-71.

⁵⁶ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. I, Exhibit G.

⁵⁷ Id., Exhibit F.

⁵⁸ Id., Pt. VII, Table 28-A.

⁵⁹ Public Examination, The Adams Express Company, at 6970.

⁶⁰ Id., at 6970-71, 75, 76-77.

Bank, and Hayden, Stone had a sizable participation in the General Realty and Utilities Corporation, and we had a sizable participation in Sterling Securities and in the United States and International first preferred offering.

h. *Résumé* of the Status of Hayden, Stone & Co. in Relation to Investment Companies at the end of 1929

By the latter part of 1929 Hayden, Stone & Co. controlled The Adams Express Company, Railway and Express Company and Haygart Corporation; and it had a considerable influence in Sterling Securities Corporation and Aviation Securities Corporation of New England. By reason of participation in the financing, it had achieved a footing in the United States & International Securities Corporation, General Realty & Utilities Corporation and Chatham Phenix Allied Corporation. It had also established contacts with some 30 other investment companies.⁶¹

2. THE BENEFITS TO HAYDEN, STONE & CO.

The investment companies were of significance to Hayden, Stone & Co., and its members in three ways:

1. Underwriting commissions on distribution of investment-company issues, stock bonuses, option warrants, brokerage fees, and compensation to officers and directors;
2. The sale of securities to investment companies underwriting commitments and participations allotted to their companies and as aids in the operations of syndicates and trading accounts;
3. As a means to secure influence in corporate enterprises and to enhance its prestige.

a. Direct Pecuniary Fees and Profits Elicited from the Investment Companies

The fees, commissions, and profits secured by Hayden, Stone & Co. from the investment companies fall into two categories:

1. Profits and fees from the underwriting of securities of the sponsored trusts and from favorable terms in the sale of such securities to sponsors.
2. Brokerage fees on transactions in the sponsored companies.

(1) PROFITS AND FEES

Hayden, Stone & Co. realized profits and fees from underwriting securities of sponsored companies in the case of practically every investment company with which that firm became identified as a sponsor.

(a) Haygart Corporation

In the case of Haygart Corporation, Hayden, Stone & Co. and its co-sponsor, Hallgarten & Co., received underwriting commissions

⁶¹ *Id.*, at 6970, and see *infra*: Poor's 1930 Govt. Manual at 70.

For a list of the offices and directorships in investment companies held by members of Hayden, Stone & Co., from 1928 through 1935, see Appendix W-1. Derived from replies to Commission's questionnaire of the various corporations, Pt. VII.

of \$375,000.⁶² In addition to receiving cash commissions for the distribution of stock the sponsors also received options to buy 100,000 shares within five years at the original public selling price, namely, \$42 per share.⁶³ By March 1929, when the sponsors exercised the options, the market price of the stock was \$77 per share, a potential profit to the sponsors of \$3,500,000.⁶⁴ The option for 100,000 shares of stock was taken up by a trading syndicate between February 11, 1929, and April 23, 1929,⁶⁵ in which Hayden, Stone & Co., Hallgarten & Co., and Chadbourne, Stanchfield, and Levy were the participants. The trading syndicate sold in the market a net of 23,313 of the 100,000 option shares. The remaining 71,687 shares were distributed at the termination of the syndicate to the syndicate participants at a net price of between \$32 and \$37 per share. At the time the syndicate terminated the market price was \$70.⁶⁶ Hence, on April 23, 1929, the participants in the account held the balance of the option stock at a discount of \$2,800,000 from current market. About \$1,300,000 or 46¼% of this discount was assignable to Hayden, Stone & Co.⁶⁷

On this point, Steele Mitchell of Hayden, Stone & Co., testified:⁶⁸

Q. Our estimate of the indicated profits from this transaction amount to about \$2,800,000 which is a little less than you said.

A. Yes, the option, even if it hadn't been exercised with the market at \$77, would have indicated a paper profit of \$3,500,000. Even if you didn't exercise it, but you still had a paper profit and the same existed here, that you had an indicated profit as a result of certain sales, and certain purchases, of stock, of approximately \$2,800,000, at the end of that trading account.

Part of this discount was actually realized as a profit. Upon the termination of the trading account the profits therein were applied to reduction of the \$42 per share option price on the stock distributed to the syndicate members. Hayden, Stone & Co. received from the trading account (after adjusting for an account run for Hayden, Stone & Co. alone, during the same period) 33,727 shares at \$1,090,922, or at about \$32.30 per share.⁶⁹ Since the option price for the shares was \$42.00 and Hayden, Stone & Co. received 33,727 shares at about \$32.30, Hayden, Stone & Co. actually applied a cash gain of \$327,251.90 against the cost of the balance of shares held.

(b) The Adams Express Company

On April 22, 1929, Hayden, Stone & Co. underwrote the sale of \$9,931,350 of common and preferred stock to common stockholders of The Adams Express Company receiving for this service a commission of 2½% of the proceeds amounting to \$248,280.⁷⁰

⁶² Reply to the Commission's questionnaire for Haygart Corporation, Part V, Item 41.

⁶³ Public Examination, The Adams Express Company, at 6921-2, and Commission's Exhibits Nos. 640-1.

⁶⁴ Id., at 6911-3.

⁶⁵ Id., Commission's Exhibit No. 646.

⁶⁶ Id., Commission's Exhibit No. 646.

⁶⁷ Ibid. and id., at 6913.

⁶⁸ Id., at 6912-3.

⁶⁹ Id., Commission's Exhibit No. 646.

⁷⁰ Reply to Commission's questionnaire for The Adams Express Company, Part I, Exhibit B; Part II, Exhibit A—Schedule 19; Part V, Table 9.

(c) Sterling Securities Corporation

Hayden, Stone & Co. became a sponsor of the Sterling Securities Corporation in May 1929, the year succeeding that of its organization. For its sponsorship Hayden, Stone & Co. exacted a discount of \$1,300,000 from market value on newly issued stock of the investment company. The Sterling Securities Corporation sold to Hayden, Stone & Co. 100,000 shares of A stock at \$12.00 per share and 25,000 shares of B stock at 50¢ per share. At the time the asset value of the A stock was \$15.00 per share or \$300,000 in excess of the issue price and the market value approximately \$25.00 per share⁷¹ or \$1,300,000 in excess of the issue price.⁷² Within two months Hayden, Stone & Co. disposed of the 100,000 A shares at a profit of \$470,000.⁷³ Half of the shares were sold to The Adams Express Company for \$800,000.⁷⁴ Hayden, Stone & Co. thereafter sold the B stock, realizing a profit of \$169,100 therefrom.⁷⁵ As previously mentioned, Hayden, Stone & Co. also sold about \$1,000,000 of a \$15,000,000 preferred stock issue for Sterling Securities Corporation and received \$48,000 as commission.⁷⁶

The total commissions and profits made by Hayden, Stone & Co. on the distribution and underwriting of Sterling Securities Corporation securities totaled \$687,100.

(d) Petroleum Corporation of America⁷⁷

Haystone Securities Corporation, a corporation wholly owned by Hayden, Stone & Co., was a member of the syndicate that bought the block of Prairie Oil & Gas Company and Prairie Pipe Line Company stock from the Rockefeller interests in November 1929, and about five weeks later sold blocks to Petroleum Corporation of America at a large profit to the members of the group. Through the ½ of 1% interest in the syndicate retained by Haystone Securities Corporation, it made a net profit of \$28,750.⁷⁸

Hayden, Stone & Co. was a member of the purchase, banking and selling groups for the distribution of the issue of 3,250,000 shares of common stock of the Petroleum Corporation of America at \$34 per share.⁷⁹ The total underwriting commission was specified at \$3 per share, or a total of \$9,750,000 together with 1,625,000 option warrants exercisable within five years.⁸⁰ The cash commission of \$3 per share was divided \$1.75 per share for the Selling Group, 62½¢ per share for the Banking Group, and 62½¢ per share for the

⁷¹ Public Examination, Atlas Corporation, at 14671, 14673, and Commission's Exhibit No. 646.

⁷² *Ibid.*, at 14671.

⁷³ *Ibid.*, at 14677.

⁷⁴ Reply to Commission's questionnaire for The Adams Express Company, Part VII, Table 32 (cost of 50,000 shares of Sterling Securities class A bought from Hayden, Stone & Co. to show allocation of profits).

⁷⁵ *Ibid.*, at 14678.

⁷⁶ *Ibid.*

⁷⁷ See Report on Investment Trusts and Investment Companies, Part Three, Ch. II, for a history of Petroleum Corporation of America (House Doc. No. 279, 76th Congress, pp. 227-309).

⁷⁸ Public Examination, Petroleum Corporation of America, at 2814, and Commission's Exhibit No. 333.

⁷⁹ *Ibid.*, Commission's Exhibits, Nos. 338, 339, 340.

⁸⁰ *Ibid.*, at 2843, and Commission's Exhibit No. 338.

Purchase Group.⁸¹ The option warrants were distributed as follows: 40% to the Purchase Group, 20% to the Banking Group, and 40% to Blair & Co., Inc., as special compensation "in procuring management for the Company" and "in forming the Purchase, Banking, and Selling Group and generally in managing the distribution of these 3,250,000 shares."⁸²

Hayden, Stone & Co.'s participation in the Selling, Purchase, and Banking Groups resulted in disposing of 50,713 shares, 162,500 shares and 65,876 shares, respectively. A total amount of \$231,482.75 was the commission, but Hayden, Stone & Co. reported \$159,276.36, which was the net amount claimed after a trading account loss was deducted.⁸³

Hayden, Stone & Co. also received its due proportion of option warrants which were granted as additional compensation for the underwriting. While none of the warrants was exercised, they were traded in on the New York stock market at prices ranging from $\$5\frac{7}{8}$ to 50¢ per warrant.⁸⁴ Hayden, Stone & Co. received \$14,397.04 and 35,861 option warrants from Blair & Co., Inc., at the time Blair & Co., Inc., distributed the warrants to the persons or firms composing the Selling, Purchase, and Banking groups. Hayden, Stone & Co. never sold or exercised the 35,861 option warrants.⁸⁵

(e) Aviation Securities Corporation of New England

Haystone Securities Corporation was the underwriter of the issue of 150,000 shares of no par capital stock of Aviation Securities Corporation of New England under an agreement dated March 7, 1929.⁸⁶

Under the agreement Haystone Securities Corporation agreed to find purchasers for the 150,000 shares of capital stock of Aviation Securities Corporation of New England at a price of not less than \$20 net to the Corporation, any excess above \$20 to be paid over to the underwriter as part consideration in finding purchasers. As further consideration, the underwriter was granted an option for three years to purchase 100,000 shares of capital stock, exercisable at \$25 per share up to 50,000 shares and at \$30 per share of the balance.⁸⁷ Haystone Securities Corporation formed an Originating Account (primary group), a Banking Syndicate, and a Selling Group to help distribute the issue. The \$3.50 spread between the net price to the issuer and the selling price was divided as follows: \$1.50 per share to the Originating Account, 50¢ per share to the Banking Syndicate, and \$1.50 to the Selling Group.⁸⁸

Haystone Securities Corporation, Hayden, Stone & Co., and Haygart Corporation participated in the various groups to the following

⁸¹ Id., Commission's Exhibit No. 338.

⁸² Ibid.

⁸³ Supplemental information supplied the Commission for The Adams Express Company (letter dated October 28, 1938).

⁸⁴ Public Examination, Petroleum Corporation of America, at 2868.

⁸⁵ Supplemental information supplied the Commission for The Adams Express Company (letter dated October 28, 1938).

⁸⁶ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. I, Exhibit E.

⁸⁷ Ibid.

⁸⁸ Reply to Commission's questionnaire for Aviation Securities Corporation of New England.

extent and received the commissions noted against their participations:

	Originating account		Banking syndicate		Selling group	
	Shares	Fees	Shares	Fees	Shares	Fees
Haystone Securities Corporation.....	56, 250	\$84, 375	50, 250	\$25, 125	None	None
Hayden, Stone & Co.	None	None	1, 000	500	30, 555	\$45, 832
Haygart Corporation.....	None	None	2, 000	1, 000	2, 000	3, 000
Total fees.....		84, 375		26, 625		48, 832

The total gross fee received by Hayden, Stone & Co. (Haystone Securities Corporation) from the underwriting of Aviation Securities Corporation of New England stock amounted to \$155,832.

Richard F. Hoyt and Lester Watson, partners in Hayden, Stone & Co. each received 1,000 shares of stock at cost, to wit, \$20 per share, thus saving the spread of \$3.50 per share.⁸⁹

Of the 100,000 option warrants received by Haystone Securities Corporation as part of the compensation for the underwriting it assigned 25,000 options to National Aviation Corporation and 50,300 options to various bankers. None of the options was exercised.⁹⁰

The total fees received within a period of one year and profits made by Hayden, Stone & Co. on the underwriting of the securities of five of the investment companies which it co-sponsored in 1928-1929, to wit, Haygart Corporation, The Adams Express Company, Sterling Securities Corporation, Petroleum Corporation of America, and Aviation Securities Corporation of New England, may be summarized as follows:

Investment company	Gross fees	Realized profit on options and rights or preferential distribution	Potential profit on options exercised
Haygart Corporation.....	\$312, 500. 00	\$327, 251. 90	* \$944, 356. 00
The Adams Express Co.	248, 280. 00	None	None
Sterling Securities Corporation.....	48, 000. 00	639, 100. 00	None
Petroleum Corporation of America.....	{ 28, 750. 00 }	* 14, 397. 04	None
	{ 231, 482. 75 }		
Aviation Securities Corporation of New England.....	155, 832. 00	None	None
Total.....	1, 024, 844. 75	980, 748. 94	944, 356. 00

* 33,727 shares times \$28, which is difference between exercised price of \$42 and market price of \$70 at time Hayden, Stone & Co. took down shares from trading account.

* Share of syndicate profit and profit on resale of The Adams Express Co.

* Hayden, Stone & Co. participation in Selling Group 50,713 shares, Purchase Group 162,500 shares, and Banking Group 65,876 shares. Net commissions claimed are \$159,276.36 because trading account loss was deducted from the above figure. (Information derived from supplemental information supplied by letter dated Oct. 28, 1938.)

* Ibid.

⁸⁹ Id., Pt. I, Exhibit D.

⁹⁰ Id. Pt. I, Exhibit H.

Hayden, Stone & Co. purchased the securities of some 33 other investment companies in the 1928-1929 period.⁹¹ Its relationship to the financing of these other investment companies was probably unimportant and was without significant influence in the guidance of the activities of the investment companies. A list of these purchases by Hayden, Stone & Co., for the purpose of indicating the wide interest of Hayden, Stone & Co. in the investment company field, is contained in Appendix W-2.

(2) BROKERAGE FEES ON TRANSACTIONS IN THE SPONSORED COMPANIES

Since the basic business of an investment company is the buying and selling of securities, it is natural that a sponsor whose business is that of security brokerage or who, as a member of an exchange, is authorized to engage in the security brokerage business, should recognize the investment company as a source of brokerage revenue. In organizing an investment company, an investment banking firm is creating for itself an affluent, active and permanent client—a client, moreover, dominated by its creator, the banking firm, which dictates the quality and quantity of the services the client requires.

The history of investment companies shows that a full measure of sponsorship is not required to secure brokerage business from an investment company. A modest participation in the financing or the presence of a member of the firm on the board of directors may be sufficient to deflect some of the brokerage business to an investment banking house. Steele Mitchell, of Hayden, Stone & Co., testified as follows:⁹²

Q. They got \$20,000 brokerage business from U. S. International last year.

A. Of course, Mr. Hayden is on the executive committee. In fact, he was on the executive committee long before Adams Express ever acquired a share of stock. He was on the original executive committee at the date of formation.

Q. That is one of the benefits that comes from being a banker and being on the executive committee, isn't it? Assuming the member is a partner in a brokerage house that does as good business as anybody else, you can throw business their way?

A. I should assume so, but in this particular case the holdings of Adams Express in U. S. and International has been entirely on the recommendation of the securities department in Adams Express. As a matter of fact, our first holdings were acquired from the Atlas Corporation. We sold the Atlas Corporation our holdings in Sterling Securities and received in exchange a small block of U. S. and International and several other securities.

Q. Has Hayden, Stone done any financing for this group?

A. U. S. and International? Yes. They participated in an offering of the first preferred stock, but at that time Adams Express had nothing to do with it and did not buy any stock.

⁹¹ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

⁹² Public Examination, The Adams Express Company, at 6976-77.

Brokerage fees paid, during the calendar year 1935, to Hayden, Stone & Co. by four investment companies which it sponsored were as follows:⁹⁸

The Adams Express Company ⁹⁹	\$68,614.01
Sterling Securities Corporation ¹⁰⁰	4,993.75
Petroleum Corporation of America ¹⁰¹ (Kuhn, Loeb & Co.—\$14,731.50)	2,718.75
Aviation Securities Corporation of New England ¹⁰² (Jackson & Curtis, Inc.—\$107.50)	1,225.00
	77,551.51

Apparently in the instance of the four companies cited above the largest share of the brokerage business was secured by the investment banking house that had been the prime sponsor while the minor banking sponsor obtained a fragment of the business. Thus, in the case of The Adams Express Company, Hayden, Stone & Co., which dominated that investment company, absorbed practically the entire brokerage business for the year 1935. In Petroleum Corporation of America, Blair & Co., Inc., played the principal role, as sponsor.¹⁰³ Elisha Walker was president of Blair & Co., Inc., and had been the most active force in the organization of that corporation.¹⁰⁴ Thereafter, Elisha Walker severed his connection with Blair & Co., Inc., and became a partner of Kuhn, Loeb & Co.¹⁰⁵ In the year 1935, when Elisha Walker was a partner of Kuhn, Loeb & Co., that firm received \$14,731.50 of the brokerage fees. Hayden, Stone & Co. received \$2,718.75.¹⁰⁶

In Aviation Securities Corporation of New England, Hayden, Stone & Co. was the leading banking sponsor and received the bulk of the rather small amount of brokerage business that year. The sum of \$107.50 was received by Jackson & Curtis, Inc.¹⁰⁷ On December 31, 1935, the sole security in the portfolio of the Aviation Securities Corporation of New England was National Aviation Corporation because in 1933 the entire investment of the former company was placed in the shares of the latter and maintained therein.¹⁰⁸

In the year 1929 and the years following, all the investment companies were very active in the purchase and sale of securities. Within

⁹⁸ It is to be remembered that fees from The Adams Express Company included those from Haygart Corporation and Railway and Express Company as the result of mergers previously discussed, *supra*, pp. 2506-7.

⁹⁹ Reply to Commission's questionnaire for Adams Express Company, supplementary information.

¹⁰⁰ Public Examination, Adams Express Company, Commission's Exhibit No. 649.

¹⁰¹ Reply to Commission's questionnaire for Petroleum Corporation of America, Pt. VI, Table 20.

¹⁰² Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. VI, Table 20.

¹⁰³ Public Examination, Petroleum Corporation of America, at 2871.

¹⁰⁴ *Id.*, at 2882.

¹⁰⁵ *Id.*, at 2881-82.

¹⁰⁶ Reply to Commission's questionnaire for Petroleum Corporation of America, Pt. VI, Table 20.

¹⁰⁷ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. VI, Table 20.

¹⁰⁸ *Id.*, Pt. IV.

a three-year period (1929-1931) Sterling Securities Corporation paid Hayden, Stone & Co. \$129,118.78 in brokerage fees.¹⁰⁴ In that period, Hayden, Stone & Co. and The Adams Express Company still held a substantial amount of stock of Sterling Securities Corporation, which was then engaged in active trading.

During 1934 and 1935 Hayden, Stone & Co. received the following brokerage fees from the investment companies with which it had a financing relationship in 1929:¹⁰⁵

	1934	1935
American International Corporation-----	\$31,150.75	\$20,077.23
U. S. & International Securities Corporation--	9,389.60	20,075.00
General Realty & Utilities Co.-----	175.00	24.50
Mayflower Associates, Inc.-----	2,523.75	6,465.75
	43,239.10	46,642.48

While Hayden, Stone & Co. had a participation in the financing of the issue of convertible debenture bonds of American International Corporation in 1929, its more substantial affiliation with American International Corporation took place in 1933 because of the acquisition of a large block of stock of that investment company by the Adams Express Company.¹⁰⁶

Harry A. Arthur, president of American International Corporation, testified that when Hayden, Stone & Co. had The Adams Express Company take up a large block of stock of American International Corporation and placed a representative on the board of American International Corporation, the brokerage commissions of American International Corporation were deflected to Hayden, Stone & Co.:¹⁰⁷

Q. There is a direct connection, isn't there, Mr. Arthur, between association, sponsorship, and the amount of brokerage commission that the brokerage firm receives?

A. I don't think sponsorship comes into it at all, but when they [Hayden, Stone & Co.] came on the Board and took up a large block of stock, and their influence became noticeable, there was a distinct difference in the commissions that were received.

(3) THE SALE OF SECURITIES TO INVESTMENT COMPANIES AND ALLOCATION OF UNDERWRITING PARTICIPATIONS

In the preceding pages the sources of direct revenue to investment bankers, involved in the organization of, and affiliation with, investment companies, as the result of underwriting commissions, favorable terms on distribution of securities, brokerage fees, and compensation to officers and directors has been indicated.

The acquisition of fees, emoluments, and profits received from the investment company does not constitute the only, nor in fact the pri-

¹⁰⁴ Public Examination, Atlas Corporation, at 14678.

¹⁰⁵ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁰⁶ Public Examination, American International Corporation, at 6798.

¹⁰⁷ Id., at 6798.

mary, interest of investment-banker sponsorship. A principal consideration to the investment banker was the opportunity to influence the investment of the resources of the investment company which he sponsored, in securities which he was distributing or had distributed.

The portfolios of investment companies which Hayden, Stone & Co. sponsored bore a striking resemblance to the underwriting commitments and subjects of financial deals of Hayden, Stone & Co.

The respects in which the affairs of the investment companies were connected with situations in which Hayden, Stone & Co. was otherwise related will be discussed under three subdivisions:

- (a) Securities of other corporations underwritten by sponsors or in which the sponsors were otherwise interested were sold to the investment companies.
- (b) Underwriting commitments were allocated to investment companies.
- (c) Investment companies were used in syndicate and trading accounts.

(a) Securities of Other Corporations, Underwritten by Sponsors or in Which the Sponsors Were Otherwise Interested, Sold the Investment Companies

More than half of the stocks of Haygart Corporation portfolio of December 31, 1929 (on which date it was merged with The Adams Express Company), 33 out of 53 common stocks,¹⁰⁸ were stocks of corporations in which Hayden, Stone & Co. was interested either through present financing or participation in the management through membership in the board of directors. Railway and Express Company, at the time of its merger with The Adams Express Company (November 29, 1929),¹⁰⁹ was heavily invested in securities in which Hayden, Stone & Co. had such affiliations. The portfolio of The Adams Express Company, itself, immediately prior to its absorption of Haygart Corporation as of December 31, 1929,¹¹⁰ consisted of from 35% to 40% of such securities. A substantial amount of these securities had found their way into the portfolio of the other investment companies with which Hayden, Stone & Co. was affiliated.

Steele Mitchell conceded that it was "natural" that Hayden, Stone & Co. should place the funds of investment companies in securities in which the latter as a banking firm was interested:¹¹¹

Q. Just taking the list of common stocks [Haygart] it looks as if the bankers were interested in 33 out of 53 common stocks listed in this portfolio. Those figures may be off of you.

A. Yes.

Q. How do you account for such a large banker interest in the stocks of an investment trust of this nature?

A. It is a very natural thing for the Haygart directors to invest the funds in companies with which they are familiar.

Q. Do you think that a sound policy? Do you see any dangers in it?

A. I think it depends entirely on the securities you buy. If they are unsound companies, there is a great deal of danger in it.

¹⁰⁸ Public Examination, The Adams Express Company, at 6940, 6944.

¹⁰⁹ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹¹⁰ Id., Pt. III, Item 14.

¹¹¹ Public Examination, The Adams Express Company, at 6944.

Mr. Mitchell also conceded that there are definite advantages flowing to the banking house in the placement of the investment company's funds in securities of such affiliated companies:¹¹²

Q. Doesn't the acquisition of this stock tend to keep the bankers interested in these companies? In other words, to perpetuate the staying of the bankers in these companies. I am not saying it does it primarily, but isn't that one of the results of it? We are interested not only in the fact you buy in stock for investment reasons, but also as to incidental benefits that flow from possession of those stocks.

A. It certainly would tend to have an influence in that direction.

He also testified further:¹¹³

Q. Now let us take the portfolio of Adams Express Company for 1935. Now, as I go through that portfolio, I find that there are still quite a few companies in which Hayden, Stone & Company are interested. Suppose that I just check them over as I go along.

A. Yes, Hayden, Stone & Company have had some present or past affiliations—

Q. Some present or past affiliations, and as bankers, I suppose that continuation of any such affiliation is worth while, isn't it, and we said that stock ownership helps to preserve that continuation, and tends in that direction, as I said, and as you said.

A. I think so. That is right.

The advantage of having the investment company available for taking up part of the securities underwritten by the sponsor is indicated by the testimony of Mr. Mitchell on a related consideration; to wit, the utilization of the investment company to assume part of an underwriting commitment of the sponsor.¹¹⁴

Q. Wouldn't you say that it may have been of some benefit to the Haygart Corporation, but that there is also a benefit to Hallgarten and Company and Hayden, Stone to have the Haygart Corporation available there to participate in these underwritings?

A. No more than it would be of benefit to have another large client who would be able to purchase certain shares in an offering.

Q. There would be a benefit, I should think.

The following discussion of the Hayden, Stone & Co. banking and corporate interests which found their way into the portfolios of the investment companies is limited to those interests and the portfolios of the Hayden, Stone & Co. investment companies of the 1928-1929 period. Both the outside banking interests and the investment-company affiliations of Hayden, Stone & Co. underwent changes subsequent to 1929. Hence, the relationship of the portfolio of Hayden, Stone & Co. affiliated investment companies to the Hayden, Stone & Co. outside interests, as of December 31, 1935, will be recorded after the presentation of the 1929 picture.

On December 31, 1929, more than 30% of the total invested capital of The Adams Express Company (after the consummation of the

¹¹² Id., at 6949-50.

¹¹³ Id., at 6952-3.

¹¹⁴ Id., at 6933.

merger of Haygart Corporation with The Adams Express Company) was invested in the securities of corporations which Hayden, Stone & Co. had financed or with the management of which Hayden, Stone & Co. was affiliated.¹¹⁵

From January through October 1929, Hayden, Stone & Co. financed, in all, security issues of nineteen corporations.¹¹⁶ Securities of twelve of these nineteen corporations were to be found in the portfolio of The Adams Express Company on December 31, 1929.

The portfolio of The Adams Express Company, as of December 31, 1929, includes the portfolios of Railway and Express Company and Haygart Corporation, both of which had been absorbed by The Adams Express Company on November 29, 1929, and December 31, 1929, respectively. Prior to the respective mergers, Hayden, Stone & Co. managed the portfolio of Railway and Express Company, and, together with Hallgarten & Company, the portfolio of Haygart Corporation. The largest holdings of Railway and Express Company and Haygart Corporation prior to their merger into The Adams Express Company consisted of securities of corporations with which Hayden, Stone & Co. was affiliated.¹¹⁷

The securities of a substantial number of Hallgarten & Company affiliated corporations found their way into the Haygart Corporation portfolio and from there into The Adams Express Company portfolio.¹¹⁸

From May 1929 to the end of 1931, Hayden, Stone & Co. occupied the position of a sponsor of Sterling Securities Corporation. Several of the Hayden, Stone & Co. affiliations that appear in 1929 in the Haygart Corporation, Railway and Express Company, and The Adams Express Company portfolios are to be found also in the Sterling Securities Corporation portfolio at the end of 1929.

The following is a list of securities of such corporations in the December 31, 1929, portfolio of Sterling Securities Corporation:¹¹⁹

Name	Shares	Original cost
Delaware and Hudson Co.....	1, 000	\$201, 300. 00
International Cement Corporation.....	2, 000	172, 325. 00
International Nickel Co.....	15, 000	741, 700. 00
Mathieson Alkali Works.....	15, 068	621, 862. 37
Otis Elevator Co.....	1, 500	242, 905. 86
Underwood Elliott Fisher Co.....	3, 000	339, 587. 50

It would seem from the correspondence between Paul C. Cabot and Hugh R. Johnston, of Atlas Corporation, that the participation of Hayden, Stone & Co. in the management of Sterling Securities Cor-

¹¹⁵ A list of such securities in the portfolio of The Adams Express Company, as of December 31, 1929, and the reference to the nature of the Hayden, Stone & Co. affiliation in each case is contained in Appendix W-3.

¹¹⁶ American Underwriting Houses and Their Issues, 1929, Vol. 2, p. 129.

¹¹⁷ In fact, numerous instances may be seen from Appendix W-4. Both investment companies had separate blocks of the same issue in their portfolios.

¹¹⁸ Public Examination, The Adams Express Company, Commission's Exhibit No. 651.

¹¹⁹ Reply to the Commission's questionnaire for Sterling Securities Corporation, Pt. III.

poration was short-lived. Paul C. Cabot in his letter of October 9, 1930, states:¹²⁰

At the time that Hayden, Stone & Company were invited into the picture you will remember that I was very much opposed for two principal reasons: In the first place, that in my opinion, the price of their admission was excessive and, secondly, I felt that their participation on the investment committee would do more harm than good. You will remember that I did all in my power to block this. You will also remember that after their admission, we had several discussions as to who should be in control of the portfolio, and I believe it was finally decided that Scudder, Stevens, and Clark should not be troubled with interference from Hayden, Stone & Company.

The portfolios of Petroleum Corporation of America and Aviation Securities Corporation of New England were each limited to securities of a particular field of industry. Petroleum Corporation of America held the stock of oil and oil refining companies only, and Aviation Securities of New England, the securities of aviation companies. Hence, neither the portfolio of Petroleum Corporation of America nor of Aviation Securities Corporation of New England as of December 31, 1929, contained securities of affiliated corporations of Hayden, Stone & Co. operating outside the specific industrial field. Aviation Securities Corporation of New England, on December 31, 1929, held the securities of the following corporations which Hayden, Stone & Co. had assisted in financing:¹²¹

Name	Shares	Original cost to declarant
Aviation Corporation of America	3,500	\$198,662.50
Aviation Credit Corporation	6,000	128,475.00
Curtiss-Wright Corporation:		
Class A	7,812	262,089.60
Common	25,000	796,596.81

The United States & International Securities Corporation held in its portfolio from December 31, 1929, through December 31, 1935,¹²² a number of the securities of companies affiliated with Hayden, Stone & Co. Hayden, Stone & Co. had a sizable participation in the financing of, and received substantial brokerage fees from, the United States & International Securities Corporation.¹²³ Charles Hayden was a director and member of the finance committee of this company from the time of its organization in October 1928.¹²⁴

¹²⁰ Public Examination, Sterling Securities Corporation, Commission's Exhibit No. 1500.

¹²¹ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. III.

¹²² Reply to Commission's questionnaire for United States & International Securities Corporation, Pt. III.

¹²³ Public Examination, The Adams Express Company, at 6971-6977.

¹²⁴ Reply to Commission's questionnaire for United States & International Securities Corporation, Pt. VII.

The securities held by United States & International Securities Corporation of companies affiliated with Hayden, Stone & Co. are contained in Appendix W-5.

(b) Shifting Part of Underwriting Commitments to Investment Companies

The usefulness of an investment company to a banking sponsor as a convenient instrumentality for the purchase of securities, which the sponsor underwrites or in which the sponsor is otherwise interested, was discussed in the preceding section. The usefulness of the investment company in taking over part of the underwriting commitment (which the sponsor has assumed) and the availability of the investment companies for banking, selling, or distribution groups, or all of these, whichever best suits the sponsor, are considered in this section.

Haygart Corporation: During the year 1929, the Haygart Corporation participated in fourteen underwritings. In all but three of these fourteen underwritings, either Hayden, Stone & Co. or Hallgarten and Company (or both) were the manager or one of the managers of the group. Hayden, Stone & Co. was the banker or one of the managers in the case of six of these underwritings; Hallgarten and Company in the case of five.¹²⁵ Steele Mitchell testified:

I think probably Hayden, Stone, and Hallgarten were interested in all of these, and they were offered participations and arranged for Haygart to get either a part of their participation or a separate one.

The total commissions received by Haygart Corporation for its participation in the fourteen underwritings amounted to \$69,933.51.¹²⁶ The unrealized loss suffered by Haygart Corporation in the case of four of the underwritings, where it (or its transferee, The Adams Express Company) had to take stock down from the syndicate, amounted to \$94,823.38, as follows:

(1) Allis-Chalmers Manufacturing Company, common stock:¹²⁷ Haygart Corporation's participation was transferred on December 31, 1929, to The Adams Express Company with the rest of the Haygart Corporation's assets. At that date Haygart Corporation's net commitment in the underwriting exceeded the market value of the stock by \$66,666.67.¹²⁸

(2) Hotel Waldorf Astoria Corporation, 7% 1st Mgt. Leasehold Bonds. Haygart Corporation took down \$184,000 principal amount of bonds at \$103. This was transferred to The Adams Express Company on December 31, 1929, at book value. Since the market price of the bonds on that date was \$103, there appears to have been no unrealized loss or profit on that date.¹²⁹ Both Hayden, Stone & Co. and Hallgarten and Company were managers of the purchase and banking groups.¹³⁰

¹²⁵ Public Examination, The Adams Express Company, at 6927-6931; Commission's Exhibit No. 647, Table 24.

¹²⁶ Id., Commission's Exhibit No. 647.

¹²⁷ The list of the portfolio companies in which Hayden, Stone & Co. was interested discloses that Allis-Chalmers Manufacturing Company had been financed several times by Hayden, Stone & Co. and was carried in the portfolios of Railway and Express Company, Haygart Corporation, and The Adams Express Company.

¹²⁸ Public Examination, The Adams Express Company, Commission's Exhibits Nos. 647, 658.

¹²⁹ Id., Commission's Exhibit No. 658.

¹³⁰ Id., Commission's Exhibit No. 657.

(3) United Dry Docks, Inc., 5,000 shares of unsold securities were delivered at the closing of the group to Haygart Corporation at a cost of \$107,500. The loss to Haygart Corporation, based on the approximate market price on that date, was \$22,500.¹³¹ The Haygart Corporation portfolio, as of December 31, 1929, held 5,000 shares of United Dry Docks and 1,250 United Dry Docks option warrants.¹³²

(4) Bethlehem Steel Corporation: Haygart Corporation took up 498 shares at a cost of \$53,215.71, at a loss based on the approximate market price of the unsold securities amounting to \$5,656.71.¹³³

The other securities in the underwriting of which Haygart Corporation was accorded a place were issues of Aviation Credit Corporation, Aviation Securities Corporation of New England and Warner Quinlan Company. The securities of these companies will be found in the list of Hayden, Stone & Co. financed underwritings, and also will be found in the portfolio of The Adams Express Company.

The experience of Haygart Corporation in being accorded part of the sponsor's underwriting was not at all profitable. In the instances where Haygart Corporation took down stock from the syndicate, the portfolio of Haygart Corporation contained this stock thereafter.

The Adams Express Company: The Adams Express Company participated in four underwritings of securities issued by others.¹³⁴ Hayden, Stone & Co. were the bankers or in the management group of three of these: to wit, Warner Quinlan Company, Allis-Chalmers Manufacturing Company, and Hotel Waldorf Astoria. In all three of these underwriting syndicates, Haygart Corporation also participated.¹³⁵

The Adams Express Company received a \$3,000 commission from the Warner Quinlan underwriting and had an unrealized profit of \$11,314.67 at the date of the closing (January 13, 1930), on the Allis-Chalmers syndicate account, but suffered unrealized losses of \$36,511.29 on Seaboard Airline Railway Company and \$23,835 on the two Hotel Waldorf Astoria syndicate operations based on the approximate market price of the unsold securities at the date of the closing of the respective groups.¹³⁶

The net loss on all five of the participations procured for The Adams Express Company by the sponsors, was \$46,031.62.¹³⁷

Mr. Mitchell's contention that an investment company is a gratuitous beneficiary of a sponsor by reason of its admission in the participation in underwritings¹³⁸ is hardly borne out by the history of the underwriting participations of Haygart Corporation and The Adams Express Company. On the other hand, two points are espe-

¹³¹ Id., Commission's Exhibit No. 647.

¹³² Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹³³ Public Examination, The Adams Express Company, Commission's Exhibit No. 647, Table 24.

¹³⁴ Id., Commission's Exhibit No. 657.

¹³⁵ Id., Commission's Exhibit No. 647.

¹³⁶ Id., Commission's Exhibits Nos. 657, 658.

¹³⁷ Ibid.

¹³⁸ Public Examination, The Adams Express Company at 6933.

cially noteworthy in connection with the underwriting participations into which the trusts were "invited" by the sponsors: namely,

(1) That the securities were almost exclusively of companies which might be called the special proteges of the sponsors by virtue of a considerable history of prior financing and participation by the sponsors in the management.

(2) That large blocks of each one of these securities were to be found in the portfolios of the investment companies.¹³⁹

(c) USE OF INVESTMENT COMPANIES IN SYNDICATES AND TRADING ACCOUNTS

Haygart Corporation: The Haygart Corporation participated in a trading account in Curtiss-Wright Corporation class A stock and common stock, a trading account in The Prairie Pipe Line Company common stock, and a trading account in The Prairie Oil & Gas Company common stock, and a trading account in New York Petroleum Royalty Corporation common stock.¹⁴⁰

In four of the trading accounts in which Haygart Corporation was a participant with Hayden, Stone & Co., Haygart Corporation suffered losses.¹⁴¹

In connection with the Curtiss-Wright Corporation trading account, Haygart Corporation suffered an unrealized loss of \$104,200.22, based on the approximate market price of the unsold stock delivered to Haygart Corporation on the date of the closing of the account.¹⁴²

The association of Hayden, Stone & Co. with the financing of the Curtiss-Wright Corporation and with its subsidiary companies, and the Hayden, Stone & Co. connection with the management of Curtiss-Wright Corporation have been noted in the preceding section.¹⁴³

In addition to Haygart Corporation, Railway and Express Company (whose participation was taken over by The Adams Express Company on November 29, 1929), Aviation Securities Corporation of New England, and National Aviation Corporation (on the board of which Hayden, Stone & Co. was represented) had a participation in this trading account.¹⁴⁴

In the Prairie Pipe Line Company trading account, Haygart Corporation made a profit of \$230.79, but in the Prairie Oil & Gas Company trading account, Haygart Corporation suffered an unrealized loss of \$1,711.71, the amount by which Haygart Corporation's commitment exceeded the market value of the shares representing the Haygart Corporation participation on December 31, 1929, when the Haygart Corporation interest in the account was transferred to The Adams Express Company.¹⁴⁵

The Prairie Oil & Gas Company and the Prairie Pipe Line Company trading account participations by Haygart Corporation and

¹³⁹ Replies to Commission's questionnaire, for The Adams Express Company and Haygart Corporation, Pt. III.

¹⁴⁰ Public Examination, The Adams Express Company, Commission's Exhibit No. 647.

¹⁴¹ Id., Commission's Exhibit No. 647.

¹⁴² Id., Commission's Exhibit No. 647.

¹⁴³ See Appendix W-3.

¹⁴⁴ Reply to Commission's questionnaire for The Adams Express Company, supplemental information (letter dated 12/9/36).

¹⁴⁵ Public Examination, The Adams Express Company, Commission's Exhibit No. 647.

the subsequent investment in that stock by The Adams Express Company¹⁴⁶ came about through Hayden, Stone & Co. The part played by Hayden, Stone & Co. and Haystone Securities Corporation (wholly owned by Hayden, Stone & Co.) in the syndicate that purchased the Prairie Oil & Gas Company and Prairie Pipe Line Company stock from the Rockefeller interests and ran several trading accounts in this stock prior to the sale of the same to Petroleum Corporation has been reported elsewhere.¹⁴⁷ Haygart Corporation's interest in the account was transferred on December 31, 1929 to The Adams Express Company, and an unrealized loss of \$4,711.71 was charged to Haygart Corporation.¹⁴⁸

From June 1929 to October 1929, while the Prairie Oil & Gas Company trading account was still open, Haygart Corporation bought in the open market 3,000 shares of Prairie Pipe Line Company stock and 5,000 shares of Prairie Oil & Gas Company stock.¹⁴⁹ These purchases were transferred to The Adams Express Company portfolio on December 31, 1929, at an original cost valuation of \$437,250.¹⁵⁰ The trading participation was an entering wedge for the placement of approximately \$450,000 of the Haygart Corporation's money in this transaction.

Haygart Corporation's losses in trading accounts into which it was drawn by Hayden, Stone & Co. totaled \$109,395.77.¹⁵¹

The Adams Express Company: The Adams Express Company carried on Haygart Corporation's participation in the Prairie Oil & Gas Company trading account until its termination on February 28, 1930, at which time The Adams Express Company took down 249 shares of stock with an unrealized profit of \$549.45.¹⁵²

The Adams Express Company participated in one other trading account; to wit, in the common stock of Continental Diamond Fibre Company. The Continental Diamond Fibre Company was a concern in which Hayden, Stone & Co. had been interested for some time. Steele Mitchell testified:¹⁵³

Q. Continental Diamond Fibre is a company in which Hayden Stone has always been definitely interested.

A. They have been interested for some time.

Q. And in a trading account of this sort who gets the brokerage business, on an account like Continental Diamond Fibre?

A. I wouldn't know. I should think that perhaps part of the brokerage commission would go to Hayden Stone.

On the closing of the group, The Adams Express Company had to take down 2,500 shares of unsold securities at an (unrealized) loss of \$16,016.85.¹⁵⁴ Stock of the Continental Diamond Fibre Company

¹⁴⁶ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

¹⁴⁷ See Part Three, Ch. II, p. 233 et seq.

¹⁴⁸ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁴⁹ Ibid.

¹⁵⁰ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

¹⁵¹ Public Examination, The Adams Express Company, Commission's Exhibit No. 647.

¹⁵² Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁵³ Public Examination. The Adams Express Company, at 6981.

¹⁵⁴ Id., Commission's Exhibit No. 656.

found a place in the portfolio of the Railway and Express Company, Haygart Corporation, and The Adams Express Company.¹⁵⁵

Sterling Securities Corporation: Sterling Securities Corporation participated in three trading syndicates, two of which, the International Nickel Co. of Canada, Ltd., and Warner Bros. Pictures, Inc., were headed by Hayden, Stone & Co.¹⁵⁶ It appears that the corporation made a commission of \$11,540.80 on the former and \$26,060.77 on the latter.

The syndicate in International Nickel Co. of Canada, Ltd., was a secondary distributing group headed by Hayden, Stone & Co. Sterling Securities Corporation's participation amounted to 10,000 shares, or a total amount of \$200,000. Hayden, Stone & Co. was associated with International Nickel Co. of Canada, Ltd., Charles Hayden being the chairman of the board of directors. A block of the securities of that corporation was present in the portfolio of The Adams Express Company on December 31, 1929.¹⁵⁷ Likewise, Sterling Securities Corporation held a substantial investment in International Nickel Co. of Canada, Ltd., as follows:¹⁵⁸

<i>Date</i>	<i>Shares</i>	<i>Cost</i>
December 31, 1929.....	15, 000	\$741, 700
December 31, 1930.....	15, 900	759, 700

The syndicate in Warner Bros. Pictures, Inc., stock was also a secondary distributing group, headed by Hayden, Stone & Co. and Goldman, Sachs & Company. The syndicate opened on August 14, 1930 and closed on September 29, 1930.¹⁵⁹ Railway and Express Company on November 29, 1929, the date of the transfer of its portfolio to The Adams Express Company, held 3,900 shares of Warner Bros. Pictures, Inc., at a cost of \$147,322.50.¹⁶⁰

Aviation Securities Corporation of New England: Aviation Securities Corporation of New England, together with Railway and Express Company, Haygart Corporation, and National Aviation Corporation, participated in the Curtiss-Wright Corporation account. The corporation took down some shares of the common stock on the date of the closing of the account.¹⁶¹

(4) HAYDEN, STONE & CO.'S AFFILIATION WITH INVESTMENT COMPANIES SUBSEQUENT TO 1929

Hayden, Stone & Co. established a position of influence in two additional investment companies subsequent to 1929; namely, American International Corporation and National Investors Corporation.

¹⁵⁵ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁵⁶ Derived from supplementary material supplied the Commission for Sterling Securities Corporation.

¹⁵⁷ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

¹⁵⁸ Reply to Commission's questionnaire for Sterling Securities Corporation, Pt. III.

¹⁵⁹ Derived from supplementary material supplied the Commission for Sterling Securities Corporation.

¹⁶⁰ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁶¹ Reply to Commission's questionnaire for Aviation Securities Corporation of New England, Pt. VI.

American International Corporation was organized in 1915 as an investment company of the management type without open-end provisions.¹⁶² Up to 1923, Frank Vanderlip, then president of the National City Bank of New York, and Charles Stone, of Stone & Webster, constituted the predominating controlling interest.¹⁶³ At that time Matthew C. Brush, who was active in the public utility field, became a dominating figure in the management of American International Corporation.¹⁶⁴ In 1926 Blair & Co., Inc., an investment banking organization, took up 36,627 shares of American International Corporation common stock at a cost of \$1,208,224.98, and several of its representatives went on the board of directors.¹⁶⁵ In 1927 Lazard Frères and Lehman Brothers acquired a substantial block of stock by virtue of which they received representation on the board of directors.¹⁶⁶

In November 1933 Hayden, Stone & Co. became influential in the affairs of American International Corporation.¹⁶⁷ The gradual ascendancy of Hayden, Stone & Co. coincided with the diminution of the stock ownership of Lazard Frères and Lehman Brothers.¹⁶⁸

The Adams Express Company began to acquire substantial holdings of American International Corporation in 1932 through purchases in the open market.¹⁶⁹ Late in 1933 Hayden, Stone & Co., by virtue of the holdings of The Adams Express Company of a sufficiently large block of stock of American International Corporation, received representation on the board of directors. Charles Hayden and Steele Mitchell were elected to the board of directors.¹⁷⁰ On December 31, 1933, The Adams Express Company held 42,300 shares of common stock of American International Corporation.¹⁷¹ Subsequently, in 1936, The Adams Express Company held 98,000 out of 1,000,000 shares of American International Corporation.¹⁷²

Hayden, Stone & Co., however, did not hold any direct ownership of stock in American International Corporation. Its position in American International Corporation was secured by virtue of the ownership of stock of that investment company by The Adams Express Company. Harry A. Arthur, president of the American International Corporation, testified:¹⁷³

Q. Now, Hayden, Stone has no management contract with American International?

A. None at all.

Q. And Hayden, Stone does not have any direct interest in American International Corporation. They have the interest by virtue of the fact that Adams Express has a substantial position in American International Corporation, isn't that so?

¹⁶² Public Examination, American International Corporation, at 6688.

¹⁶³ *Id.*, at 6712-3.

¹⁶⁴ *Ibid.*

¹⁶⁵ Public Examination, American International Corporation, at 6741 and Commissions Exhibit No. 621.

¹⁶⁶ *Id.*, at 6792 and Commissions Exhibit No. 626.

¹⁶⁷ *Id.*, at 6798.

¹⁶⁸ *Id.*, at 6798 and Commission's Exhibits Nos. 624, 626.

¹⁶⁹ *Id.*, at 6808.

¹⁷⁰ *Id.*, at 6809.

¹⁷¹ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

¹⁷² Public Examination, The Adams Express Company, at 6978.

¹⁷³ Public Examination, American International Corporation, at 6808-9.

A. Yes.

Q. So that the banking firm of Hayden, Stone so far as you know has no stock position in American International?

A. No.

Q. But it is the trust which they manage, the Adams Express Company, which has that position.

A. Yes.

Q. And I assume that it was by virtue of that position that Adams Express Company had in the stock that Hayden, Stone received this representation on the Board of American International Corporation, isn't that so?

A. Well, Mr. Hayden and Mr. Steele Mitchell came on the board of American International and they were board directors of Adams Express.

Since 1933, Hayden, Stone & Co. received large brokerage commissions from American International Corporation, to wit: In 1934, \$37,858.47, or approximately 50% of the gross commission paid, and in 1935, \$24,577.98, or approximately 40%.¹⁷⁴ Prior to the advent of Hayden, Stone & Co. into American International Corporation, the other investment bankers, Lazard Frères and Lehman Brothers, who had been interested in that American International Corporation, had received the bulk of the brokerage business.¹⁷⁵ Lazard Frères received \$427,704.54 in commissions from 1927 down to the end of 1934.¹⁷⁶

Charles Hayden and Steele Mitchell became members of the board of directors of American International Corporation to represent the large holding of stock by The Adams Express Company and by reason of such membership they participated in the selection of the portfolio investments of the American International Corporation. The relationship between the latter company and The Adams Express Company resulted in the acquisition by American International Corporation of a considerable number of securities recommended or suggested by The Adams Express Company and the two members of Hayden, Stone & Co. who served as directors on both boards.¹⁷⁷

Toward the end of 1936 approximately one-third of the portfolio securities of each investment company was represented in the portfolio of the other.¹⁷⁸

National Investors Corporation: As late as July 1936, Hayden, Stone & Co. continued to extend its influence in the investment company field through the purchase by The Adams Express Company of the common stock of the National Investors Corporation.¹⁷⁹

The National Investors Corporation had been formed on June 16, 1927, as an investment company of the unrestricted management type without open-end provisions, primarily for the purpose of organizing and managing other investment companies.¹⁸⁰ The orig-

¹⁷⁴ Id., Commission's Exhibit No. 623.

¹⁷⁵ Public Examination, American International Corporation, at 6794-6798.

¹⁷⁶ Id., Commission's Exhibit No. 623.

¹⁷⁷ Reply to the Commission's questionnaire for American International Corp, supplemental information.

¹⁷⁸ Reply to Commission's questionnaire for American International Corporation, Pt. III and supplemental information. The portfolio securities of the American International Corporation at the end of 1935 and 1936 which were suggested by The Adams Express Company or members of Hayden, Stone & Co. are contained in Appendix W-6.

¹⁷⁹ Public Examination, The Adams Express Company, at 6978.

¹⁸⁰ Public Examination, National Investors Corporation, at 4271, 4273, 4282, 4319.

inal sponsors were Fred Y. Presley, who was president throughout the period, the Guardian Detroit Company of Detroit, Mich., and the Shawmut Corporation of Boston.¹⁸¹

In 1928 and 1929, the Guardian Detroit Company, the Shawmut Corporation of Boston and National Investors Corporation formed three other investment companies, to wit: Second, Third, and Fourth National Investors Corporation, which they controlled by means of ownership of stock-management contracts and common directorates.¹⁸² The initial financing of the four investment companies involved capital contributions of about \$50,000,000.¹⁸³

At the public examination of National Investors Corporation, Steele Mitchell testified that The Adams Express Company, a client of Hayden, Stone & Co., purchased a block of 157,000 shares of National Investors Corporation, that the block was acquired "entirely as a speculative investment" and that Hayden, Stone & Co. had "no purpose of exercising any control, present or future."¹⁸⁴

Nevertheless, directly after the purchase, Mr. Hayden requested representation on the board of directors of National Investors Corporation and was informed by Mr. Presley that "no partner of a house of issue and no part of a stock exchange house would be acceptable to our group."¹⁸⁵ Thereafter Mr. Hayden suggested Jesse H. Van Alstyne, president of Otis Elevator Company. Mr. Presley agreed to Mr. Van Alstyne who was elected a director and has continued to serve as such.¹⁸⁶

On December 31, 1936, the total acquisition of the stock of National Investors Corporation by The Adams Express Company consisted of 160,000 shares, at an original cost to the latter company of \$349,387.45.¹⁸⁷ The entering wedge of Hayden, Stone & Co. obtained by means of The Adams Express Company investment in National Investors Corporation constituted about 20% of the 792,000 shares of issued common stock of the latter company.¹⁸⁸

(5) INTERESTS AFFILIATED WITH HAYDEN, STONE & CO. IN THE PORTFOLIO OF THE ADAMS EXPRESS COMPANY SUBSEQUENT TO DECEMBER 31, 1929

In a preceding section an examination was made of the 1929 portfolios of The Adams Express Company, Sterling Securities Corporation and Aviation Securities Corporation of New England,¹⁸⁹ and these portfolios contained securities of corporations which Hayden, Stone & Co. had underwritten, or in the management of which Hayden, Stone & Co. participated.

The leading Hayden, Stone & Co. interests appearing in the portfolio of The Adams Express Company on December 31, 1929, con-

¹⁸¹ Public Examination, National Investors Corporation, at 4264; Reply to Commission's questionnaire for National Investors Corporation, Pt. I.

¹⁸² Public Examination, National Investors Corporation, at 4271, 4273, 4282, 4319, 4513.

¹⁸³ Id., at 4333.

¹⁸⁴ Id., at 4587.

¹⁸⁵ Id., at 4543.

¹⁸⁶ Id., at 4544.

¹⁸⁷ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

¹⁸⁸ Public Examination, The Adams Express Company, at 6978.

¹⁸⁹ See *supra*, pp. 2505-10.

tinued to be included in its portfolio on December 31, 1935.¹⁹⁰ On the other hand, the portfolio of The Adams Express Company for December 31, 1935, includes the securities of an added group of corporations which Hayden, Stone & Co. had underwritten or in the management of which Hayden, Stone & Co. was interested to the extent of having representation on the boards of directors.¹⁹¹

3. INDIRECT BENEFITS TO SPONSORS

a. The Investment Company as a Means To Secure Contacts in Corporate Enterprises and To Enhance Prestige

The investment company was also a means by which the sponsor could establish new contacts and create additional sources of pecuniary profit for itself. The investment resources of investment companies were used in many instances by banking sponsors to secure an influential position in corporate enterprises to secure directorships and thereafter to acquire for themselves the handling of the financial operations that such enterprises required. In many instances the holding of the stock of certain corporations by the investment company supplemented the direct holdings of the principal stockholders or sponsors of the investment company, and the combined holdings enabled the sponsors to exercise substantial influence upon the corporation.

Steele Mitchell stated that the holding of the stock of a corporation by an investment company established contacts between the banking sponsor of the investment company and the issuing corporation, which tended to secure for the sponsor the financing of the issuing corporation.¹⁹²

Q. Doesn't the acquisition of this stock tend to keep the bankers interested in these companies? In other words, to perpetuate the staying of the bankers in these companies? I am not saying it does it primarily, but isn't that one of the results of it? We are interested not only in the fact you buy in stock for investment reasons, but also as to incidental benefits that flow from possession of those stocks?

A. It certainly would tend to have an influence in that direction.

* * * * *

Q. And two of the main assets of a banking house are (1) information and (2) contacts, wouldn't you say? I don't say they are the only two, but I say they are two principal assets.

A. They are two very important assets, but I think ability comes first, ability as a banker.

Q. I am not trying to rank them. Ability may come first, but I say these two are important bits of their trade, to have information, in the first place, and contacts, in the second place. Information and contacts may very often lead to financing, and that is the indirect effect that this sort of stockholder-

¹⁹⁰ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

¹⁹¹ A list of the securities of corporations with which Hayden, Stone & Co. was affiliated, contained in the 1935 (and in the 1936) portfolios of The Adams Express Company, and not contained in the 1929 portfolio, is contained in Appendix W-7.

¹⁹² Public Examination, The Adams Express Company, at 6949-6950.

ship may have. I am not saying it was done for that purpose, but I say that it is one of the indirect effects of it.

A. It tends in that direction.

Ownership of stock of portfolio corporations by The Adams Express Company led to directorships and influence in those corporations by Hayden, Stone & Co. While Hayden, Stone & Co. had the "use" of 50,000 shares of class A stock of Sterling Securities Corporation to support its sponsor role in that corporation, the 50,000 shares were owned not by Hayden, Stone & Co. but by The Adams Express Company.¹⁹³

The major role of Hayden, Stone & Co., in both American International Corporation and National Investors Corporation arose from the ownership of the stock of these companies by The Adams Express Company, and not by Hayden, Stone & Co.¹⁹⁴

Steele Mitchell, vice president of The Adams Express Company, testified that directorships were obtained by members of the firm of Hayden, Stone & Co., as a result of the purchase of stock of companies by The Adams Express Company.¹⁹⁵

Q. Were there any of these companies that I just read you in which the financing or directorships of these companies by the sponsoring bankers were subsequent to 1929?

A. In other words, the Haygart Corporation purchased the stock first and then the banking business arose out of that purchase?

Q. That is right. The banking business or directorship, one or the other.

A. I have submitted a list in the case of Adams Express where directorships arose as a result of the purchase of stock.

Q. At this time I will offer in evidence, if you will identify it, a list of directorships in corporations which resulted from the acquisition of stock by The Adams Express Company.

A. That is correct.

The list of the corporations in which directorships resulted from the acquisition of stock by The Adams Express Company follows:¹⁹⁶

Company	Name	Became director
American International Corp.....	Charles Hayden.....	November 1933.
American International Co.....	Steele Mitchell.....	December 1933.
Cleveland-Cliffs Iron Co.....	Steele Mitchell.....	April 1936.
Cliffs Corp.....	Steele Mitchell.....	June 1936.
Continental Shares, Inc.....	Steele Mitchell.....	November 1936.
Delaware & Hudson Co.....	T. L. Chadbourne.....	June 1935.
Delaware & Hudson Railroad.....	T. L. Chadbourne.....	June 1935.
Franklin Simon & Co.....	Steele Mitchell.....	September 1936.
Kansas City Southern Railway.....	A. S. Knowles *.....	June 1935.
Mayflower Associates.....	Charles Hayden *.....	February 1935.
National Distillers Products Corp.....	Charles Hayden *.....	June 1933.
Sterling Securities Corp.....	Steele Mitchell *.....	May 1929.

* No longer a director.

* Directorship accepted at the request of R. E. McConnell, president of Mayflower Associates, Inc.

¹⁹³ Id., at 6971.

¹⁹⁴ See supra, pp. 2527-2530.

¹⁹⁵ Public Examination, The Adams Express Company, at 6948-6949.

¹⁹⁶ Id., Commission's Exhibit No. 648.

Hayden, Stone & Co. secured brokerage business from 18 corporations (other than investment companies), the securities of which companies were present in the portfolio of The Adams Express Company and constituted the largest holdings by The Adams Express Company.¹⁹⁷ As previously shown, these securities were also placed in the portfolio of the other investment companies dominated by Hayden, Stone & Co.

It is to be noted that although The Adams Express Company formed the key company for this extensive brokerage business, Hayden, Stone & Co.'s position of dominance and influence in The Adams Express Company itself was without any proprietary interest and was entirely the result of a fiduciary relationship to the clients of its brokerage and investment banking business. Hayden, Stone & Co. itself at no time owned any considerable stock of The Adams Express Company. However, a number of clients of the Springfield office of Hayden, Stone & Co. were substantial holders of The Adams Express Company stock. By virtue of the fact that its clients owned stock of The Adams Express Company, Hayden, Stone & Co. received representation on the board of The Adams Express Company¹⁹⁸ and thereafter came to be the controlling force in that investment company. Steele Mitchell testified:¹⁹⁹

Q. And Hayden, Stone's interest in this company dates back to when?

A. It is a rather difficult question to answer. I can say this, Mr. Smith, that Mr. Hayden was elected a member of the board of managers in 1918 as a result of the clients of Hayden, Stone's Springfield office being substantial holders of Adams Express Co.

Q. Mr. Hayden, I mean. Mr. Hayden did not have any stock of his own at that time.

A. At that time, so far as I know, he had none.

Steele Mitchell suggested as the explanation for Hayden, Stone & Co.'s large share of the brokerage business of American International Corporation, the quality of the service rendered by Hayden, Stone & Co.²⁰⁰ and as the explanation for the \$20,000 brokerage business received in 1935 from United States & International Securities Corporation, the fact that Mr. Hayden was on the executive committee of United States & International Securities Corporation:²⁰¹

Q. That is one of the benefits that comes from being a banker and being on the executive committee, isn't it? Assuming you are in a brokerage house that does as good business as anybody else, you can throw business their way?

A. I should assume so, but in this particular case the holdings of Adams Express in United States and International has been entirely on the recommendation of the securities department in Adams Express. * * *

In addition to the brokerage business, Hayden, Stone & Co. secured underwriting business from the portfolio companies. Out of eighteen

¹⁹⁷ Reply to Commission's questionnaire for The Adams Express Company, Pt. III.

Steele Mitchell denied that Hayden, Stone & Co. in soliciting the brokerage business would urge the fact of the substantial holding of The Adams Express Company. Public Examination, The Adams Express Company, at 6974.

¹⁹⁸ *Id.*, at 6826.

¹⁹⁹ *Id.*, at 6825-6.

²⁰⁰ *Id.*, at 6975.

²⁰¹ *Id.*, at 6976-7.

investment companies which were held in the portfolio of The Adams Express Company during the period from January 1, 1927 to November 20, 1936, Hayden, Stone & Co. participated in the financing of nine.²⁰²

Hayden, Stone & Co. also participated in selling, banking and purchase groups for the distribution of the securities of investment companies and corporations other than investment companies which were held in The Adams Express Company portfolio. In the previous section reference was made to the large proportion of the securities underwritten by Hayden, Stone & Co. which found their way into the portfolio of The Adams Express Company, and to a lesser extent, into the portfolios of the other investment companies in which Hayden, Stone & Co. had influence.

There are two important respects in which an investment banker-sponsor of an investment company may influence other corporations by virtue of the fact that the investment company, of which it is the sponsor, holds blocks of stock of these other corporations; namely, (1) if the portfolio company is a company which itself carries a portfolio, the sponsor may have the opportunity of introducing into the portfolio of such portfolio company, securities in which the sponsor is interested; (2) in the case of any portfolio company, situations may arise where that company can utilize the brokerage or underwriting services of an investment banker.

Reference has been made to the instances, wherein the securities in which Hayden, Stone & Co. was interested were present in the portfolios of investment companies of which The Adams Express Company constituted a substantial stockholder.

Hayden, Stone & Co. in 1934 and 1935 received from approximately 50 corporations having partners or representatives of Hayden, Stone & Co. on their directorates an aggregate for both years of approximately \$80,000 in brokerage commissions.²⁰³

b. Enhancement of Sponsor's Prestige

The opinion held by the public and by the banking world of the resources, enterprise, and influence of an investment banker is, of course, a crucial feature in determining the amount of business which such banker can procure. The standing and reputation of the banker are of great significance to the two classes with which he primarily deals—the investing public which purchases the securities that the banker seeks to sell and the clients of the banker who retain him to do their financing. Control of an investment company is an important element in the personal relationship of an investment banker to the investing public and, furthermore, is conducive in helping the banker to secure private financing business.

(1) RELATIONSHIP TO THE INVESTING PUBLIC

The objective of an investment banking firm is to sell securities. A large section of the investing public, which takes the securities

²⁰² Id., at 6974, and Commission's Exhibit No. 652.

²⁰³ Reply to Commission's questionnaire for The Adams Express Company, supplemental information.

from the hands of the investment bankers, makes its purchases in reliance upon the reputation and standing of the investment banking firm. The significance in the sale of securities of participation of a well-known banking house is indicated by the fact that the investment companies have in most instances sought to exploit the prestige of well-known banking houses associated with the company.

The control of an investment company of substantial assets secures publicity to the investment banker. It gives the banker individual contact with the host of investment company stockholders by way of the prospectuses, stockholders' meetings, proxies, distribution of dividends, and in many other ways. The firm's name is associated in the public's mind with the successful promotion of a large investment company and the management of a large investment fund; hence, the investing public is inclined to be prepossessed in favor of an offering by the banking firm of securities of an industrial, utility, or railroad corporation which such banking firm is distributing or underwriting. The stockholder's list of the investment company supplies access to a large body of individuals who have already demonstrated that they are purchasers of securities.

Investing bankers when called upon to suggest securities to clients who wish to make security purchases generally recommend securities which they have distributed or underwritten. When the public has become "investment-company-minded," it is highly desirable for an investment banker to have a commodity of that nature which he himself has sponsored to recommend.

(2) IN THE BANKING COMMUNITY

In the efforts of a banking firm to secure underwritings and do financing, the resources and avenues of distribution which the firm is reputed to have are of great importance. The fact that an investment banking firm is known to control a large investment company undoubtedly recommends it to organizations seeking financing and enables the firm to obtain better terms in the underwriting of new issues.

The importance of the avenues of distribution available to financing organizations is illustrated in the explanation given by Hayden, Stone & Co. itself, when the firm was invited to participate in the financing of the issue of first-preferred stock of Sterling Securities Corporation.²⁰⁴ Steele Mitchell testified:

Q. * * * was Hayden, Stone in the original financing of Sterling securities?

A. No; the original financing was handled through a concern called the Insurance Shares of New York.

Q. Wouldn't you say that Hayden, Stone's participation in this financing came as a result of your holding—of your Adams Express holding?

A. No; I should say that it came as a result of the Insurance Shares Corporation of New York not having a wide enough avenue of distribution of that first preferred stock, and wanted Hayden, Stone & Co. to head up the group.

The control of an investment company by an investment banker naturally impresses the client, who desires to be financed, with the

²⁰⁴ Public Examination, The Adams Express Company, at 6971-6972.

resources that the investment banker may call upon to make the financing operation successful, such as, selling some of the securities to the investment company, securing the company's participation in the underwriting commitment, including the company in trading accounts or using the company's funds in stabilizing the market. It is not difficult to appreciate the advantages which a corporation that seeks financing may visualize in connecting itself with a banking firm which controls a potential buyer of securities and a potential lender of funds.

c. Sponsors in Position to Distribute Business Patronage

Since the investment banker-sponsor dictates the purchases of large blocks of stock and frequently the loans of large sums of money by the investment company, it is natural that the good will of the investment banker should be solicited by individuals and corporations who anticipate entering into such transactions with the investment company. Furthermore, the control of an investment company brings with it the power to secure the selection of individuals and institutions to render services of a technical, mechanical, or formal nature for which compensation is paid. Among these are legal services, auditing services, registration, transfer and custody of securities, research, insurance and bonding, and printing. Individuals and organizations that are selected by the investment banker-sponsor to render these services to the investment company are naturally inclined to make themselves useful to the investment banker-sponsor.

In the case of The Adams Express Company, The Chase National Bank served as transfer agent, as custodian; handled the dividends; carried the checking account; and handled the call-money loans for The Adams Express Company.²⁰⁶

The connection of The Chase National Bank with The Adams Express Company seems to have begun in 1918, when a loan of \$1,000,000 which The Adams Express Company had had from Guaranty Trust Company was shifted to The Chase National Bank.²⁰⁸

Mr. Wiggin, the chairman of the board of The Chase National Bank, became a member of the board of managers of The Adams Express Company. The resultant influence of The Chase National Bank in the affairs of The Adams Express Company was considerable, for it was Mr. Wiggin who first brought Hayden, Stone & Co. into The Adams Express Company by inviting Mr. Hayden to become a member of the board of The Adams Express Company.²⁰⁷

B. Goldman, Sachs & Co.

1. ORGANIZATION OF THE GOLDMAN SACHS TRADING CORPORATION

The Goldman Sachs Trading Corporation was formed in December 1928 by the investment banking firm of Goldman, Sachs & Co. Prior to this time Goldman, Sachs & Co. had been engaged in the business of dealing in commercial paper and foreign exchange for approxi-

²⁰⁶ Public Examination, The Adams Express Company, at 6856-6858.

²⁰⁸ *Id.*, at 6825.

²⁰⁷ *Id.*, at 6826.

mately half a century. From 1906 on, the firm had also engaged in the investment banking business.²⁰⁸ Although active in placing issues of securities of industrial and commercial companies into the possession of the public, neither the firm of Goldman, Sachs & Co. nor its individual partners had had any connection with investment companies or their security issues prior to the formation of The Goldman Sachs Trading Corporation.²⁰⁹

Waddill Catchings, formerly president of The Goldman Sachs Trading Corporation and formerly senior partner of Goldman, Sachs & Co., cited the following as the principal reasons for the formation of the investment company:²¹⁰

(1) To afford an opportunity to customers of Goldman, Sachs & Co. to purchase stock in a corporation which would be managed and supervised by the banking firm.

(2) To simplify the discharge of the responsibility of Goldman, Sachs & Co. to its clientele as to advice and investments, by centralizing that obligation in a company for whose management the banking firm would be directly responsible.

(3) To segregate the investment capital of Goldman, Sachs & Co. from that firm's banking operations, and to invest such capital in a separate corporation in which others would also participate.²¹¹

(4) To enable Goldman, Sachs & Co. to place the investment trading corporation into underwriting commitments in which field the banking firm had not been prominent prior to this time.²¹²

(5) To afford Goldman, Sachs & Co. as a firm, an opportunity to offer "to its clientele the same type of investment opportunity and service which every house was affording to their clientele."²¹³

Mr. Catchings further testified:²¹⁴

You pressed upon me before quite a little bit the point about how far we were influenced by making money out of commissions and out of getting business for the firm of Goldman, Sachs & Co. My strong belief is that that played a very small part in it; we had those opportunities anyhow. We had never had difficulties in forming syndicates; we had never had difficulties in getting business; and The Goldman Sachs Trading Corporation was not a creation of business for us. It was merely a means of handling it.

Now, I grant you we expected to gain much in our position in the world and our standing by having a successful company, but I don't think that the actual getting of Stock Exchange business and the getting of money in investing, played an important part in that decision.

The Goldman Sachs Trading Corporation was incorporated on December 4, 1928, under the laws of Delaware:²¹⁵

to buy, sell, trade in, or hold stocks and securities of any kind, to participate in syndicates and underwritings and to exercise such other of its charter powers as its Board of Directors may from time to time determine.

²⁰⁸ Public Examination, The Goldman Sachs Trading Corporation, at 15886.

²⁰⁹ Derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation.

²¹⁰ Public Examination, The Goldman Sachs Trading Corporation, at 15895-7.

²¹¹ *Ibid.*

²¹² Derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation.

²¹³ Public Examination, The Goldman Sachs Trading Corporation, at pp. 15895-7.

²¹⁴ *Id.*, at 15896-7.

²¹⁵ *Id.*, Commission's Exhibit No. 1652.

On the same date the investment company entered into an agreement with its sponsor whereby: ²¹⁶

The Firm (Goldman, Sachs & Co.) shall manage the affairs of the Corporation (The Goldman Sachs Trading Corporation) subject to its Board of Directors, and especially shall superintend its financial transactions, advise and recommend on the purchase and sale of securities and on participations in underwritings and syndicates, and place at the disposal of the Corporation its judgment, experience, statistical information and data.

For its services in this connection, the firm of Goldman, Sachs & Co. was to be entitled to receive, in cash, 20% of the net profits of the investment company after provision had been made to set aside a return of 8% annually, on a cumulative basis, on the invested capital. Mr. Catchings stated: ²¹⁷

* * * The Board consisted of the active partners of the firm of Goldman, Sachs & Company.

and: ²¹⁸

* * * The management contract between the Goldman Sachs firm and The Goldman Sachs Trading Corporation put the entire responsibility for the management of The Goldman Sachs Trading Corporation upon the firm of Goldman, Sachs & Company.

Therefore, it is apparent that the investment company was in effect without independence from its sponsors from its very inception.

The initially authorized capital consisted of 2,500,000 shares of no par value, and 1,000,000 shares were issued at \$100 per share net to the investment company, payment being made by the sponsor on January 4, 1929. This corporation had originally been conceived as a \$25,000,000 company, in which the sponsor would invest \$10,000,000, or 40% of the total contributed capital. However, as the date of the offering approached, the public receptivity to shares of the new company had caused the sponsors successively to step up the amount of the capital stock issuance to the \$100,000,000 finally reached. Thus the investment stake of Goldman, Sachs & Co. actually became but 10% of the initial stock issuance. ²¹⁹

Two months after the investment company's formation 125,000 additional shares were issued to cover technical short sales by The Goldman Sachs Trading Corporation, from which it had derived total sales proceeds of \$15,776,010.50. It is interesting to note that during the same period, while it was raising the additional capital, this investment company, instead of investing its funds in more permanent forms of investment, continuously had had upwards of \$50,000,000, or more than one-half of its initial capital invested in call loans. ²²⁰

Shortly after the organization of The Goldman Sachs Trading Corporation its sponsors planned to merge that investment company with Financial and Industrial Securities Corporation, an investment company. ²²¹ As a preparatory step towards carrying out the mechanics of

²¹⁶ Id., Commission's Exhibit No. 1654.

²¹⁷ Id., at 15863.

²¹⁸ Id., at 15863-4.

²¹⁹ Id., at 15902-3.

²²⁰ Id., at 16123-4.

²²¹ Financial and Industrial Securities Corporation, a closed-end investment company, had been incorporated under the laws of Maryland on December 24, 1925. Its sponsors

its merger with Financial and Industrial Securities Corporation, The Goldman Sachs Trading Corporation declared a 100% stock dividend on February 7, 1929, thus changing its outstanding capital stock to 2,250,000 shares, and the authorized number of shares was increased to 10,000,000 shares without par value. A cash dividend of \$2 per share was also paid to stockholders of The Goldman Sachs Trading Corporation for the purpose of equalizing the assets of the two merging companies.²²²

On February 21, 1929, The Goldman Sachs Trading Corporation merged with Financial and Industrial Securities Corporation on an equal asset value basis, and issued 2,250,000 shares of its capital stock as consideration for the net assets of the latter firm. The total assets of the combined companies were then valued at \$235,000,000.²²³

In July 1929 The Goldman Sachs Trading Corporation, jointly with Central States Electric Corporation (an investment company sponsored by Harrison Williams, a public utility promoter), sponsored the organization of Shenandoah Corporation, an investment company. Upon the formation of Shenandoah Corporation, an agreement was entered into whereby The Goldman Sachs Trading Corporation issued 238,096 shares of its capital stock in exchange for 500,000 shares of the preference stock of Shenandoah Corporation, the reasonable worth thereof being stated as not less than \$25,000,000.²²⁴

About one month later the board of directors of The Goldman Sachs Trading Corporation approved an exchange offer to be made by that corporation to the stockholders of American Company (which owned over 99% of the common stock of the American Trust Company, of San Francisco, California). The terms of the offer provided for an exchange ratio consisting of 9 shares of The Goldman Sachs Trading Corporation stock for 7 shares of American Company common stock, and the fair value of the latter stock was stated as being worth not less than \$135 per share. Under this offer 679,776 shares of the capital stock of the The Goldman Sachs Trading Corporation were issued in exchange for common stock shares of American Company, which were recorded on the investment company's books for a total valuation of \$71,399,620.72.²²⁵

The Goldman Sachs Trading Corporation issued stock dividends of 1½% quarterly from April 1, 1929, through April 1, 1930.

By September 1929 The Goldman Sachs Trading Corporation had increased its capitalization to \$326,000,000, the same being represented by 5,537,892 shares of capital stock without par value. By the end of 1932, these assets had shrunk in value to approximately \$33,700,000 or a shrinkage of 90%.²²⁶

Mr. Catchings testified: ²²⁷

were Ralph Jonas, at that time president of Manufacturers Trust Company, a large New York City bank, and his associates. (Public Examination, Financial and Industrial Securities Corporation, at 18903, 18895, et seq., and Commission's Exhibit No. 2096.) The total assets of this investment company at the time of the merger were valued at \$111,000,000. (See Pt. Three, Ch. IV, p. 1523.)

²²² Id., Commission's Exhibit No. 1680-A.

²²³ Id., Commission's Exhibit No. 1681.

²²⁴ Id., at 15869.

²²⁵ Public Examination, The Goldman Sachs Trading Corporation, at 11.

²²⁶ Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1657.

²²⁷ Id., at 15910-11.

Q. * * * Now in your offering circular, Mr. Catchings, you stated "Capitalization: Capital Stock, no par value. Authorized: 2,500,000 shares; to be presently issued: 1,000,000 shares." * * * Now it is one thing for a person to be a stockholder in a \$100,000,000 investment company, and another thing for him to be a stockholder in an investment company that has \$115,000,000; and it is another thing being a stockholder in a corporation that has \$234,000,000; and it is another thing to be a stockholder in a corporation that has \$329,000,000; isn't it?

A. I don't know just what you mean by "another thing," but obviously the corporations are different. But it seems to me that a corporation, whether it has \$100,000,000 or \$115,000,000, is much the same kind of corporation.

Under the original plan of the investment company's capitalization (a total of \$25,000,000, with \$10,000,000 of that sum contributed by the sponsor), the investment of Goldman, Sachs & Co. would have been 40%; under the original issuance amount, this subscription had become 10%; and in less than a year the sponsor's original investment of \$10,000,000 represented but 3.07% of the total capital raised.²²⁸

2. BENEFITS TO SPONSOR FROM INVESTMENT COMPANY

a. Tangible Benefits

Through its formation of The Goldman Sachs Trading Corporation the firm of Goldman, Sachs & Co., received the following direct benefits during 1929:

(1) Underwriting and selling group commissions from sales of capital stock of The Goldman Sachs Trading Corporation (net)-----	²²⁹ \$1, 184, 772
(2) Money broker's fees for placing call funds for The Goldman Sachs Trading Corporation....	²³⁰ 100, 000
(3) Compensation received from Lambert Co. common stock trading account (which operation was entirely financed by the investment company without any risk or liability being assumed by its sponsor)-----	²³¹ 500, 000
(4) Originating commissions received in connection with organization and financing of the following inter-related companies of The Goldman Sachs Trading Corporation:	
(1) Shenandoah Corporation-----	²³² 1, 500, 000
(2) Blue Ridge Corporation-----	²³³ 2, 500, 000
(5) Brokerage commissions (net) received from execution of transactions for The Goldman Sachs Trading, Shenandoah, and Blue Ridge Corporations -----	²³⁴ *807, 100

Total income received by sponsor from above sources during 1929-----	6, 591, 872

*Represents 42% of total net brokerage commissions received by sponsor in 1929.

²²⁸ Id., at 16094.

²²⁹ Id., at 16120.

²³⁰ Id., at 16124.

²³¹ Id., at 16120-22.

²³² Id., at 16119.

It is significant that over \$5,000,000 of the above income was received from the organization and distribution of the securities of three closely-related, newly formed investment companies. When examined as to the necessity for forming other investment companies in order to extend the investment scope of The Goldman Sachs Trading Corporation, Mr. Catchings indicated that it was deemed more practical to raise new capital by forming new companies than by the issuance of additional amounts of existing listed securities.²³³

In addition to the above sources of income derived by the sponsor as a result of the operations of the investment company organized by Goldman, Sachs & Co., other direct possible benefits included—

(1) Interest spread on credit balances carried with sponsor by the investment company.

(2) Profits received on sales of securities, as principal, to the investment company.

(3) Compensation received by sponsor for services as manager of certain underwriting, syndicate and joint trading accounts.

(4) Profits from greater opportunities to engage in primary financing activities.

(5) Possible investment management fees based upon net profits after a stipulated provision of 8% annually (on a cumulative basis) of the net assets.²³⁴

b. Intangible Benefits

Other advantages which accrued to the sponsor of The Goldman Sachs Trading Corporation through its formation consisted of the following:

(1) Enhanced prestige in the financial field due to the control of the general and investment management of the new company.

(2) Use of the investment company's larger buying power to support the market activities of its sponsor in certain securities.

(3) Use of the investment company's capital to acquire full or effective control of security firms, banks, and insurance companies, all of these being potential purchasers of securities distributed by Goldman, Sachs & Co.

(4) Availability of a convenient repository, in the form of The Goldman Sachs Trading Corporation's investment portfolio, to invest in unseasoned ventures of a type in which Goldman, Sachs & Co., as a conservative banking firm, would not indulge. Future financing needs of such ventures, if successful, would naturally flow to the sponsor firm.

Mr. Catchings testified:²³⁵

I don't think there is any doubt about it, but when you form an investment company and sponsor it that you get income from stock-exchange business and income relationships created. That is basic; that is true of investment companies today and banking houses; it always has been and possibly always will be. There is a relationship between them.

Since all transactions were initiated by the individual partners of the sponsor firm (who were directors of the investment company)

²³³ Derived from supplementary information supplied this Commission.

²³⁴ No management fees became payable to Goldman, Sachs & Co. under this agreement, because the investment company never made sufficient profits.

²³⁵ Public Examination, The Goldman Sachs Trading Corporation, at 15983.

and were handled at the offices of Goldman, Sachs & Co., the investment company itself had no opportunity to achieve a position of independent standing, or acquire separate goodwill, in the financial community.

The relative significance of The Goldman Sachs Trading Corporation in the financial sphere was brought out by the following testimony by Mr. Catchings:²³⁶

Q. Let me ask you in connection with all these new situations, like Frosted Foods, and the comparatively enlarged new scope of the Mississippi Valley, and the A. M. Bing and Sons venture and so forth, if there was any banking in the situations, do you deny Goldman, Sachs & Co. were going to get that banking?

A. They would not necessarily get it, but I think we [Goldman, Sachs & Co.] expected to get it. There was no commitment that they should get it. We had found in Goldman Sachs, Mr. Schenker, that where we had relations with businesses we naturally got a lot of banking business from them, although there was never any commitment to give it to us—as long as we handled it properly.

Q. A lucrative part of the banking business, of course, is the originating or overriding commission, isn't that so?

A. Well, that is a real source of income.

Q. Of course, that does not entail any retail distributing agency. The brunt of the work is done by the retail distributing agency in the distribution.

A. The function of a house of issue, which was one of the activities of Goldman, Sachs & Company, and I think that is what you are speaking of now—the function of a house of issue does not necessarily involve retail distribution.

Q. Was Goldman Sachs Trading Corporation to be a house of issue?

A. It was not to be a house of issue, no. There was no expectation that The Goldman Sachs Trading Corporation would go into the banking business as such.

Q. But it was contemplated that it might take participations in those situations where the house of issue was Goldman Sachs?

A. And other houses of issue, too.

3. CONCENTRATION OF FUNDS UNDER CONTROL OF SPONSOR AS A RESULT OF SPONSORSHIP

The Goldman Sachs Trading Corporation acquired a 40% common-stock interest in Shenandoah Corporation, and the latter firm thereafter acquired 86% of the common stock of Blue Ridge Corporation. The firm of Goldman, Sachs & Co. acted as investment bankers for these three financial corporations in which the public had invested nearly half a billion dollars within a 10-month period ending in September 1929, as follows:

²³⁶ Id., at 16109-11.

The Goldman Sachs Trading Corporation.....	²²⁷ \$303, 748, 860. 50
Shenandoah Corporation.....	62, 500, 000. 00
Blue Ridge Corporation.....	81, 825, 000. 00
Aggregate total.....	448, 073, 860. 50

Mr. Catchings testified:²²⁸

Q. In order to get the record straight, with respect to the \$326,000,000 the Trading Corporation raised, there is no doubt you controlled the disposition of that money in the first instance, isn't that so?

A. That is the money that was originally subscribed and that was the stock that was issued in connection with the merger of F. & L., and that is the stock issued in connection with Shenandoah and in connection with financing the properties. We certainly did.

Q. And the only one there is any question at all about is the \$62,000,000 in Shenandoah that the public put in and the \$81,000,000 in Blue Ridge that Shenandoah put in, and there you say it was co-controlled with the Harrison Williams interests, isn't that so?

A. Yes.

Q. So that control of approximately a half billion dollars was acquired by Goldman, Sachs & Co., the banking firm, through their participation as members of boards of directors during a period of many years, isn't that so?

A. Yes.

4. RAPIDITY AND SCOPE OF INVESTMENTS BY THE GOLDMAN SACHS TRADING CORPORATION

Mr. Catchings testified that the specific investments in certain companies in which The Goldman Sachs Trading Corporation subsequently acquired a direct or indirect interest²²⁹ were not contemplated prior to the formation of the investment company.²⁴⁰ Nevertheless, within "six or eight months" after the inauguration of the activities of The Goldman Sachs Trading Corporation over

²²⁷ Excluding cross-holdings of Shenandoah Corporation, but including the \$10,000,000 investment of the sponsor.

²²⁸ Public Examination, The Goldman Sachs Trading Corporation, at 15875-15876.

²²⁹ Id., Commission's Exhibit No. 1667.

²⁴⁰ Id., at 16093-4.

Q. The fact is, these situations arose after the \$100,000,000 additional was raised and therefore these investments and the study or investigation or analysis you made of each one of these particular situations was made after the time you raised the \$100,000,000; isn't that so?

A. I think I can say yes to that with this addition, if you will permit me, that many of the situations we [Goldman, Sachs & Co.] had known about for many years.

Q. But you do not mean to say you knew about them in the same manner as a person knows about them when he is going to buy 100% control?

A. No, no; we made investigations after money was raised, which led to the actual investment.

Q. And all that transpired in a period from, at the earliest, September 1928 to December 1929?

A. That is correct.

\$300,000,000 of its funds had been invested ²⁴¹ in the situations listed in the following schedule:

	Percent of stock ownership	Investment at 1929 year end	(Original cost 1929)
Banks:			
Manufacturers Trust Co., N. Y.....	32.....	\$51,984,000	
Pacific Trust Company, N. Y.*.....	50.....	4,786,000	
Colonial Trust Co., Philadelphia *.....	25.....	4,261,000	
Foremen-State National Bank, Chicago *.....	10.....	5,139,000	
American Trust Co., San Francisco *.....	99.....	43,750,000	
Total banks *.....			\$109,920,000
Insurance companies:			
National Liberty Insurance Co.....	47.....	34,485,218	
Peoples National Fire Insurance Co.....	49.....	3,575,095	
Baltimore American Insurance Co.....	33.....	3,363,312	
Total insurance companies.....			41,423,000
Total banks and insurance companies.....			151,363,000
Investment companies:			
Insuranshares Corp. of Delaware.....	5 of class "B," 33 1/4 of class "A."	2,203,000	
Shenandoah Corporation.....	40.....	58,474,477	
Total investment companies.....			60,677,000
Real estate, etc.:			
A. M. Bing & Son Realty Co.....	50.....	4,165,000	
Albert Pick, Barth & Co., Inc.....		801,000	
Broadmore Corporation.....		3,001,200	
Total real estate, etc.....			8,023,000
Department store: Stern Bros., New York.....	82.....		4,005,000
Transportation:			
Mississippi Valley Barge Line.....	66 2/3.....	400,000	
Motor Transit Corporation.....	20 of pfd., 11 of com.	360,000	
Total transportation.....			760,000
Miscellaneous:			
Pacific American Co., Ltd., San Francisco, (and its investment subsidiaries).....	100.....	62,651,000	
Frosted Foods Co.....	49.....	12,750,000	
Princeton Rayons, Inc.....	33 1/4.....	556,000	
Total miscellaneous.....			75,957,000
Aggregate total.....			* 300,785,000

* Including security affiliates.

²⁴¹ Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1667; and see the reply to the Commission's questionnaire for The Goldman Sachs Trading Corporation, Pt. III.

Mr. Catchings agreed that most of these investments were not liquid, that is, that the underlying securities did not have an established market which would readily absorb offerings for sale.²⁴²

²⁴¹ Id., at 16084.

²⁴² Id., at 16068.

Thus, Goldman, Sachs & Co., as sole manager, had within a period of less than a year, invested over 90% of the investment company's capital in situations of a semi-permanent or special character and had been forced to borrow from commercial banks.²⁴³

Mr. Catchings testified:²⁴⁴

Q. And then eight or nine months after that you found yourself with a \$328,000,000 company; isn't that so?

A. Yes.

Q. You say that this was your honest and best judgment when you made these investments?

A. Yes.

Q. But I have a more fundamental problem than that. After all, initially you asked the American public to entrust in your custody, care, and management—and when I say your, I mean you and the partners in Goldman, Sachs—\$100,000,000, less \$16,000,000 you contributed yourself [Goldman, Sachs & Co. and partners' families]; and I assume you will admit, Mr. Catchings, that this type of investments were not the usual investments made by the usual investment trust; isn't that so?

A. I don't know that one can say that they are "usual investment trusts" or "usual investments" made by them, but I will certainly grant you they are not the type of investments made by many investment trusts.

The total resources of certain miscellaneous companies in which The Goldman Sachs Trading Corporation had acquired substantial equity ownership aggregated approximately \$1,350,000,000 in 1929.²⁴⁵ This total was, roughly, equal to five times the capital contributed to the investment company, or one hundred seventy times the gross investment of Goldman, Sachs & Co. in the capital stock of The Goldman Sachs Trading Corporation.²⁴⁶

Walter E. Sachs, a general partner in Goldman, Sachs & Co. and the successor of Mr. Catchings as president of The Goldman Sachs Trading Corporation, stated that it is more difficult to invest \$100,000,000 than a relatively smaller sum (such as \$10,000) and that it is necessary to seek investment opportunities when entrusted with a large amount of money to invest. Mr. Catchings testified as follows:²⁴⁷

A. The important thing is that as a matter of fact none of these things were acquired with the intention of running them or dictating to them and actually there was no dictation to any of them * * * but I want to make it perfectly clear that in this picture that you present on your chart that it creates an incorrect impression that there was a purpose, or that there actually was in fact a control exercised or even attempted to be exercised.

Q. And the thing that I can't understand is your difficulty in your understanding how we came to the understanding that you did intend to control where you owned 100% of a bank. Now you can call it an investment and be facetious about it—

A. I don't mean to be facetious.

²⁴³ Id., at 16076-7.

²⁴⁴ Id., at 16094-5.

²⁴⁵ Id., Commission's Exhibit No. 1671.

²⁴⁶ Id., Commission's Exhibit No. 1671.

²⁴⁷ Id., at 16064-6.

Q. You don't even make a pretense that there is any cohesion or integration in this collection?

A. I know, but you see it wasn't intended to be an integrated proposition. They represent investments in different activities and in different fields;
 * * * it isn't in any sense, as you once said, a modeling group * * *.

5. INCREASE OF SPONSOR'S DISTRIBUTION FACILITIES AS A RESULT OF SPONSORSHIP OF INVESTMENT COMPANY

The investment company, through a series of exchange offers and outright purchases, acquired a large number of security distributing outlets²⁴⁹ located on the West Coast, in Chicago, Philadelphia, and other principal points which were served through the extensive wire facilities of a wholly owned subsidiary, C. F. Childs & Co.²⁴⁹

Counsel for the Commission stated:²⁵⁰

Q. Now, as I visualize it, and we will see if the record doesn't substantiate this theory, it seems to me that the following was the pattern of the Goldman Sachs Trading Corporation: First, that the banking firm, Goldman, Sachs & Co. would organize this Goldman Sachs Trading Corporation and raise this fund of money which would be invested according to a plan; second, The Trading Corporation would get control of institutions which were substantial purchasers of securities like commercial banks, insurance companies and investment trusts; third, having acquired the buying power; the Trading Corporation would concentrate in situations which might be speculative, promotional, but which represented potentialities of future new issues in which the banking firm could participate; fourth, that the Trading Corporation would build up an effective, or get control of an effective, distributing vehicle and agency, by getting control of substantial over-the-counter houses and substantial distributing agencies; and that the scope of this pattern covered the entire country so that you had this far-flung dynasty which was self-sustaining. Now we will see whether that pattern is incorrect or whether the emphasis on the investment policy of The Goldman Sachs Trading Corporation was what you say, or what it appears to me, upon superficial analysis, to be.

To which Mr. Catchings replied:²⁵¹

I most strongly and emphatically disagree with everything that you have just said.

Goldman, Sachs & Co. sold securities aggregating approximately \$26,000,000 over a period of about a year and a half during 1929 and

²⁴⁹ Id., Commission's Exhibit No. 1667.

²⁵⁰ Mr. Catchings testified (id., at 15988-9) :

A. Goldman Sachs Trading Corporation owned Childs [C. F. Childs & Co.] 100 per cent. I will grant you that is real, unadulterated control.

Q. What was the nature of their business?

A. C. F. Childs was one of the largest dealers in United States Government securities. They had branch offices all over the United States.

Q. One of the big wire houses?

A. It was a big wire house, acting only in connection with the sale of United States Government bonds.

Q. Where were their principal offices?

A. They originally had their principal office in New York, but when they were owned by the American National, the Pacific Company that owned them, I am not sure but what their principal office had been transferred out there. But originally it was a New York concern. They had offices throughout the United States.

²⁵¹ Id., at 15899-900.

²⁵² Ibid.

1930 to the Manufacturers Trust Co. and other financial and insurance houses in which The Goldman Sachs Trading Corporation held a substantial stock interest. A recapitulation of the purchasers of these securities is as follows:²⁵²

Stock ownership of purchaser's firm held by investment company	Purchaser	Total amount of securities purchased from Goldman, Sachs & Co.
<i>Percent</i>	<i>Banks:</i>	
32.....	Manufacturers Trust Co., N. Y.....	\$16,122,602.86
10.....	Foreman-State National Bank and its security affiliate, Chicago, Illinois.....	4,290,850.00
25.....	Colonial Trust Co. and its security affiliate, Philadelphia, Pa.....	1,099,862.50
99.....	American Trust Co. and its security affiliate, San Francisco, Calif.....	184,007.25
	Total sales to banks.....	21,697,322.61
	<i>Insurance companies:</i>	
47.....	National Liberty Insurance Co.....	2,611,993.08
33.....	Baltimore American Insurance Co.....	774,131.25
49.....	Peoples National Fire Insurance Co.....	342,887.50
	Total sales to insurance.....	3,729,011.83
100.....	Securities distributing wire house: C. F. Childs & Co., New York and San Francisco.....	518,114.50
	Aggregate total.....	25,944,448.94

Goldman, Sachs & Co. were the investment bankers for approximately one-third of the portfolio companies whose securities were purchased by the closely related companies mentioned in the foregoing schedule. The sponsor firm, therefore, was in a position to profit on certain transactions by more than the usual brokerage fees. This was due to the fact that the remuneration derived from sales resulting out of primary financing activities, and as principal, are customarily higher than the regular commission rates charged a broker for transactions in listed and unlisted securities.

When examined regarding the opportunities for exerting control and the potential sales outlets for securities issued by the firm of Goldman, Sachs & Co., because of the substantial equity holdings of The Goldman Sachs Trading Corporation, Mr. Catchings testified as follows:²⁵³

I don't say anything about the power, that is the only thing. I am saying that we did exercise a considerable influence in the Manufacturers Trust Company * * * I am simply saying, as a matter of fact, we did exercise influence in the situation, although we did not exercise control.

Well, if you want to put it this way, that a bank such as the Manufacturers Trust Company of this size might possibly at times have been a large buyer of securities, I will say yes. * * *

²⁵² Id., Commission's Exhibit No. 1663.

²⁵³ Id., at 15949.

²⁵⁴ Id., at 15954.

I think we can say with regard to insurance companies that they were what you would call "big purchasers" of securities * * *.²⁸⁵

Mr. Catchings testified that C. F. Childs & Co., being a large wire house with representative offices throughout the United States and with several foreign branches,²⁸⁶ was acquired:

with the idea of creating a division of The Goldman Sachs Trading Corporation for the Pacific Coast.²⁸⁷

The thought was to use a wire system, which was supported by a business in United States government bonds, as a means of connecting a number of investment houses which would sell to investors, existing securities.²⁸⁸

It was not contemplated in connection with the plan for national distribution of securities that the different investment houses would be wholly owned, necessarily substantially owned in the different cities, but to gather together in an organization acting together a means of distributing securities throughout the United States * * *.²⁸⁹

Mr. Catchings elaborated on the projected expansion plans for the investment company as follows:²⁹⁰

Goldman, Sachs & Co., the banking firm, were interested in the issuing of securities, and that is new issues, and this nation-wide development that I am speaking of was not in connection with the issue of securities. There was no intention of having Goldman Sachs Trading Corporation, or this organization that I am speaking of, issue securities.

Q. What did you contemplate, an association of the big or small type of investment banking houses, engaged in the distribution of securities, which would center around Goldman Sachs Trading Corporation?

A. Yes. Now, it wasn't required that we have ownership in these different investment houses, it was simply important to have them active as part of the general machinery for distributing existing stocks.

Now, if you will permit me, I would like now to cover something which ought to be entirely clear on the record, if you want to cover this adequately, and that is this: That so far as the existing securities are concerned, particularly Stock Exchange securities, there is no established mechanism of reaching the investor with regard to those securities.

Securities that are dealt with on the New York Stock Exchange are sold to a considerable extent by tips and are bought to a considerable extent on expectation of rises in the market. The same kind of an organization which is available in the distribution of a new issue never has been and is not now available in connection with existing securities. There is no mechanism for paying salesmen or of getting out information to the investor with regard to existing securities except the mechanism of Stock Exchange houses, and they are not engaged actively in seeking investors.²⁹¹

At the public examination of The Goldman Sachs Trading Corporation it was suggested that the investment company was not intended to become a house of issue, because in such a case it would be put into

²⁸⁵ Id., at 15962.

²⁸⁶ Id., at 16814-17.

²⁸⁷ Id., at 16814.

²⁸⁸ Id., at 16818.

²⁸⁹ Id., at 16816.

²⁹⁰ Id., at 16817-18.

²⁹¹ Id., at 16823-4.

direct competition with its sponsor. Counsel for the Commission stated:²⁶²

In that connection, you were building up for Goldman, Sachs & Co., one of the most powerful distributing agencies that you could use as an effective argument in getting issues, because you would have a distributing agency which was being maintained and carried by The Goldman Sachs Trading Corporation, that could be used in connection with the issues of securities that Goldman, Sachs & Co., the banking firm, would get.

To which Mr. Catchings replied:

* * * they [Goldman, Sachs & Company] didn't need any assistance of any sort in connection with their issue business. * * * There was no problem for Goldman, Sachs & Co. at any time in making a national issue of securities.²⁶³

Inasmuch as The Goldman Sachs Trading Corporation was not a house of issue²⁶⁴ and since the record does not indicate that this investment company actually made any secondary distribution of large blocks of existing securities through its investment affiliates in the manner envisioned by Mr. Catchings,²⁶⁵ it is evidence that, as a practical matter, the sponsor alone benefited from the business transacted²⁶⁶ through the security distributing outlets financed by the investment company.

6. OTHER SPECIFIC BENEFITS FROM SPONSORSHIP

Goldman, Sachs & Co. acted as principal in certain sales of securities to The Goldman Sachs Trading Corporation and at the same time were also investment bankers for the issuers of these securities. In several instances the sponsor functioned in effect as a middleman in placing the available funds of The Goldman Sachs Trading Corporation into various channels of investment.

Incidentally, the firm of Goldman, Sachs & Co. was represented, among others, on the boards of directors of the following companies:²⁶⁷

Archer-Daniels-Midland Co.	Minneapolis-Moline Power Implement Company
Blaw-Knox Company	Pet Milk Co.
Blue Ridge Corporation	Pillsbury Flour Mills, Inc.
Cluett, Peabody & Co.	Shenandoah Corporation
General Foods Company (formerly Postum Co.)	United Biscuit Co.
The Lambert Company	Van Raalte Co., and
Lehn & Fink Products Co.	Warner Bros. Pictures, Inc.
Long-Bell Lumber Co.	

Walter E. Sachs, who served as president of the investment company from May 27, 1930 until April 17, 1933, testified:²⁶⁸

* * * in searching for opportunities that we [Goldman, Sachs & Co.] consider profitable opportunities for the trading corporation, we naturally were close

²⁶² Id., at 16820.

²⁶³ Id., at 16820.

²⁶⁴ Id., at 16111 and 17294.

²⁶⁵ Id., at 16823-4.

²⁶⁶ Approximately \$26,000,000. (Id., Commission's Exhibit No. 1663.)

²⁶⁷ Id., Commission's Exhibit No. 1653.

²⁶⁸ Id., at 17258.

to these companies for whom we were bankers; and we felt that we knew more about their condition and about their prospects; and we kept in close touch with them, and many of them we might have made investments for other clients or for ourselves, and it was perfectly natural that we should suggest to the Trading Corporation investments in companies that we were as close to as that. Except in that sense, there is no coincidence about it.

Under such circumstances the question was presented wherein the firm of Goldman, Sachs & Co., as investment manager for The Goldman Sachs Trading Corporation, as investment bankers for numerous issuers, and also as brokers in executing orders for its own clientele, could discharge its duties to the publicly-financed The Goldman Sachs Trading Corporation in a wholly impartial manner. In other words the sponsor firm, Goldman, Sachs & Co., and its partners, were in conflicting positions.

Mr. Catchings testified:²⁶⁹

Q. * * * In the first place Goldman, Sachs & Co. didn't have to look very far to find a purchaser; the Trading Corporation was always there and didn't ask any questions; isn't that so?

A. Well, I wouldn't subscribe to that. I don't think that Goldman, Sachs & Company would ever have sold anything to The [Goldman Sachs] Trading Corporation that they couldn't have sold to someone else at the same time * * *.

Among other benefits received by the sponsor because of its dominant association with the investment company were the following:²⁷⁰

a. Profits to Sponsors on Sales as Principal

One of the other benefits that came to Goldman, Sachs & Co. from its sponsorship of The Goldman Sachs Trading Corporation arose from the sales by the sponsors as principals of securities to the investment company. One instance may be cited.

(1) VAN RAALTE CO., INC.

Goldman, Sachs & Co. and Lehman Brothers were the investment bankers for the Van Raalte Co., Inc., in a public offering of \$3,492,500 of its 7% cumulative preferred (\$100 par value) stock in 1919 at \$98 per share. The preferred stock carried a provision that, in case of default of three (3) consecutive dividend payments, this class of stock would have sole voting power in the election of directors. By January 1, 1929, the preferred stock was in arrears five (5) consecutive dividends, and the preferred stockholders therefore controlled the company.

Early in January 1929, The Goldman Sachs Trading Corporation purchased 4,920 shares of Van Raalte Co. preferred stock at 65, through its sponsor, from E. Van Raalte Trustee, who had on that date sold 5,900 shares through Goldman, Sachs & Co. "on order." An additional 480 shares were purchased by the investment company at 70 a share during the next two months.

²⁶⁹ Id., at 17331-2.

²⁷⁰ The material used in this subsection a, except as otherwise noted, has been derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation.

On April 1, 1929, Goldman, Sachs & Co. bought 5,139 shares of Van Raalte Co. preferred stock at 65 net from various members of the Van Raalte family, and immediately resold these shares at 70 net to The Goldman Sachs Trading Corporation, thus achieving a profit of five (5) points, or \$25,695, on the turn. The market range on this date was 78-80, so it would appear that the investment company received the stock at an advantageous price despite the profit spread realized by its sponsor. However, it is possible that the market for this security could not have absorbed such a quantity of stock without suffering a severe set-back, inasmuch as only 8,350 such shares were traded in on the New York Stock Exchange during the entire year of 1929.

As there were only 36,525 shares of Van Raalte Co. preferred stock outstanding at this time, the purchases for account of The Goldman Sachs Trading Corporation represented effective working control, inasmuch as the 10,539 shares thus bought, at a cost of \$713,130, comprised 29% of the total voting stock. Since Goldman, Sachs & Co. was the sole manager of the investment company, it also was enabled to retain and possibly to increase its influence in Van Raalte Co., Inc., through these direct investments of The Goldman Sachs Trading Corporation.²⁷¹

b. Increase of Sponsors' Influence With Certain Commercial Banks Through the Use of the Investment Company

The commercial banking and related requirements of so large a financial organization as The Goldman Sachs Trading Corporation were, naturally, quite substantial. Deposit facilities and loans from time to time, together with such incidental services as registrar, transfer agent, custodian, and as trustee for various securities issues were a substantial source of income to the banks chosen to supply these needs. This business was dispensed principally to the 5 banks in which the Trading Corporation was interested: Manufacturers Trust Company, Pacific Trust Company of New York, The Colonial Trust Company of Philadelphia, Foreman-State National Bank and Foreman-State Trust and Savings Bank, the latter two of Chicago.²⁷²

With respect to this situation, Mr. Catchings testified:²⁷³

Q. * * * so, we have a situation where you expect to get deposits and other business through your connections with these big industrial companies?

A. I have only mentioned so far the matter of getting additional accounts and deposits and large borrowers from the Bank. There was in addition to that the possibility of contributing to the Bank a large income based upon our doing business with them, which was our own business in Goldman Sachs Trading Corporation and Goldman, Sachs & Company as our business grew, instead of taking that business to other banks, and that was in itself a very important element.

In giving you the reasons for forming The Goldman Sachs Trading Corporation, I pointed out to you the important earnings which have been given to Goldman, Sachs & Company in the course of developing the business of Goldman, Sachs, and there would have been much the same opportunity in connection with the

²⁷¹ Id., Commission's Exhibit No. 1668.

²⁷² The relationship of these banks with Goldman, Sachs & Co. and The Goldman Sachs Trading Corporation is discussed more fully in a later section of this report. See Economic Significance of Investment Companies, Part Four.

²⁷³ Public Examination, The Goldman, Sachs Trading Corporation, at 16508-10.

Manufacturers Trust Company, during its period of upbuilding, to give them the same kind of opportunity of earning money.

We were all the time figuring out, deciding who was to be transfer agent, deciding who was to be registrar, deciding who was to be trustee under the mortgages. That all has to be given to some bank. You are forming underwriting groups; you can include banks in relative amounts in those. There were plenty of opportunities for Goldman Sachs—

Q. Don't forget pools.

A. So long as you confine yourself to this definition that we had yesterday, I won't forget them.

Q. So that you contemplated increasing the earnings, the stature of the bank through your connections either with industrial clients or by virtue of the activities of Goldman, Sachs & Company and Goldman Sachs Trading Corporation?

A. Yes.

Q. And then after you increased the earnings and the price of the stock rose, you contemplated you would be able to liquidate the stock at a substantial profit?

A. I wouldn't say afterwards. I would say during the process, because one has to sell during the process of building up. You don't sell after the thing has been fully accomplished. The buyer of the stock has to have some chance of making money out of the development.²⁷⁴

* * * * *

Q. Of course, you don't increase the earnings of a bank over night, do you, Mr. Catchings? That is a pretty long process, involving an increase in the various and divers activities of a bank; isn't that so?

A. Yes; but you have to increase them overnight sometimes, if you increase them at all; that is, the earnings have to go up over a period of time. They don't go up all on one day, but we started in right away to build up the bank and adding to its connections and resources. * * *

In connection with the investment of The Goldman Sachs Trading Corporation, in the Foreman-State banks of Chicago, Mr. Catchings testified as follows:²⁷⁵

Q. You say it was not contemplated that you [Goldman, Sachs & Co.] would take the deposits of these industrial corporations completely out of banking institutions with which they were banking—

A. It may have had some effect one way or another. I don't know. It seems to me that it is an obvious business fact that with a great deal of business, the development of companies and more banking business, that there was plenty of banking business for these institutions, and there would be plenty of banking business remaining for these others. It is such a common experience, Mr. Schenker, every day now—I don't believe I ever go to a board of directors' meeting that an account is not opened at some new bank. The creation of business relations between corporations and banks is a normal and natural feature of the process of business.

Some day I would like to show you a list of accounts of some of the large corporations.

Q. Of course, this has additional significance to me, to show the influence exerted by investment banking firms on industrial corporations who are their clients.

²⁷⁴ Id., at 16502.

²⁷⁵ Id., at 16538-40.

A. It may have that, but it is a fact that a great many corporations look to us for advice as to where it would be of benefit to have their banking relations, what would be good banks to have as associates. We give many, many corporations advice on that, with regard to banks and other things.

Q. You think Continental Can opened up an account with Foreman Bank, don't you?

A. I don't know whether they did or not. I can't remember those details. I think probably they did.

Q. General Foods Corporation?

A. I can't remember each one of these. I have told you I think we got a great many accounts for it, and it would be among such companies as that that we would get them.

c. Profits to Sponsor from Funds of Investment Company on Deposit with Sponsor

During the period January 4 to August 20, 1929, The Goldman Sachs Trading Corporation had substantial funds out on call. These funds were placed through its sponsor, the firm of Goldman, Sachs & Co., who received the usual money brokers' fees, which, in this instance, aggregated about \$100,000 for the entire period.²⁷⁶ The investment company consistently kept more than \$25,000,000 out on call until June 6, 1929. In March 1929 when the call-money rate was at a high of 20 percent, the investment company reached a peak lending position of \$65,100,000.

The investment company also maintained credit balances with its sponsor, on which funds varying rates of interest were allowed by the firm. Call renewal rates, less one-half of 1 percent were credited for certain periods, but only the same rate allowed other customers (3 percent) was credited for certain periods.

	Rate of interest credited by sponsor	Call money rates during current month		Average daily credit balance of investment company on books of sponsor (approximate)
		High	Low	
1929:				
Sept. 3-10.....	3%.....	10%.....	6%.....	\$414,000
Oct. 9-31.....	3%.....	10%.....	5%.....	358,000
Nov. 1-30.....	3%.....	6%.....	4½%.....	383,000
Dec. 1-31.....	3%.....	6%.....	4½%.....	207,000
1930: Jan. 1-30.....	3%.....	6%.....	4%.....	80,000

The Goldman Sachs Trading Corporation instituted its policy of borrowing from banks on August 30, 1929, and owed \$20,000,000 to banks from January 2 to April 2, 1930.²⁷⁷ While these bank loans were outstanding large credit balances were maintained by the investment company with Goldman, Sachs & Co., and with various

²⁷⁶ Id., at 16124.

²⁷⁷ Id., at 15880.

commercial banks. Month-end balances of The Goldman Sachs Trading Corporation reflect the following:

	Loans payable to banks	Total cash balances	Credit balances with sponsor, percent of total	Credit balances with sponsor, amount	Total credit balances with banks	
					Percent of loans	Amount
Jan. 31, 1930.....	\$20,000,000	\$4,110,077.77	5.36	\$220,500.70	19.45	\$3,889,577.07
Feb. 28, 1930.....	20,000,000	6,069,094.44	26.79	1,626,064.65	22.22	4,443,029.79
Mar. 31, 1930.....	20,000,000	7,738,161.95	16.90	1,308,091.56	32.15	6,430,070.39
Apr. 30, 1930.....	10,000,000	4,906,957.22	19.11	937,950.08	39.69	3,969,001.14
May 31, 1930.....	13,000,000	5,083,588.04	19.73	1,003,175.50	31.39	* 4,080,412.54

* Id., Commission's Exhibit No. 1676.

Because interest spreads are an important source of income in the brokerage business as well as in the banking business, the investment company's relatively high compensating bank balances and wholly superfluous cash balances with its sponsor, which balances were maintained by Goldman, Sachs & Co. as sole manager of the investment company, represented hidden costs to The Goldman Sachs Trading Corporation. By settling transactions daily with its sponsor on a net check basis, and keeping its bank balances within compensating level of perhaps 10% borrowing might have been reduced, and the resultant gross savings in interest carrying costs for bank loans would have been at the rate of \$10,000 per annum per million dollars on each 1% charged on loans outstanding.

d. Compensation of Sponsor as manager of underwriting Syndicate, of which Investment Company was a Member

Three months after the termination of a group trading account in the common stock of General Cigar Co., Inc., the investment banking firm of Goldman, Sachs & Co. formed a syndicate with Lehman Brothers to underwrite an offering of rights to be issued by General Cigar Co., Inc., to its common stockholders to subscribe to 81,514 additional shares of common stock at \$60 per share. These rights entitled common stockholders of record on August 5, 1929, to subscribe to 1 new share for each 5 shares held on that date, the subscription privileges to expire three weeks later.²⁷⁸

Since the market price for this stock had risen to 73%, the success of the underwriting was assured. Whereas the investment company had been the major participant in the more hazardous group trading venture in which it had taken a 30% interest,²⁷⁹ The Goldman Sachs Trading Corporation was given a participation in the underwriting syndicate of only 10,000 shares, or approximately 12.3%. Although

²⁷⁸ Id., Commission's Exhibit No. 1904.

²⁷⁹ Id., Commission's Exhibit No. 1903.

details of the account were not made available, the firm of Goldman, Sachs & Co. presumably retained a 10,000-share interest in the venture.

Paragraph Seven of the underwriting syndicate agreement contained the following clause:²⁸⁰

* * * The managers [Goldman, Sachs & Co. and Lehman Brothers] will make no charge to the Syndicate for their services as such, but shall be entitled to retain for their own use, without accountability to the Syndicate, the compensation which they are to receive from the Company [General Cigar Co., Inc.] for their services in forming the Syndicate.

The firm of Goldman, Sachs & Co. received \$40,757 on September 4, 1929, representing its one-half share of the profit received from the "Bankers' Underwriting Syndicate." Therefore this special compensation to the managers for their services in forming that syndicate amounted to \$1 per share or a total of \$81,514 in which the investment company, in accordance with the foregoing stipulation,²⁸¹ did not participate.

e. Increased Profits and Prestige of Sponsors from Joint Undertakings with Investment Company

In sundry transactions with The Goldman Sachs Trading Corporation, including underwritings, syndicates, trading accounts, and joint ventures, the firm of Goldman, Sachs & Co. received approximately \$6,500,000 during the calendar year 1929.

While this compensation was being received, increased "income from stock-exchange business and income relationships created", mentioned by Mr. Catchings as being basic types of remuneration which always are received by the sponsor of an investment company,²⁸² undoubtedly added to Goldman, Sachs & Co.'s earnings and increased its standing in the financial field.

The following schedule of trading by the investment company and/or its sponsor in certain securities gives some indication of the scope of the sponsor's influence in stock-market trading and also indicates the extent of the brokerage commissions resulting therefrom:²⁸³

²⁸⁰ Id., Commission's Exhibit No. 1904.

²⁸¹ Ibid.

²⁸² Public Examination, The Goldman Sachs Trading Corporation, at 15983.

²⁸³ Id., Commission's Exhibit No. 1853.

Trading by The Goldman Sachs Trading Corporation and/or its sponsor in certain securities

Title	Sponsor represented on board of directors of company	Class of stock	Period	Ratio of trading to volume traded on respective exchanges ^a	
				Purchases	Sales
Chubb, Peabody & Co., Inc.....	Yes.....	Common.....	Jan. 31 to Oct. 18, 1929.	24%	3%
Eitingon-Schild Co., Inc.....	Yes.....	Preferred.....	Apr. 2 to Oct. 30, 1929.	30%	-----
		Common.....	Jan. 24 to Apr. 22, 1929.	46%	-----
General Cigar Co., Inc.....	Yes.....	Common.....	Dec. 17, 1928 to Apr. 17, 1929.	21%	21%
The Goldman Sachs Trading Corporation [*]	Yes.....	Common.....	Sept. 13 to Dec. 6, 1929.	20%	5%
Kelly-Springfield Tire Co.....	Yes.....	Common.....	Apr. 12 to June 11, 1929.	27%	-----
Kelsey-Hayes Wheel Co.....	Yes.....	Common.....	Jan. 4 and 8, 1929.	65%	-----
Lambert Company.....	Yes.....	Common.....	Jan. 4 to Feb. 15, 1929.	2%	23%
Lehn & Fink Products Co.....	Yes.....	Common.....	Dec. 26, 1928 to Nov. 21, 1929.	11%	3%
Long-Bell Lumber Corp.....	Yes.....	Class A.....	Jan. 4 to July 31, 1929.	51%	-----
McGraw-Hill Publishing Co.....	Yes.....	Common.....	Jan. 18 to Sept. 13, 1929.	52%	1%
National Bellas Hess Co.....	Yes.....	Common.....	Dec. 29, 1928 to Jan. 4, 1929.	47%	-----
National Dairy Products Corp.....	Yes.....	Common.....	Jan. 4 to 16, 1929.	30%	5%
Pet Milk Co.....	Yes.....	Common.....	Jan. 4 to Mar. 28, 1929.	55%	-----
Pillsbury Flour Mills, Inc.....	Yes.....	Common.....	Jan. 4 to Aug. 12, 1929.	4%	1%
			Aug. 30, to Oct. 29, 1929.	18%	1%
United Biscuit Co. of America.....	Yes.....	Common.....	Mar. 26 to Sept. 21, 1931.	19%	9%
Van Raalte Co., Inc.....	Yes.....	Preferred.....	Jan. 25 to Apr. 1, 1929.	23%	-----
Warner Bros. Pictures, Inc.....	Yes.....	Common.....	Feb. 4 to 25, 1929.	6%	-----

^{*} Public Examination, The Goldman Sachs Trading Corporation, at 17278-17280.

^a Based upon net long position, details offered being unavailable.

^{*} Although several of its affiliated companies participated therein, the investment company itself did not trade in its own capital stock during this period.

The Goldman Sachs Trading Corporation, under the initiative and management of its sponsor, conducted extensive trading operations in its own capital stock and that of Financial and Industrial Securities Corporation which it subsequently acquired.²⁸⁴ The firm of Goldman, Sachs & Co. collected in excess of \$200,000 in brokerage commissions as a result of such trading by the investment company.

²⁸⁴ See Ch. IV of this part of the report, p. 1523 et seq.

f. Increase of Sponsor's Banking Business Through Participation by Investment Company in Promotional and Unseasoned Business Ventures

The Goldman Sachs Trading Corporation, under the management of Goldman, Sachs & Co., made substantial investments in certain enterprises of an unseasoned or promotional nature²⁸⁵ with the following results:

	Total investment	Total sales proceeds and or fair valuations as at 12/31/35	Net loss as at 12/31/35
Frosted Foods Co., Inc.....	\$25,370,100.00	\$11,728,822.50	\$13,641,277.50
A. M. Bing & Son Realty Corp.....	6,005,000.00	* 1.00	6,004,999.00
Greyhound Corp. (Formerly: Motor Transit Corp.).....	3,241,537.23	* 5,133,525.38	* 1,891,988.15
Mississippi Valley Barge Line Company.....	2,333,335.00	* 1,400,000.00	933,335.00
Totals.....	36,949,972.23	18,262,348.88	18,687,623.35

* Fair valuations as used by parent company, Atlas Corporation, as at 12/31/35.

* Including unrealized market appreciation on long position (45,817 shares) as at 12/31/35.

²⁸⁵ Mr. Catchings testified (Public Examination, The Goldman Sachs Trading Corporation, at 16004-5; 16042-4:

Q. * * * Now you had a 49%-stock interest in Frosted Foods?

A. Yes.

Q. And a 51% stock interest was held by the Postum people; isn't that so?

A. Yes.

Q. And what was the nature of the business of Frosted Foods?

A. That was a corporation formed to enable the Postum Company to engage in putting out frozen meats and vegetables and supplying that to the public.

Q. That was a comparatively new enterprise?

A. Very definitely.

Q. That was a new one?

A. It was a new and revolutionary discovery which represented a great advance.

Q. That is Frosted Foods. * * * Now the Mississippi Valley Barge Line, you had 66% control of that; what was the nature of that?

A. You won't mind changing that to 66% of the stock interest?

Q. I will accept the amendment for the entire chart [Commission's Exhibit No. 1667] and we will say 66% ownership of the entire stock.

A. That was a company engaged in transporting merchandise by self-propelled barges on the Mississippi River and tributaries.

Q. And that investment was made in the early part of 1929?

A. You have the date there.

Mr. BENJAMIN. The contract was signed in August.

Q. That was a brand new enterprise that you and your associates were starting; isn't that so?

A. Which are you talking about?

Q. Mississippi Valley Barge Line.

A. It wasn't brand new in quite the emphasis that you put on it. It was a newly formed company but it took over activities and developments that had taken place before. It was a continuation of an enterprise that had started before.

Q. Now the Greyhound Corporation, that was the bus line, isn't that so?

A. Yes, sir.

Q. That was acquired in April 1929 and the General Foods Corporation was June 1929.

A. Yes. That wasn't called Greyhound then, was it?

Q. It was American Motor Transport.

Q. What was the nature of the business of A. M. Bing & Son?

A. That was the business of developing New York real estate. A. M. Bing had been one of the partners of Bing & Bing and had had great success in the real-estate business in New York. He had been engaged in business in connection with housing development around New York for several years, and was about to go back into the real-estate business and to form his company of A. M. Bing & Son, and we took an interest with him in business which he was developing.

Mr. Catchings testified:²⁸⁶

Q. Let me ask you in connection with all these new situations, like Frosted Foods, and the comparatively enlarged new scope of the Mississippi Valley and the A. M. Bing & Sons ventures, and so forth—if there was any banking in the situations, do you deny Goldman, Sachs & Co. was going to get that banking?

A. They would not necessarily get it, but I think we expected to get it. There was no commitment that they should get it. We had found in Goldman Sachs, Mr. Schenker, that where we had relations with businesses, we naturally got a lot of banking business from them, although there was never any commitment to give it to us—as long as we handled it properly.

The following testimony by Walter E. Sachs and Waddill Catchings, respectively, both officers and directors of the investment company and partners of the sponsor firm, indicates the potential sources of investment banking revenues which were provided for the sponsor through its investment of the funds of The Goldman Sachs Trading Corporation in these projects:²⁸⁷

A. It [A. M. Bing & Sons] was going to buy property, and sell it at a profit, it was hoped a general business in real estate, as was the custom of companies of that kind.

Q. Wasn't it also contemplated at the same time, or at some other time, that all these properties were to be had in one corporation, and that there would be a bond issue or security issue covering the entire property holdings of A. M. Bing & Sons, to be sold to the public?

A. There was no reason why there should not be in contemplation the fact that as the company developed and grew and established earning power, that The Goldman Sachs Trading Corporation could have sold these debentures or an issue refunding these debentures to the public.

Q. You say The Goldman Sachs Trading Corporation. Was it The Goldman Sachs Trading Corporation that was going to sell these debentures or the securities or the bond issue, or was it the banking house of Goldman, Sachs & Company that was going to get that piece of business?

A. Of course, some banking house would have to handle the business, and there is no reason to doubt that Goldman Sachs, under the incidence of their business, would have handled it.

Q. So that is another instance where The Goldman Sachs Trading Corporation went into an operating scheme with the ultimate hope that some time there would be a bond issue that the Goldman Sachs banking house could float?

A. That was so incidental a matter, I am sure it was never even discussed or thought of. The objective was to make money in this Trading Corporation.

Q. It is true, is it not, that all the circumstances and all the instances that the Trading Corporation were going to make investments in, if there was to be any banking business or issues, Goldman, Sachs & Company would get those issues; isn't that so?

A. It might.

Q. Is there any doubt in your mind?

A. No. Goldman Sachs Trading Corporation might well make investments of substantial size in companies which had other banking relationships. They did that frequently.

²⁸⁶ Id., at 16109-10.

²⁸⁷ Id., at 16015-18.

Q. This real estate company that was developed had no banking interests, had it?

A. Quite true.

Q. It was a new thing started in 1929?

A. Quite true.

Q. It was not an established real-estate property that had been operating properties for years?

A. Quite true.

Q. This thing was thrown together in a few months?

A. Yes.

* * * * *

Q. So that as far as the new situations were concerned, new real-estate developments, new bus developments, new barge line developments, and those sort of things, there is no doubt that if there was any future financing, Goldman, Sachs & Company would get the banking business?

A. I still maintain that was a very incidental situation.

Q. The fact is from the very inception of the A. M. Bing & Sons situation, it was contemplated that there would be some security issued in connection with that situation, and that Goldman Sachs would get the business?

A. I explained to you that at the proper time that might very well have occurred, and naturally Goldman Sachs would handle the business.

Q. So that the \$6,000,000 of the Trading Corporation money went into a new real estate operation company, and incidentally if there was to be any banking business, Goldman, Sachs & Co. was to get it; isn't that so?

A. Yes; but that \$6,000,000 issue would have been, if I may be permitted to say so, a matter of very minor importance in the great fabric of Goldman Sachs & Co.'s other business.

Q. But you didn't know to what extent that development was ultimately to be carried, did you?

A. Nobody can look into the future; no.

Mr. Catchings, discussing the investment of The Goldman Sachs Trading Corporation in Greyhound Corporation, testified: ²⁸⁸

Q. * * * Now Mr. Cruikshank was not unmindful of the possible benefits that would accrue to Goldman, Sachs & Company, the banking firm, by virtue of the substantial investment by The Goldman Sachs Trading Corporation in this situation [Greyhound Corp.] which he characterized as very speculative; isn't that so?

A. * * * on the whole I don't want to question it the least bit, but that it was possible and actually resulted in Goldman, Sachs & Company, the firm, getting some business as a result of The Goldman Sachs Trading Corporation.

As to the wide scope and variety of the investments made for The Goldman Sachs Trading Corporation by Goldman, Sachs & Co., its sponsor-manager, Mr. Catchings testified: ²⁸⁹

A. * * * I will certainly grant you they are not the type of investments made by many investment trusts * * *.

²⁸⁸ Id., at 15985-6.

²⁸⁹ Id., at 16095.

Mr. Catchings also testified that investors in the capital stock of The Goldman Sachs Trading Corporation:

* * * naturally expected that the investment would be such as the firm [Goldman, Sachs & Co.] had made for the public in the past and which had proven so successful for the public * * *.²⁰⁰

When I say type I don't mean in the same line of business, but I mean the investments which had been so satisfactory were the investments which had been made in the earlier stages of business and had made money in the early development of business.²⁰¹

g. Increase of Sponsors' Banking Business and Enhancement of Sponsors' Prestige Through Sales of Securities to Investment Company

(1) MINNEAPOLIS-MOLINE POWER IMPLEMENT CO.

An illustration of the continuing nature of the influence of Goldman, Sachs & Co. over the investment company is exemplified by an examination of the record in connection with the investment of The Goldman Sachs Trading Corporation, in 1929, in securities of the newly-formed Minneapolis-Moline Power Implement Co.

The latter firm was organized to acquire and consolidate the following three companies:

Minneapolis Steel & Machinery Company,
Minneapolis Threshing Machine Company, and
Moline Implement Company'

Upon consummation of the deal, the new company's capitalization was as follows:

	Authorized shares	Outstanding shares
Convertible \$5.50 cumulative preferred stock (without par value)-----	100,000	100,000
Common stock (without par value)-----	²⁰² 1,500,000	700,000

A syndicate was formed to purchase the 100,000 shares of preferred stock and up to 260,000 shares of the common stock. All the preferred stock and 20,000 shares of the common stock were purchased from the issuing company, and the remainder of the common stock was purchased from various individuals. The group of underwriting syndicate managers consisted of the following firms:

Goldman, Sachs & Co.
Eastman, Dillon & Co.
Lane, Piper & Jaffray, Inc.
The Minnesota Company.
First Minneapolis Trust Company.

The public offering prices were \$101.75 per share, plus accrued dividends for the preferred stock and \$41.75 per share for the common stock.²⁰³

²⁰⁰ Id., at 16103.

²⁰¹ Id., at 16104.

²⁰² 220,000 shares to be reserved for conversion of preferred stock and against exercise of certain options.

²⁰³ Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1854.

Apparently the originating group paid \$94 per share, plus accrued dividends, for the preferred stock, and an average of \$31.78 for each share of common stock.²⁸⁴ The bankers also were given certain options expiring June 30, 1934, enabling them to purchase common stock in an unspecified portion of 45,000 shares at \$13½ per share, and 25,000 shares at \$50 per share.²⁸⁵

On April 18, 1929, The Goldman Sachs Trading Corporation received a participation of \$1,717,200 (about one-twelfth of the total) in the underwriting syndicate. This syndicate was terminated on June 5, 1929, all the stock having been distributed. The investment company received \$23,783.77 as its share of the income derived by the underwriting syndicate.²⁸⁶

Walter E. Sachs testified as follows:²⁸⁷

Q. Now, in connection with that distribution, the bankers operated a trading account in the Minneapolis Moline Stock?

A. There was a trading account which was formed, yes, at or about that time.

Q. Now, on June 27, 1929, the trading account sold to the Trading Corporation for delivery June and July 1, 1929, 10,000 shares of the common stock of Minneapolis Moline Power Implement at \$35 a share for a total of \$350,000.

A. Yes.

Q. Now, Goldman Sachs Trading Corporation had no participation in the trading account, did it?

A. No; I think that that is quite correct.

Q. There we have a situation where the banking firm was running a trading account, in connection with the syndicate operation and found, shall we say, a ready buyer in the investment trust of 10,000 shares.

A. I think it is well to point out at the same time that the 10,000 shares was sold to The Goldman Sachs Trading Corporation—10,000 shares. Check me if I am wrong on this—10,000 shares were sold for instance to The Chicago Corporation, which was an entirely independent investment trust.²⁸⁸

Mr. Sachs further testified:²⁸⁹

Q. But in any event the Trading Corporation was a purchaser of 10,000 shares from the trading account in which the banking firm was interested.

A. And again the banking firm thought that this was an investment that would be a profitable investment, and it was below the then market, as I recall, and it was for these reasons that I have repeated to you a number of times—

Q. Well, you say you thought that it was a good thing. You can conceive of situations where an investment banking house finding itself with a long position in a trading account, and seeking to terminate the account can sell the balance of its long position in the account to the investment company.

A. I can conceive of a lot of things, yes, and that is one of them.

Q. Now, these shares were subsequently sold during the Atlas management period of Goldman Sachs Trading Corporation, for a total of \$31,837.50, for a

²⁸⁴ Ibid., and supplemental information furnished to the Commission by Goldman, Sachs & Co.

²⁸⁵ Ibid.

²⁸⁶ Ibid.

²⁸⁷ Id., at 17284-5.

²⁸⁸ Reply to Commission's questionnaire for The Chicago Corporation, Pt. VI. The Chicago Corporation, which, like The Goldman Sachs Trading Corporation, had been a participant in the underwriting syndicate, had also been excluded from participation in the trading account formed by the bankers under the terms of the underwriting syndicate agreement.

²⁸⁹ Public Examination, The Goldman Sachs Trading Corporation at 17285-6.

loss of \$318,162.50, original cost being \$350,000. That was one of the transactions which took place aside from the type of transactions which took place in the Lambert Company,³⁰⁰—the investment company may be a purchaser from the trading syndicate in which the bankers are interested.

A. That comes under the head of a double or conflict of interest, if you wish to call it so.

(2) KELLY-SPRINGFIELD TIRE CO.³⁰¹

Goldman, Sachs & Co. were the investment bankers for Kelly-Springfield Tire Co.³⁰² and on December 31, 1928, owned the following securities which had been issued by that company:

4,900 shares Kelly-Springfield Tire Co. common.
500 shares Kelly-Springfield Tire Co. 6% preferred.
500 shares Kelly-Springfield Tire Co. 8% preferred.

Arthur Sachs, a partner in Goldman, Sachs & Co. and a director of the investment company, was also a director of Kelly-Springfield Tire Co.

By January 16, 1929, the bankers had disposed of their common stock holdings, and had bought another 10 shares. On the other hand, for account of The Goldman Sachs Trading Corporation, the sponsor had purchased and sold 10,000 shares of common stock and 100 shares of 6% preferred stock at a slight profit, but also had acquired 1,100 shares of 8% preferred stock. The sponsor liquidated its holdings of preferred stock in Kelly-Springfield Tire Company by October 19, 1931.³⁰³

The Goldman Sachs Trading Corporation subsequently purchased the following Kelly-Springfield Tire Co. shares:

1929		
4/12-6, 11	60,000 shares common stock.....	\$1,039,587.50
1/4 -5/24	2,800 shares 8% preferred stock.....	241,745.00
4/15	100 shares 6% preferred stock.....	8,520.00
Total.....		1,289,852.50

Goldman, Sachs & Co., with its long years of background and familiarity with the affairs of Kelly-Springfield Tire Co., sold its own holdings of 5,000 shares of common stock, but shortly thereafter caused The Goldman Sachs Trading Corporation to purchase 60,000 shares of this common stock.

Walter E. Sachs testified:³⁰⁴

Q. Will you please tell us what the investment policy was, which persuaded the banking firm for Kelly-Springfield Tire to advise the investment company

³⁰⁰ See discussion, *infra*.

³⁰¹ Moody's Industrial Manual for 1929 showed that Kelly-Springfield Tire Co. had operated at a considerable loss in 1926 and 1928 and had earned \$357,741 in 1927. The company's balance sheet as at December 31, 1928, recorded a deficit of \$1,285,580. No dividends had been paid on the preferred stocks since the first quarter of 1924, and none had been paid on the capital stock since November, 1921. Moody's rated the preferred stocks as speculative and the common stock was rated as highly speculative.

³⁰² Public Examination, The Goldman Sachs Trading Corporation, at 17260.

³⁰³ Derived from supplementary information supplied the Commission for The Goldman Sachs Trading Corporation.

³⁰⁴ Public Examination, The Goldman Sachs Trading Corporation, at 17262-3.

to purchase one million and a couple of odd hundred thousand dollars of Kelly-Springfield Tire, in the light of the record as contained in Poor's Manual?

A. I don't know whether Poor's Manual indicates the exact year in which the Kelly-Springfield Tire Company moved its plant to Cumberland, Maryland, but I do know that in that period there was the very distinct belief that through a change in the locale of operation, and because of the improved labor conditions, as a result of that, that that company would make a very definite come-back, and it was that—

Q. When did that improvement take place, do you remember?

A. I don't recall it at the moment, the exact year, I would have to refresh my memory on that, but it was in that period.

Q. According to Poor's Manual Kelly-Springfield had no earnings on its common stock in 1924, earned two dollars in 1925, had no earnings on the common in 1926, 1927, 1928, and 1929.

Q. And I am just curious to find out what the extent or value or the benefits of intimate knowledge that Goldman, Sachs & Company had of Kelly-Springfield to the Trading Corporation, because ultimately the investment company sustained a loss on the investment in Kelly-Springfield Corporation, on an investment of \$1,281,332.50, of \$1,078,262.06. The trading corporation virtually dropped every nickel that you invested in that, isn't that so?

A. That is perfectly true, but, Mr. Schenker, you are constantly losing sight of the fact, it seems to me, of the thing that we have tried to point out—

Q. That there was a depression?

A. Yes; that there was a depression, that conditions changed. I was discussing the situation at the time that these investments were made, and I have stated repeatedly that we didn't foresee the depression.³⁰⁵

The sponsor firm completely liquidated its own holdings of Kelly-Springfield Tire Co. 6% preferred stock (600 shares) and 8% preferred stock (500 shares) by October 19, 1931, while the larger holdings of the investment company were left intact, except for the sale of 100 shares of 6% preferred stock. The ultimate disposition of the holdings of The Goldman Sachs Trading Corporation did not take place until after Goldman, Sachs & Co. had relinquished control of the investment company to Atlas Corporation in April 1933.³⁰⁶

7. RESULTS OF MANAGEMENT BY GOLDMAN, SACHS & CO. OF THE GOLDMAN SACHS TRADING CORPORATION

The Goldman Sachs Trading Corporation was under the sole management of Goldman, Sachs & Co.³⁰⁷ from its inception on December 4, 1928,³⁰⁸ until Atlas Corporation acquired control of the investment company on April 17, 1933.³⁰⁹ Thereupon, as of the latter date, the management contract with Goldman, Sachs & Co. was cancelled. Walter E. Sachs continued as a director of the investment company,

³⁰⁵ Id., at 17261.

³⁰⁶ See Pt. Three, Ch. IV, p. 1523 et seq.

³⁰⁷ Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibit No. 1654.

³⁰⁸ Ibid.

³⁰⁹ Public Examination, Atlas Corporation, Commission's Exhibit 2001 (pp. 321-2).

and the name of the latter was then changed "so as to eliminate all reference to 'Goldman Sachs'" in accordance with the provisions of the management contract. The investment company thereafter functioned under the title of Pacific Eastern Corporation.

Mr. Catchings testified:³¹⁰

Q. In order to get the record straight, with respect to the \$326,000,000 The [Goldman Sachs] Trading Corporation raised, there is no doubt you controlled the disposition of that money in the first instance; isn't that so?

A. That is the money that was originally subscribed, and that was the stock that was issued in connection with the merger of F. & I., and that is the stock issued in connection with Shenandoah and in connection with financing the properties; we certainly did.

Q. Do you know what the net worth of The Goldman Sachs Trading Corporation was at December 31, 1932?

A. No.

Q. The net worth was \$33,709,003.21, or a shrinkage due to realized losses and unrealized losses on The Goldman Sachs Trading Corporation funds alone of \$289,566,330.34 * * *

Q. * * * the fact is that this money that was raised by September 1929, by December 31, 1932, in a period of three years, there was lost \$289,566,000 of the \$326,000,000 that originally went into the Goldman Sachs picture.

A. Do you feel the word "lost" is exactly accurate? That means the price of things went down. They have come back; and everything went down at that time.

Q. That observation would have some efficacy and some force if on December 31, 1932, you still had your original investments. * * *

A. * * * You say they had left \$33,000,000. That \$33,000,000, whatever it was, came back.

Q. Do you know to what extent it has come back?

A. When you take 1929 and compare it with 1932, you are going through a period when everything in the world went down, and I just want to point out, so that you will have it in mind, that everything went down at that time.

Q. And everything has gone up since that time?

A. The things that people held on to have gone up since that time.

Q. The fact of the matter is that the net worth, including unrealized depreciation of The Goldman Sachs Trading Corporation:

in 1932 was \$33,709,003.21;

in 1933, Mr. Catchings, it was \$27,686,371.29;

in 1934, it was \$29,750,770.94;

and in 1935, after that tremendous security rise in prices, it was still only \$39,817,033.

Of course, Mr. Catchings, once you sell a stock there is no way it can come back, so far as you are concerned, is there?

A. Well—

Q. Yes or no, please. We will never get a record unless I can get an unequivocal answer. You cannot have an appreciation in any situation unless you still own the situation.

³¹⁰ Public Examination, The Goldman Sachs Trading Corporation, at 15875-9.

A. But, if you have sold something and put the money into something else on the same general level, you can come back with the other things.

Q. The fact is that, during the years 1932 and 1933, it not only didn't come back, but it had flopped:

to \$33,709,003.21 in 1932;
to \$27,686,371.29 in 1933; and
to \$29,750,770.94 in 1934,

and that included the profit on the Blue Ridge transactions. The figures mentioned by Mr. Schenker are contained in an exhibit entitled "Pacific Eastern Corporation—Capital Account and Shrinkage of Capital," which details the total capital contributions \$329,675,631.22, return of capital \$7,039,782.67, and net capital contributed \$322,635,848.55.²¹¹

As at December 31, 1935, the net worth had been reduced to \$39,177,548.91, indicating a capital shrinkage or loss aggregating \$283,458,299.64. These figures reflect the result of operations and revaluation of portfolio items to market, or in the absence of market quotations, the fair estimate thereof by the management, as of December 31, 1935. If original cost, or market, whichever was lower, had been used as a basis for the items in its portfolio as at that date, the net worth of the investment company would have been \$23,998,241.94, thereby indicating a net capital shrinkage or loss of \$298,637,606.61 as of December 31, 1935.

PACIFIC EASTERN CORPORATION

*Capital contributions and subsequent disposal thereof **

Total Capital Contributions:

Original underwriting by Goldman, Sachs & Co.....	1,000,000 shs.	\$100,000,000.00
Additional shares issued to cover sales by company on		
New York Curb Exchange.....	125,000 shs.	15,776,010.50
100% stock dividend, February 1929.....	1,125,000 shs.....	

Cash contributions..... 2,250,000 shs. 115,776,010.50

Issued in exchange for assets of Financial and Industrial Securities Corporation, February 21, 1929..... 2,250,000 shs. 117,500,000.00

Issued in exchange for 2,000,000 shs. Shenandoah Corporation Common and 500,000 shares Shenandoah Corporation Preferred—Aug. 7, 1929.....	{	Paid in cash by	(20,025,000.00)
		Co.	
		238,096 shs..	45,025,000.00

Sale of 500,000 shs. Shenandoah Corporation Preferred to Goldman, Sachs & Co. in accordance with agreement of July 23, 1929.....	{	Book value of	
		Pfd. Stk....	(25,025,000.00)
		Rec'd in cash by Co.....	25,025,000.00

Issued in exchange for 528,733 shares American Co. (after deduction of 350 shares American Co. canceled)..... 679,776 shs. 71,388,020.72

Stock dividend payments (1929-30)..... 347,209 shs.....

Total received for stock issued..... 5,765,081 shs. 329,675,631.22

Total received..... \$329,675,631.22

* Public Examination, The Goldman Sachs Trading Corporation.

* By this method the investment company received \$5,000,000 in cash, in the last analysis, from the public.

²¹¹ See *infra*.

PACIFIC EASTERN CORPORATION—continued

Capital contributions and subsequent disposal thereto—Continued

Disposition of Above Capital Funds:

"Equalization" dividend of \$2 per share paid in March 1929.....	\$3,481,230.00	
Cash paid in lieu of stock dividends paid in 1929 and 1930.....	2,919,067.67	
Cost of 171,294 shares treasury stock at December 31, 1935.....	639,485.00	
Total return of capital.....		7,039,782.67
Net capital contributed.....		322,635,948.55
Applied as follows:		
Capital Charges, including items in re Financial and Industrial Securities Corporation merger.....	* 7,183,018.77	
Operating results:		
Profit from operations (before depreciation).....	(\$30,904,768.21)	
Write-down of securities 1929-35.....	322,359,356.05	
Unrealized appreciation at December 31, 1935.....	(15,179,306.97) * 276,275,280.87	
Total.....		283,458,299.64
Net worth as at December 31, 1935.....	{ At market, or in the absence thereof, at management's fair valuations.....	39,177,548.91

* These items represent a capital shrinkage of \$283,458,299.64 by valuing securities in the portfolio as at December 31, 1935, markets, or in the absence of market quotations, at management's fair valuations. If computed at cost or market, whichever was lower, the shrinkage in capital totaled \$298,637,606.61. Therefore, the capital shrinkage, based upon net capital contributed, would amount to 88% or 93%, respectively.

C. Lehman Brothers

Lehman Brothers is a co-partnership engaged in the investment banking and brokerage business in New York City. The firm holds membership on the New York Stock Exchange and on most of the important security and commodity exchanges of the country. Founded about 1848,³¹² the firm engages in the business of underwriting and distributing securities, trading in securities and commodities, both as brokers and for its own account, and participates in the management of various commercial, industrial, and financial enterprises, including investment companies.³¹³ Members and employees of the firm hold numerous directorships in a wide variety of business ventures.³¹⁴

Lehman Brothers entered the investment company field as a co-sponsor with Lazard Frères, another investment banking-brokerage firm, of General American Investors, Inc., in 1927. In 1929, Lehman Brothers organized its own investment company, The Lehman Corporation. Lehman Brothers also acted as distributor and broker

³¹² Public Examination, The Lehman Corporation, at 5325.

³¹³ Ibid.

³¹⁴ These included the following: automobiles, automobile accessories, aviation, banking, building and building supplies, business machines, drugs and cosmetics, food and dairy products, garments, glass, machinery and tools, mining, motion pictures, oil, radio, real estate, transportation, tobacco, shoes and leather. The total assets of the companies in which members of the firm served as directors or otherwise participated in the management amounted to more than \$2,500,000,000 at the end of 1936 and \$2,600,000,000 at the end of 1938. (Reply to Commission's questionnaire for The Lehman Corporation, item 68.)

for, and participated in, underwriting the securities of American International Corporation, another large closed-end, unrestricted management type investment company, and Selected Industries, Inc., an investment company of the same type. In addition to these companies, Lehman Brothers and Lazard Frères each owned a substantial stock interest in French & Foreign Investors Corporation, Inc.

The result of the entry of Lehman Brothers into the investment company field was that the firm thus had control of, or a substantial influence on, investment companies whose assets amounted to \$284,000,000 at the end of 1929 and \$180,000,000 at the end of 1936.³¹⁵

1. THE LEHMAN CORPORATION—INCORPORATION AND DESCRIPTION

The Lehman Corporation was incorporated under the laws of Delaware on September 11, 1929.³¹⁶ All the partners of the sponsoring firm were directors of the corporation which had no other directors.³¹⁷ The purpose of organizing the investment trust was stated in general terms by John M. Hancock, partner of Lehman Brothers and a vice president and director of the investment company:³¹⁸

A. The matter of an investment trust, and the wisdom of forming one, had been under consideration in the firm for a long period back, and I wouldn't attempt to be specific about it, and the partners had discussed the question at frequent intervals, and the decision was made in September of 1929, primarily because the partners came to the conclusion at that time that it was a wise thing to do.

Their purpose, of course, was to make money for the firm, if they could do a good job, and their purpose was also to create, in their opinion, as good an investment vehicle as they could.

There were the two major purposes, I suppose, back of it.

There were a number of ways by which benefits came to Lehman Brothers as a result of its sponsorship of The Lehman Corporation. These advantages may be divided into three groups: (a) direct and measurable benefits; (b) incidental benefits; and (c) indirect benefits which arose from the control of the large funds owned by The Lehman Corporation.

a. Direct and Measurable Benefits

(1) RECEIPTS AS ORGANIZER, PRINCIPAL UNDERWRITER, AND PRINCIPAL DISTRIBUTOR OF STOCK OF THE COMPANY

When The Lehman Corporation was formed in September 1929, Lehman Brothers agreed to purchase 1,000,000 shares of the capital stock of the corporation at \$100 per share, or a total price of \$100,000,000.³¹⁹ The sponsors retained 100,000 shares and syndicated the

³¹⁵ This figure does not include French & Foreign Investors, Inc., concerning which precise data are lacking. Other figures are taken from the replies to the Commission's questionnaire for the respective companies.

³¹⁶ Reply to the Commission's questionnaire for The Lehman Corporation, item 1.

³¹⁷ Id., item 3.

³¹⁸ Public Examination. The Lehman Corporation, at 5321-2.

³¹⁹ Reply to Commission's questionnaire for The Lehman Corporation, Item 6.

remaining 900,000 shares for public offering at \$104 per share.³²⁰ The sponsors also formed a selling group, of which they were members, to retail the stock to the public.³²¹ Group members received a concession of two points, and the underwriter-sponsor, the remaining two points.³²² Thus, on the sale of the stock, the sponsors not only received as underwriter \$2 on each share sold, or a total of \$1,800,000 in the offering, but also \$2 on each share that it retailed. The gross profits as underwriter were about \$3,600,000.³²³ However, with respect to the net profit of Lehman Brothers, Monroe C. Gutman, vice-president of The Lehman Corporation and partner of Lehman Brothers, testified:³²⁴

Q. What is your total profit from the sale of stock for the corporation?

A. Here I have a statement Mr. Sachs has prepared. I will give it to you exactly. Our gross profit before any selling group expenses, or any other expenses connected with the public issue, was four points on 900,000 shares, or \$3,600,000. From this should be deducted the following:

Selling commission.....	\$1,582,500.00
Syndicate expenses.....	\$321,900.63
Market stabilizing account, loss.....	\$1,243,159.26
Making total deductions of.....	\$3,147,309.89
Leaving a net profit of.....	\$452,690.11

If we deduct from this the loss which would come on the securities which we had purchased for the corporation before this money was paid in and reimbursed the corporation for it, as to the difference between the market price on that date and the cost of those securities, this sum was \$269,787.62, which would leave a net profit of \$182,902.49.

In addition to the above, Lehman Brothers, as members of the selling group, subject to the expenses and salesmen's commission's involved, made \$479,243.

(2) BROKERAGE COMMISSION

When considering the formation of The Lehman Corporation the sponsors had in mind the possibility of brokerage business for themselves.³²⁵ Mr. Hancock testified:

A. Yes; there was to develop a possibility of brokerage, gross brokerage, out of the business done by the corporation, primarily, of course, on the Stock Exchange.

The sponsor was able through its control of the directors, to obtain for themselves the exclusive brokerage of Lehman Corporation. The brokerage received from the investment company constituted 25% of the firm's entire brokerage income.³²⁶

While a certain part of this brokerage was dispensed to other brokers such as floor brokers, specialists, etc., the total gross commissions received by Lehman Brothers from The Lehman Corporation

³²⁰ Ibid.

³²¹ Ibid.

³²² Ibid.

³²³ Public Examination, The Lehman Corporation, 5709-10.

³²⁴ Ibid.

³²⁵ Public Examination, The Lehman Corporation, at 5322.

³²⁶ *Id.*, at 5357.

for the period from the inception of the company to December 31, 1935 (a period of about six and a half years), aggregated approximately \$1,200,000.³²⁷

(3) MANAGEMENT FEES

On September 16, 1929, when the sponsors controlled the investment company, they entered into a contract between themselves and the company, whereby the sponsors were to act as general managers of the company; to supervise financial transactions, advise with respect to the purchase and sale of securities, and render available to the company its judgment, experience and statistical information.³²⁸ As compensation for these services, the sponsors were to get 12½% of the income on the invested capital, payable out of the net profits of the corporation after paying all expenses, deducting unrealized depreciation but excluding payments under the agreement itself and the payment of 6% on the stock. Deficiencies in the compensation were to carry over until paid.³²⁹

Under the language of the agreement, no payments could be made thereunder unless and until the assets of the corporation at any year end aggregated \$100,000,000.³³⁰ Since the stock market collapse occurred shortly after the execution of the agreement, and a substantial part of the stock was retired in the period that followed, the capital assets never reached this figure. No management fees were therefore paid to Lehman Brothers under that contract. In order to secure some compensation for their services, the management contract was amended by a vote of the shareholders on October 22, 1935, so that the invested capital at such date was fixed at \$100 per share outstanding or a total of \$68,270,000, and the rate of compensation was fixed at 8½% of the invested capital, after deducting 4% on such invested capital for payment of dividends to stockholders.³³¹ The sums thus paid or payable under this agreement amounted to \$1,335,000 from October 1935 to June 30, 1937.³³²

John M. Hancock, vice president and director of The Lehman Corporation and a partner of Lehman Brothers, testified:³³³

A. The principal change was changing the basis from which compensation was reckoned. Previously it had been that the management fee was 12½ per cent of the total, provided 6 per cent were earned and paid to stockholders, accumulative; taking that same [principle], it was changed to 8½ against 4 per cent having been paid.

³²⁷ These commissions for brokerage also included the transactions with the company wherein the sponsor, although acting as a dealer in purchases and sales of the company's portfolio securities, really was acting as a broker, i. e., includes over-the-counter transactions.

³²⁸ See reply to Commission's questionnaire for The Lehman Corporation and supplementary material.

³²⁹ *Ibid.*

³³⁰ *Ibid.*

³³¹ *Ibid.*

³³² *Ibid.*

³³³ Public Examination, The Lehman Corporation, at 5349-52. It will be noted that the testimony here quoted, taken on November 9-10, 1936, obviously does not take into account the period to the end of 1936. Material covering the year-end 1936 was supplied the Commission by The Lehman Corporation in the spring of 1937.

Q. Now, under this new contract the assets of the trust have to amount to \$68,000,000.

A. We start with values as of December 30 [5], 1935.

Q. Now, this new contract went into effect October 16th, and I have the figures here that up to September 30, 1936, under this contract, you have actually payable on realized profits, \$596,000.

A. No, I think that is not correct.

Q. It is payable but not paid.

A. That may be correct. My recollection is that \$432,000 have been paid, and nothing is payable at [until] the end of a period. You may compute and you may figure that it may be payable, but again it may not.

Q. Actually you had realized appreciation through September 30, which would entitle you to \$168,000.

A. If we don't have some outside losses later on; but that is pure——

Q. You have also accrued on your books for unrealized appreciation, for management fee, \$1,275,000.

A. That is correct, if we get it.

Q. So that, if you stop today without any alteration, for this period, you would have a total of \$1,871,200.

A. If we could sell the securities at the valuation stated, and assuming also that we didn't get some further possible deductions for the new corporate tax, undistributed earnings tax.

Q. So that that is approximately \$1,800,000 on gross assets of about \$90,000,000; isn't that right, for a period of a year, approximately a year, let us say?

A. Let us say seven years.

Q. This is for a year, this particular period, isn't it?

A. Well, we understand each other, and I don't agree with you, and I say it is for seven years, and you think it is for one.

Q. Well, let me ask you whether this isn't calculated on the profits for one year.

A. Correct.

Q. Correct?

A. Yes.

Q. All right. Now the reason that you say it is for seven years is because you say that you didn't receive any compensation from your——

A. I know that it was for at least seven, and maybe for seventeen years. I can't see the future, but I know that it was seven years past, and that was the total compensation.

Q. But under this new management contract, that is giving you compensation, assuming things standing the way they are, at the rate of \$1,800,000 per year; that is correct, isn't it?

A. That is possible.

(4) PROFITS ON SALES BY SPONSORS AS PRINCIPALS

Lehman Brothers as principals sold securities to The Lehman Corporation for the latter's portfolio and purchased portfolio securities from The Lehman Corporation.³³⁴ Such transactions were not

³³⁴ Id., at 5317. Mr. Hancock testified:

Q. Then there is the purchase of securities for investment from the firm [Lehman Brothers] as principal, instead of through them as broker?

A. There were some.

only simple purchases and sales, but in some cases involved securities in the hands of the sponsor or the investment company at the termination of a trading operation, or at the close of an underwriting or other joint venture, wherein the investment company placed its unsold allotments in its portfolio or the sponsor purchased the securities from the investment company.

During the period 1929-1935 securities were sold by the sponsors as principals to the investment company at a total price of \$11,104,-686.10.³⁸⁵

An example of the incidental benefit to the sponsor is the fact that out of the aggregate of the \$209,495 paid by The Lehman Corporation as fees for registration, transfer, and custody of securities from the date of organization to December 1935, \$184,477 was paid to the Commercial National Bank and Trust Company, which was sponsored and controlled by Lehman Brothers.³⁸⁶

b. General Benefits

The third, and perhaps the most significant type of benefit which the firm of Lehman Brothers received by virtue of its sponsorship of The Lehman Corporation consisted of intangible advantages which are not measurable but are of incalculable importance to the sponsors.

The investment banking business consists primarily of the underwriting and distribution of securities. One of the principal problems of investment bankers is finding companies which need or desire financing of this type and who will employ such investment bankers to distribute their securities. Frequently, investment bankers are represented on the boards of directors or otherwise in the management of their banking clients. It is invariably urged that they are so represented: (a) to protect the interests of their customers—the persons to whom they have sold the securities of the corporation; and (b) to give the corporation the benefit of the experience and knowledge of such representatives. However, no small element of this representation is the fact that the investment bankers are in a better position because of this representation to maintain and protect their status and interests as the corporation's bankers. Any circumstance, therefore, which gives an investment banking house additional opportunities for securing new business, for protecting old business, or for increasing its contacts and stature in the business community is not merely desirable, but is essential to the investment banking business. An investment company creates a multitude of such circumstances.

The Lehman Corporation furnished means of assisting and increasing its sponsors' normal banking operations; and created goodwill and influence as a potential purchaser of securities and a potential lender of funds, and a large stockholder in important corporations.

(1) USE OF SPONSORSHIP TO FACILITATE BANKING OPERATIONS

The charter and the express policy³⁸⁷ of The Lehman Corporation contemplated participation by the company in underwriting and trading activities. The investment company did, in fact, participate sub-

³⁸⁵ Derived from supplemental information submitted to the Commission for Lehman Corporation.

³⁸⁶ *Ibid.*

³⁸⁷ Reply to the Commission's questionnaire for The Lehman Corporation, items 3 and 9.

stantially in underwriting and trading activities. When the firm of Lehman Brothers engaged in a financing operation for a client, it was in the position of having Lehman Corporation advance the cash or credit to help the operation along by participating in the underwriting.

(2) GOODWILL AS LARGE PURCHASER OF SECURITIES

Only a few institutional investors are able to make such large purchases as are investment companies. It is apparent that sponsors of investment companies which are among the largest purchasers of securities are in an advantageous position with respect to their dealings with corporations which are sellers or potential sellers of such securities. Sponsorship of The Lehman Corporation placed Lehman Brothers in such a position. Examples of such purchases are those of 50,000 shares of U. S. Foil Company, 100,000 shares of Simms Petroleum Corporation, and 60,000 shares of Columbia Broadcasting Corporation stock from Paramount Publix Corporation.³³⁸

(3) INFLUENCE AS A LARGE STOCKHOLDER IN NUMEROUS CORPORATIONS

As the dominant influence in a corporation which holds large blocks of stock in various corporations, Lehman Brothers was enabled to increase its general influence and prestige. This influence was not only an intangible factor but apparently was exercised.

A single incident will illustrate this point. In 1935, The Lehman Corporation was the owner of over 4% of the stock of the Brooklyn-Manhattan Transit Company, while at the same time Lehman Brothers was the owner of about 3.4% of the same stock.³³⁹ This made a total of about 7.5% of the stock one of the largest single blocks, controlled by Lehman Brothers. Lehman Brothers participated in the financing of the Brooklyn-Manhattan Transit Company for the first time when, in 1935, they were participants in an underwriting syndicate for an issue of the portfolio company's securities.

Monroe C. Gutman, vice president and director of the Corporation, testified with respect to this situation:³⁴⁰

A. We had a block of B. M. T. We originally had some small holdings. Then the corporation bought a block of B. M. T. at a time when in the course of certain provisions in a bank loan which they had, the dividend had to be passed, even though the earnings were fairly good. We made a very thorough study at that time. I think the suggestion to make the study came from the firm. We made a thorough study and we bought a big block of stock at a time when it was under pressure and bought at great advantage. I think on the block of stock the corporation purchased at that time it has a book profit, most of which is realized, somewhere in the neighborhood of a half million dollars, so that our judgment was vindicated. We had no idea at the time we made that purchase of going on the Board or doing any banking business for the B. M. T.

Q. But that has resulted in—

³³⁸ Public Examination, The Lehman Corporation, at 5622-4.

³³⁹ Reply to Commission's questionnaire for The Lehman Corporation, supplemental information. See also Public Examination, The Lehman Corporation, at 5470-2.

³⁴⁰ Public Examination, The Lehman Corporation, at 5470-2.

A. Let me finish the story. I will give you the whole picture, and then you can draw your own conclusions. Sometime after that we were asked by another interest whether we would represent them and ourselves on the Board. We told them we had no particular desire to, but if we were asked to we would consider it, and as a result we were asked to represent our own shareholdings and another interest on the Board of the B. M. T. Then as it happened the Chase Bank, which was forbidden under the new law to do financing, and which had been a participant in the B. M. T. financing, withdrew, and then we made a request to try to get their place, to get some of their place.

Q. You made a request—

A. To get some of their place in the financing.

Q. Whom did you make the request of?

A. Of the banking firm that had headed the financing.

Q. And who was that?

A. Hayden, Stone & Company.

Q. Wouldn't you say your stock interest and your directorship on the Board there had definitely resulted in financing for the firm?

A. I would like to put it this way, if I may. I would like to put both sides. I would say that the firm's judgment on B. M. T. and the suggestions they made to the corporation made a half million dollars for the corporation, and I would say that probably there was some incidental benefit to the firm that probably helped them get a position which they might or might not otherwise have gotten.

Q. I am saying that your stock interest and your directorship in that case, did have—

A. It helped some.

Q. —a helpful influence?

A. Yes.

It is not possible to isolate each transaction and show categorically each item of new business secured by the sponsor as a result of each investment made by The Lehman Corporation. It is a fact, however, that subsequent to the formation of the Corporation the sponsor participated in the financing of a large number of companies in which the Corporation had substantial investments and that these participations were new accounts for Lehman Brothers.

By September 1936 Lehman Brothers were represented on the boards of directors of 34 corporations on whose boards they were not represented prior to the formation of The Lehman Corporation.³⁴¹ At the end of 1939 the portfolio of The Lehman Corporation consisted of the securities of 166 companies.³⁴² Lehman Brothers was represented on the boards of directors of 19 of these portfolio companies at the end of 1939, and in the preceding three years had underwritten securities for at least 29 of them.³⁴³

Since 1936 Lehman Brothers have acted as underwriters for least 51 security issues of companies whose securities or the securities of whose parents were in the portfolio of The Lehman Corporation.³⁴⁴

³⁴¹ Reply to the Commission's questionnaire for The Lehman Corporation, supplemental information.

³⁴² *Ibid.*

³⁴³ *Ibid.*

³⁴⁴ *Ibid.*

(4) INFLUENCE AND GOODWILL AS A POTENTIAL LENDER OF FUNDS

The Lehman Corporation made the following loans: In 1929, Meyer Mittenenthal, \$286,428; Burton F. Peek, of Deer & Co., \$186,260; Sidney Z. Mitchell, of Electric Bond and Share Corp., \$1,858,868; George Pick, of Pick, Barth & Co., \$11,409; in 1930, Julius Rosenwald, of Sears, Roebuck & Co., \$1,083,428; National Union Corp., \$100,000; The Hitofa Company, \$375,000; and the Rhodesian Selection Trust, \$232,352, which was increased to \$364,983 in 1931. All these loans were repaid by the end of 1935.

Mr. Bunker testified with respect to some of these loans:³⁴⁵

Q. Now, in how many of those eight loans did the firm also have an interest? Are you familiar with that? How about the Penney firm?

Q. On the S. Z. Mitchell there was, because it came from the firm?

A. Not at the same time.

Q. Not at the same time; but it was taken over by the trust from the firm, was it not?

A. That is right.

Q. And the same applies to the Penney loan? That was taken over with the Mitchell?³⁴⁶

A. Yes.

Q. So that that came from the firm, too?

A. Yes.

Q. And the Julius Rosenwald was also something that the firm was interested in, wasn't it?

A. I don't think the firm was interested in it.

Q. I don't know whether the firm was. It was in the Penney account, but didn't that go through the firm originally?

A. That particular one had come to us through the firm.

Q. Came through the firm, and Rosenwald was a friend of the firm?

A. That is correct.

Mr. SELIGMAN (counsel for Lehman Corporation): By interest you don't mean any financial interest in the firm?

By Mr. SMITH:

Q. Let us make it clear. The firm had no financial interest in it.

A. That is right.

Q. They had merely a connection with Rosenwald because of their interest in Sears, Roebuck, and your firm had been interested in the financing?

A. That is right.

Q. How about this Mittenenthal loan? That carried options to purchase Interstate Department Stores stock.

A. Well, about that, that loan was paid off in full, and some of the options were exercised.

Q. Just so we clear this up. I understand all these loans were paid off.

A. That is right; all paid off.

³⁴⁵ Public Examination, The Lehman Corporation, at 5520-25.

³⁴⁶ A correction in the transcript of the Public Examination of The Lehman Corporation, p. 5521, made by The Lehman Corporation states that the Penney loan was taken initially by the corporation and not from the firm; that the Mitchell account was not taken over by the corporation from the firm at the same time as the Penney loan was made. (See letter from The Lehman Corporation inserted at beginning of transcript of testimony.)

Q. Was the firm interested in Interstate Department Stores, or any of its subsidiaries, do you know? Maybe I shouldn't ask you these questions about the firm, because you are not a member of the firm.

A. At that time, I don't know.

Mr. SELIGMAN: I think the answer is the firm had done financing for Interstate Department Stores prior to the loan.

Mr. SMITH: The firm had done financing prior to the loan.

Mr. SELIGMAN: Yes, sir.

By Mr. SMITH:

Q. And the Pick loan, you said the firm was not interested in; is that right?

A. That is correct.

Q. That involved purchase of direct stock?

A. Yes.

Q. The National Union Radio loan, the firm had a substantial interest in that company?

A. They had done banking for that company.

Q. And had a substantial interest in it, I believe?

A. I don't know that. They had a member on the Board.

Q. The firm had a substantial interest in National Union Radio, did it not?

Mr. SELIGMAN: Yes.

By Mr. SMITH:

Q. The answer is yes, and they financed the company, and they had a member on the Board?

A. Yes.

Q. The Hitofa loan. You don't know what that loan was for. How did you get into that? That was a loan for \$375,000.

A. It was. That was brought to us again through Lehman Brothers. That was collateralized with Burroughs Adding Machine stock.

Q. What was the purpose of the loan—who was the Hitofa?

A. It was a corporation.

Q. A private holding company?

A. Formed entirely for the making of this loan.

Q. In other words, the holders of this Burroughs Adding Machine stock needed cash, is that right, so they formed a separate corporation, put the stock in and made the loan? * * *

A. That is my impression. Our natural major concern was whether the collateral was good, whether the loan was good, and whether the opportunity for profit was interesting.

* * *

Q. You did not have any individual obligation at all?

A. No, sir. It was a collateral loan, with options to purchase.

2. AFFILIATION OF LEHMAN BROTHERS WITH OTHER INVESTMENT COMPANIES

Lehman Brothers sponsored, or participated substantially in, the management, brokerage, the underwriting or distribution of the securities of at least three investment companies other than The Lehman Corporation: General American Investors Company, Inc., American International Corporation, and Selected Industries, Inc. In addition, Lehman Brothers owned a substantial stock interest in

French & Foreign Investors Corporation, a French investment company.³⁴⁷

It is significant that the portfolios of these investment companies sponsored or cosponsored by Lehman Brothers were substantially duplicated. For example, at the end of 1929, 68% of the portfolio of The Lehman Corporation was duplicated in the portfolios of General American Investors Company, Inc., Selected Industries, Inc., or American International Corporation; 54% of the portfolio of General American Investors Company, Inc., was similarly duplicated in the portfolios of the other three investment companies; 47% of the portfolio of American International Corporation was similarly duplicated in the other three portfolios, and 36% of the portfolio of Selected Industries, Inc., was duplicated in the other three portfolios. At the end of 1939, 62 of 193 portfolio holdings of The Lehman Corporation were also in the portfolio of General American Investors Company, Inc., which had a total of 102 issues. In other words 32% of the portfolio of The Lehman Corporation was duplicated by that of General American Investors Company, Inc., and 61% of the latter's portfolio was duplicated by the former. Of 138 issues of common stock held by The Lehman Corporation 46 were held in common with General American Investors Company, Inc., which held 70 common stock issues.

French & Foreign Investors Corporation, a French investment company in which Lehman Brothers, The Lehman Corporation, Lazard Frères, and General American Investors Company, Inc., had a substantial stock interest, was not a company in which there was control or notable influence exercised by Lehman Brothers.

a. General American Investors Company, Inc.

General American Investors Company, Inc., was formed in 1929 under the laws of Delaware as a result of a merger under the cosponsorship of Lehman Brothers and Lazard Frères. The predecessor companies were General American Investors Company, Inc., incorporated in 1927 under the laws of Delaware, and General American Investors Company, Inc., incorporated in 1928 under the laws of Delaware, both of which had been sponsored by the same two firms.³⁴⁸

(1) BROKERAGE

Lehman Brothers received about one-half of the brokerage business of the investment company. Raymond D. McGrath, vice president of General American Investors Company, Inc., and a partner of Lazard Frères, testified:³⁴⁹

A. The brokerage is allocated 50-50 between Lazard Frères and Lehman Brothers.

³⁴⁷ This list represents only the companies answering the general description of investment companies and in which there was a substantial public investment. It does not include the various other corporations such as the real estate and holding corporations which the corporation owned completely.

³⁴⁸ Public Examination, General American Investors Company, Inc., at 5715. Public Examination, The Lehman Corporation, at 5335-6.

³⁴⁹ Public Examination, General American Investors Company, Inc., at 5838.

Q. Is that by virtue of any written agreement, or is that just an arrangement?

A. That is just the arrangement.

Q. Has that been so throughout the time the corporation has been in existence?

A. Yes.

The net brokerage commissions of the investment company up to December 31, 1935, amounted to \$982,892. In the year 1929 alone, the net brokerage commissions aggregated \$208,078.³⁵⁰

(2) SALES TO COMPANY BY LEHMAN BROTHERS AS UNDERWRITER AND DISTRIBUTOR

General American Investors Company, Inc., bought large blocks of securities for which Lehman Brothers were underwriters, or wholesale or retail distributors.

(3) SALES OF THE CAPITAL SECURITIES OF THE INVESTMENT COMPANY BY LEHMAN BROTHERS

Lehman Brothers had a 50% participation in the distribution of the securities of General American Investors Company, Inc. (after the merger); Lazard Frères was the other underwriter. The total underwriting commissions paid to the sponsors (Lehman Brothers and Lazard Frères) amounted to \$467,577 for the period from 1927 to 1935, inclusive. In addition, 25-year warrants to purchase 500,000 shares of the common stock at \$15 per share were received by the sponsors as partial compensation for underwriting the offering of 100,000 shares of voting preferred stock.³⁵¹

(4) SALE OF STOCK OF THE LEHMAN CORPORATION TO GENERAL AMERICAN INVESTORS COMPANY, INC.

Lehman Brothers sold a large block of the stock of The Lehman Corporation to General American Investors Company, Inc. The latter company acquired this stock at a cost of \$3,068,000, and the stock represented about 4.4% of that outstanding. It was held intact until 1933, when part of it was sold at a loss of \$632,000. In 1935 another part of it was sold at a loss of \$524,000. At the end of 1935 General American Investors Company, Inc., still held shares of The Lehman Corporation carried at a cost of \$1,133,000.³⁵²

(5) INFLUENCE OF LEHMAN BROTHERS IN GENERAL AMERICAN INVESTORS COMPANY, INC.

Four of the eight members of the original board of directors of General American Investors Company, Inc., were partners of Lehman Brothers.

³⁵⁰ Derived from supplementary material supplied the Commission for General American Investors Company, Inc.

³⁵¹ Derived from material supplied the Commission for General American Investors Company, Inc. See also testimony of Raymond D. McGrath, Public Examination, General American Investors Company, Inc., at 5728, et seq.

³⁵² Derived from material supplied the Commission for General American Investors Company, Inc. Public Examination, General American Investors Company, Inc., at 5731.

While it was testified ³⁵³ that Lazard Frères assumed a more active part in sponsorship of this company than Lehman Brothers, the latter firm had 50% control and their influence was not insubstantial.

b. Selected Industries, Inc.

Selected Industries, Inc., was incorporated in Delaware on December 15, 1928. Its maximum assets, at December 31, 1929, amounted to \$81,019,000 (market). Its primary sponsors were members of the Reynolds-Barney group.³⁵⁴

While Lehman Brothers were not the organizing sponsors of Selected Industries, Inc., they had a 19% participation in the underwriting of the company's stock. Robert Lehman, a partner of Lehman Brothers, was a director of the company, so that Lehman Brothers participated in the management of Selected Industries, Inc.

(1) BROKERAGE

Selected Industries, Inc., awarded its brokerage, prior to May 1931, to its five sponsors, among whom was Lehman Brothers. This business was distributed pro rata to the sponsors based on their participation in the underwriting of the company's stock, which in the case of Lehman Brothers was 19%.³⁵⁵ No data are available to indicate the exact amount of this brokerage commission.

(2) SALE OF THE CAPITAL SECURITIES OF THE INVESTMENT COMPANY BY LEHMAN BROTHERS

Lehman Brothers had a 19% participation in the original offering of the stock of Selected Industries, Inc.³⁵⁶ The total commission to underwriters on this distribution was \$4,200,000 and the share of Lehman Brothers of this commission was \$806,400.³⁵⁷ In addition to this commission, the sponsors realized a substantial profit by having taken over a substantial quantity of junior securities of the company and distributing them to the public.³⁵⁸

c. American International Corporation

American International Corporation was incorporated under the laws of New York on or about November 23, 1915, under the original sponsorship of Frank A. Vanderlip and other officials of National

³⁵³ The testimony of Mr. Hancock, Public Examination, The Lehman Corporation, at 5336.

³⁵⁴ This group consisted, among others, of R. S. Reynolds, C. K. Reynolds, G. C. Allen, W. R. Perkins, and Chas. D. Barney & Co. In addition to these persons and Lehman Brothers, other sponsors were Stone & Webster and Blodget, Inc., Kidder Peabody & Co. (predecessor firm), Brown Brothers (predecessor to Brown Brothers, Harriman & Co.), and Tri-Continental Corporation. (Reply to Commission's questionnaire for Selected Industries, Inc., item 5.)

³⁵⁵ Reply to Commission's questionnaire for Selected Industries, Inc., supplemental information.

³⁵⁶ Public Examination, The Lehman Corporation, at 5336.

³⁵⁷ Derived from supplemental information submitted to the Commission for Selected Industries, Inc.

³⁵⁸ Ibid.

City Bank of New York. At the year-end 1929 its assets aggregated about \$60,000,000.³⁵⁹

Harry A. Arthur, president, American International Corporation, testified:³⁶⁰

Q. I also notice that during that period, Lehman Bros. received some of the commissions, \$33,110.60 in 1929, and then they take a few thousand dollars every year thereafter. Of course, it is evident, is it not, and I am not being critical of that situation, that with the association of a brokerage firm or banking firm with an investment trust, the brokerage commission flows to that firm, does it not?

A. To some extent.

Q. That was true, and you notice Lehman Bros. got no commission from American International before 1927; isn't that so?

A. Before 1929.

The total amount of these brokerage commissions received by Lehman Brothers from this company for the period 1929 to 1935, inclusive, was \$49,547.³⁶¹

(1) SALES OF PORTFOLIO SECURITIES TO THE AMERICAN INTERNATIONAL CORPORATION BY LEHMAN BROTHERS

During the period 1929 to 1935, inclusive, American International Corporation acquired certain securities which Lehman Brothers had underwritten, and certain securities from Lehman Brothers as principal. The cost to the investment company of the securities for which Lehman Brothers were the underwriters was approximately \$1,505,055 and of those purchased from Lehman Brothers directly were approximately \$475,875, or a total of \$1,980,920 of securities.³⁶²

(2) SALE OF CAPITAL SECURITIES OF AMERICAN INTERNATIONAL BY LEHMAN BROTHERS

Lehman Brothers participated in the distribution of the securities of American International Corporation. On January 18, 1929, Lehman Brothers and Lazard Frères jointly underwrote an issue of 20-year 5½% debentures in the principal amount of \$25,000,000. The public paid \$26,250,000, and the gross underwriting commission was \$1,250,000.³⁶³ From this point on Lehman Brothers was represented on the board of directors of the company.³⁶⁴

3. CONFLICTS OF INTEREST

The possible conflict of interest which appears where several companies are under common sponsorship is best illustrated in connection with portfolio management. Portfolio management is the primary duty of managers of investment companies. Because the business of investment companies is the management of assets consisting of participations in other enterprises, and it is the degree of success

³⁵⁹ Reply to Commission's questionnaire for American International Corporation, item 13.

³⁶⁰ Public Examination, American International Corporation, at 6797.

³⁶¹ Reply to Commission's questionnaire for American International Corporation, supplemental information.

³⁶² Reply to Commission's questionnaire for American International Corporation, supplemental information.

³⁶³ Ibid.

³⁶⁴ Public Examination, The Lehman Corporation, at 5337.

or failure in performing this function which determines the effect on the investors' money, persons presumptively expert in financial matters become managers of these companies. When situations arise which preclude the unbiased rendition of this service the likelihood of harm to investors is greatly increased.

With reference to the portfolio duplication among the investment companies sponsored by Lehman Brothers, Mr. Gutman testified:³⁶⁵

Q. Mr. Gutman, I think I would like to take up this morning this comparative list of the portfolios in 1929 of Lehman Corporation, General American, American International and Selected Industries, of which I had a table made up showing the overlapping or duplication, showing that 68 percent of Lehman Corporation was duplicated in the other portfolios, and lower percentages for the other trusts.

A. Yes.

* * * * *

The WITNESS: I would start in by saying, Mr. Smith, this tabulation is doubtless mathematically accurate, but I frankly believe it has no significance at all. To begin with, I would say the fact that 68 percent of our portfolio is duplicated in the other corporations means nothing so far as the investment policy is concerned. For example, if one concern had \$1,921,000 in Liggett and Myers and we, The Lehman Corporation, had \$181,000, and the American International Corporation had nothing, and the General American Corporation had nothing, I would say the fact that we had \$1,900,000 happens to be part of the total, and the \$181,000 happens to be part of the total, shows no parallel of investment policy at all as between them.

Mr. Gutman testified that as between The Lehman Corporation and any other of these companies The Lehman Corporation would be given preferential treatment by Lehman Brothers:³⁶⁶

Q. Mr. Gutman, I want to ask you about the problems that happen when you want to make joint purchases or joint sales, and you have a question of simultaneous action by The Lehman Corporation, and your investment advisory service, the brokerage plant of Lehman Brothers, by Lehman Brothers as a firm, and by Lehman Brothers individually, and by Lehman Brothers as officers of General American Investors?

A. Yes.

Q. What do you do in a case of that sort?

A. Let me start with General American Investors first. In General American Investors, General American Investors Company is really more run in Lazard Frères office than in Lehman's office, and the initiative is more with Lazard Frères' staff than with the research staff of General American Investors. We communicate with them over the telephone and go to executive meetings which are held weekly, but we do not feel in the General American case the same responsibility as we do in The Lehman Corporation.

Q. So that as between General American and Lehman Corporation, The Lehman Corporation would take precedence; is that it?

A. If we have an idea, it would go first to The Lehman Corporation.

Q. Suppose you have information that indicates getting rid of a certain security, of a certain particular type of security, is desirable, that would go to The Lehman Corporation ahead of General American?

A. It probably would.

³⁶⁵ Id., at 5487-8.

³⁶⁶ Id., at 5697-9.

III. PURCHASES AND SALES OF PORTFOLIO SECURITIES

Sponsors, in their capacity as sellers of securities to and purchasers of securities from investment companies, perpetrated many abuses. They not only sold securities to investment companies to realize profits as principal or commissions as brokers, but also sold securities to these companies for a variety of other reasons. For example, "dumping" (selling to a controlled investment company securities which are otherwise unmarketable at the sale price) was very common. Also, the sponsors frequently sold securities to their investment companies in order to secure, facilitate, or maintain control of the portfolio companies, or to aid in mergers, consolidations, or other objectives of sponsors. Sales were also made to investment companies by sponsors to secure various indirect benefits.

A. Sale of Original Portfolios

In many cases sponsors sold substantial blocks of securities to the investment companies immediately after the organization of these investment companies. In some cases the entire original portfolios of the investment companies consisted of securities sold by the sponsors to the investment company. In other words, after the sponsors had raised the cash capital of the investment companies by a public distribution of securities and turned over that cash, less the selling commissions, to the company, they then sold portfolio securities to the investment company and received the cash back again in payment for such securities. In some instances, the original portfolio of the investment company was contributed to the investment companies by their sponsors for all the issued stock and other capital securities of the investment company.¹ An examination of these initial portfolio transactions usually discloses the real motives which prompted the sponsors to organize the investment company. Several illustrations may be cited.

1. ITALIAN SUPERPOWER CORPORATION

Italian Superpower Corporation was incorporated on January 19, 1928, under the laws of Delaware.² The joint sponsors were Bonbright & Co., of New York; Field Glore & Co., Inc., of Chicago, both investment bankers, and Banca Commerciale Italiana, a commercial bank of Milan, Italy.³ Total contributed capital amounted to \$34,957,902.⁴

¹ For a detailed discussion of this type of transaction see the Report of United States Senate Committee on Banking and Currency on Stock Exchange Practices, on page 3 et seq.

² Reply to the Commission's questionnaire for Italian Superpower Corporation, item 1.

³ Idem, item 5.

⁴ See Pt. Three, Ch. V, pp. 1621-4.

In anticipation of the creation of the company, the sponsors entered into an agreement among themselves on December 5, 1927, whereby the portfolio securities, consisting of shares of various Italian public utility companies owned by various of the sponsors, were to be sold to the investment company and paid for two-thirds in cash and one-third in preferred stock of the investment company.⁵ The cash was to be raised by the public sale of \$20,250,000 principal amount of 35-year 6% debentures to the public in the United States through the American sponsors.⁶ The sponsors were to receive, without cost, all the voting common stock of the investment company, to be divided equally between the American and Italian sponsors, while the non-voting common stock was to be given as a bonus with the preferred stock and the debentures.⁷

After the formation of the company the Italian sponsors, on January 31, 1928, delivered securities valued under the contract at \$26,964,300 to the investment company.⁸ These securities consisted of the Italian utility stocks accumulated by the Italian sponsors before and during the negotiations leading to the formation of the investment company.⁹ Additional shares, valued under the agreement at \$1,287,200, were delivered to the company by the American sponsors.¹⁰ The total amount of securities which its sponsors sold to Italian Superpower Corporation was thus \$28,251,500.¹¹

These securities had risen in market value to \$31,957,902 by January 31, 1928, and the sponsors found it unnecessary to issue all the non-voting common stock with the debentures in order to facilitate their sale.¹² Only 101,250 shares of this stock, together with warrants to purchase 202,500 additional shares at \$10 to \$20 per share, were issued with the debentures.¹³ Another 120,000 shares of non-voting preferred shares to affiliates of the sponsors.¹⁴ The remaining 748,750 shares of non-voting common shares and all the voting common stock were retained by the sponsors.¹⁵ Thus, although the American investing public contributed over 58% of the total assets of the investment

⁵ Id., Part I, Exhibit C-4.

⁶ Ibid.

⁷ Public Examination, Italian Superpower Corporation, at 7565, 7660-4.

⁸ Derived from supplementary information supplied the Commission by Italian Superpower Corporation.

⁹ Ibid.

¹⁰ Ibid.

¹¹ The following were the initial securities sold to the company by the sponsors: Adriatic Electric Company, 225,000 shares; General Electric Company of Sicily, 450,000 shares; Bologna Electric Company, 80,000 shares; General Italian Edison Electric Company, 50,000 shares; Terni Company for Manufacture and Electricity, 150,000 shares; Tuscany Electric Company, 50,000 shares; Sardinia Electric Company, 25,000 shares; Venice Giulia Electric Company, 12,500 shares; Rome Electric & Gas Company, 5,000 shares; Emiliana Electric Company, 36,000 shares; Piedmont Hydro-Electric Company, 300,000 shares; National Company for the Development of Electric Undertakings, 40,000 shares; Meridionale Electric Company, 445,625 shares; Adamello Electric Company, 158,500 shares; United Electric Service Company, 580,000 shares; Valdarno Electric Company, 75,000 shares. The market prices at the time of the transfer were quoted in lire, and converted to dollar prices at the exchange rate prevailing on January 31, 1929. The total valuation at this date on this basis was \$31,957,902. (Id., Part VII, Table 32.)

¹² Ibid., see also Public Examination, Italian Superpower Corporation, at 8660-74.

¹³ Ibid.

¹⁴ Ibid.

¹⁵ Ibid.

company they received only 9% of the common stock—that is the equity stock.

J. W. Maitland, vice president of Italian Superpower Corporation, and a member of its investment committee, admitted the duality of the sponsors' position in selling the securities to the investment company. He testified:¹⁶

Q. I am asking whether they were acting as agents for the people who sold the stocks, outside to Italian Superpower, or whether they acted on behalf of Italian Superpower.

A. I always assumed that they were acting on behalf of Italian Superpower.

Q. Was there any other understanding?

A. It was their statement that they were.

Q. If that is the case, wouldn't there have to be a distinction between the stocks that they owned and the stocks that they were buying on the outside?

A. I think perhaps that you are asking me a little too much, because most of the stocks which they had to maintain, were finally negotiated for after I returned, such as the Valdarno and the Tuscany. We had prices within limits there, which were on that memorandum of October.

Q. So that the \$18,000,000 which you negotiated for, were securities which they had themselves?

A. That is correct, I think.

Q. You treated them as principal?

A. That is correct, I think.

Q. And negotiated with them just as if they were selling and you were buying on behalf of the corporation.

A. That is correct, I think.

The sponsors (in particular the Italian sponsors) who had securities they desired to sell the American public, determined upon the price and the terms of the transaction among themselves. It was admitted that the fairness of the terms of the transaction could not easily be verified independently since the properties were abroad and there was a thin market as to many of the stocks sold.¹⁷ Although the sponsors were paid in full for the securities, they retained their position of control and stood to realize the benefits incident to control. The sponsors were in the position of having received the cash profits from the sale of the securities, without surrendering some of the principal benefits of ownership. They were, in essence, both buyer and seller.

While this transaction inured principally to the benefit of the Italian sponsors, there were also benefits to the American sponsors who sold part of the original portfolio to the investment company.¹⁸ These American sponsors received a considerable amount of the non-voting common stock, in addition to the shares allocated to them in the purchase of the preferred stock as compensation for underwriting the original issue of debentures, and they shared control of the investment with the Italian sponsors. In addition they underwrote subsequent issues of securities of the investment company and of course built up their Italian business connections.

¹⁶ Public Examination, Italian Superpower Corporation, at 7806.

¹⁷ *Id.*, at 7605, 7785.

¹⁸ See *supra*.

2. BLUE RIDGE CORPORATION

Blue Ridge Corporation, a closed-end management type investment company, was incorporated under the laws of Delaware on August 12, 1929.¹⁹ Its sponsors were Shenandoah Corporation, controlled by Central States Electric Corporation, an investment company (in turn controlled by Harrison Williams, a public utility promoter, and his associates) and The Goldman Sachs Trading Corporation, another investment company in turn controlled by Goldman, Sachs & Co., investment bankers.²⁰ Under the plan of organization of Blue Ridge Corporation, Shenandoah Corporation, a subsidiary of The Goldman Sachs Trading Corporation, was to contribute \$62,500,000 for which it was to receive 83% of the common stock, and the general public was to contribute directly \$67,500,000 for 1,000,000 shares of "optional 6% Convertible Preference Stock, Series of 1929" and 1,000,000 shares of common stock.²¹

To effectuate this arrangement, Shenandoah Corporation sold its preferred and common stock to Central States Electric Corporation for \$31,250,000 and a similar amount to The Goldman Sachs Trading Corporation for \$31,250,000, a total of \$62,500,000, the amount required to buy the Blue Ridge Corporation common stock.²² The capital of both Central States Electric Corporation and The Goldman Sachs Trading Corporation had been contributed by the public.²³ At the same time the sponsor corporations sold to Blue Ridge Corporation securities from the portfolios of Central States Electric Corporation and The Goldman Sachs Trading Corporation in the amount of \$70,000,000.²⁴ The only cash which passed in connection with this transaction was \$7,500,000 paid by Blue Ridge Corporation to Central States Electric Corporation and The Goldman Sachs Trading Corporation in equal amounts, as the excess of the selling price of the portfolio securities over the purchase price of the capital stock of Blue Ridge Corporation.²⁵

Piercing the technical details of this transaction, it appears that the deal was really one between Central States Electric Corporation, The Goldman Sachs Trading Corporation and their respective con-

¹⁹ Reply to the Commission's questionnaire for Blue Ridge Corporation, item 1.

²⁰ Reply to the Commission's questionnaire for Blue Ridge Corporation, items 5 and 6; see also Public Examination, Central States Electric Corporation, at 12406.

²¹ Reply to the Commission's questionnaire, Blue Ridge Corporation, item 6 and exhibits thereto. (Public Examination, Central States Electric Corporation, at 13307-9, 13601-4, and Commission's Exhibits Nos. 1233 and 1267.) The company, however, commenced business with \$52,000,000 in cash, \$5,000,000 having been paid to each sponsor as part return for the securities transferred by each (id. 13193-4 and 13197-9) and \$5,000,000 having been paid in indemnity fees (id., at 13197-9 and 13421-2).

²² Reply to Commission's questionnaire for Blue Ridge Corporation. Central States Electric Corporation and The Goldman Sachs Trading Corporation bought 375,000 shares of the common stock of Shenandoah Corporation for \$33.33½ per share and 375,000 of the "optional 6% Convertible Preference Stock, Series of 1929" at \$50 per share (Ibid., see also Public Examination, Central States Electric Corporation, pp. 13307-9 and 13601-4).

²³ Public Examination, Central States Electric Corporation, at 12272-9, 12282, 12380-9, and Commission's Exhibit No. 1233. See also Ch. V of this part of the report, p. 1683 et seq.

²⁴ Public Examination, Central States Electric Corporation, at 13307-9, 13600-4.

²⁵ Id., at 13307-11.

trolling persons. The deal was worked out by private negotiations and then carried out. Sidney J. Weinberg, a partner of Goldman, Sachs & Co., testified:²⁶

Q. But before the actual organization Goldman Sachs Trading Corporation—and I assume the members of Goldman, Sachs & Company—sat down at the table with Mr. Harrison Williams and decided what Blue Ridge should be, how it should be capitalized, and what its initial portfolio should be, and worked out all the details of the deal before Blue Ridge was even heard of by the public, isn't that so?

A. Yes, Mr. Catchings carried on the negotiations.

Q. In that connection * * * it was decided that Goldman Sachs Trading Corporation and Central States sell \$70,000,000 of stock to Blue Ridge when it is formed, isn't that so?

A. I assume that is the way it was.

* * * * *

Q. And you say, Mr. Williams says, "I will look at your securities and you look at mine. We are both mutually satisfied." In goes the \$70,000,000 of securities, isn't that so?

A. Yes.

Q. And after you had satisfied yourselves as to the securities that Mr. Williams was giving and after Mr. Williams satisfied himself as to the securities that he was putting in, who satisfied themselves as far as Blue Ridge was concerned?

* * * * *

A. We were both for our own interests, for the Goldman Sachs Trading Corporation interests Harrison Williams was checking what we were putting in and we checked what he put in.

Q. Goldman Sachs Trading Corporation was satisfied and Harrison Williams was satisfied for Central States, and who was satisfied for the public and Blue Ridge?

A. Whatever our joint decision was.

Q. The same people?

A. Yes.

Q. And you were on both sides of that transaction, you were representing the sellers, weren't you?

A. Each individually, yes.

Q. And you also were representing the buyer, the Blue Ridge, isn't that so?

A. Checking each individually, checking the other.

The portfolio stocks were apparently sold to Blue Ridge Corporation at quoted market prices.²⁷ Mr. Weinberg admitted in his testimony, however, that whereas the entire block of stock could be sold to a controlled company at its quoted market price, it could not be sold publicly at so high a price.²⁸ Moreover, the stocks which came from the portfolio of The Goldman Sachs Trading Corporation were largely stocks which had been underwritten by Goldman, Sachs & Co. Thus not only did Goldman, Sachs & Co. use its controlled investment company, The Goldman Sachs Trading Corporation, as a

²⁶ Id., at 13609-11.

²⁷ Id., at 13613.

²⁸ Id., at 13611-14.

purchaser of securities which it had to sell, but it also used Blue Ridge Corporation for the same purpose. Mr. Weinberg testified:²⁹

Q. So that of the \$35,000,000 of stocks which The Goldman Sachs Trading Corporation sold to Blue Ridge Corporation at market values at that time * * * the only stocks included in that group, for which you were not the bankers, was McCall Corporation common, 10,000 for \$973,000 * * * and the Gillette Safety Razor Company 10,000 shares for \$1,365,000 * * * and the Curtis Publishing Company common 20,000 shares, \$2,480,000 * * * isn't that so?

A. That is right. All listed on the New York Stock Exchange and it is perfectly natural * * * for us to know more about the securities that we are bankers for than any others.

Too, there were conditions attached to the \$35,000,000 of securities that came from Central States Electric Corporation. It was agreed as part of the transaction that for a period of 30 days from September 5, 1929, Central States Electric Corporation should have a call—an option to buy—on Blue Ridge Corporation for certain of the securities sold, of a total value on August 17, 1929, of \$12,789,000, at a price two points above the purchase price to Blue Ridge Corporation. It was further agreed that for the same period of 30 days from September 5, 1929, Central States Electric Corporation should have a put—an option to sell—to Blue Ridge Corporation at the same price.³⁰ The effect of these conditions was that the possible profit to Blue Ridge Corporation on a rise in price of the stock was limited to 2 points, and the company was technically barred from selling the stock to protect itself in a declining market. Central States Electric Corporation was well protected against loss, although in an advantageous position to make a profit.

Although the sale of the original portfolio to Blue Ridge Corporation by its sponsors had been agreed upon by its sponsors before the investment company was organized, no disclosure of this intention was made in the initial offering circulars of the stock of the company. Mr. Weinberg testified:³¹

Q. I have here this prospectus, and in this prospectus you say, "the sale of these shares of preference and common stock, all of which will be of additional issue, will provide Shenandoah Corporation with the required \$62,500,000 in cash. The company will commence business with at least \$127,500,000 of cash and/or common stocks valued at or below the closing prices on August 17, 1929, on the New York Stock Exchange on which all such stocks are listed" * * * This is the advertisement in the New York Times * * * Will you please take this ad, Mr. Weinberg, and tell me where there is even the slightest intimation that the \$70,000,000 of securities that was to go into this portfolio by pre-arrangement between the sponsors at the very inception of this corporation came from those sponsors?

A. It says that we start with \$127,000,000 of cash and/or common stocks. Now, if you take the circular, you will know that they got—what was it, \$71,000,000 in cash. They got \$62,000,000 from * * * Shenandoah and the balance was common stocks that had to come from somewhere * * *.

Q. I asked you a simple question. Is there any statement in that advertisement that \$70,000,000 of the securities with which the company was going to start

²⁹ Id., at 13620.

³⁰ Id., at 13325-35, and Commission's Exhibit No. 1268.

³¹ Id., at 13614-17.

were securities that were sold to Blue Ridge by the sponsor(s) Goldman Sachs Trading Corporation and Central States?

A. Don't specifically state that.

Q. It doesn't state it specifically. Show me where it states inferentially that Goldman Sachs Trading Corporation and Central States were to sell them \$70,000,000 of stock?

A. It says it is going to start with \$127,000,000 of cash and/or common stocks * * *.

Q. * * * so that the only thing that it says is that there is going to be common stocks in there; isn't that so?

A. Yes.

Q. There may or may not be, it says, and/or.

A. There and/or means and common stocks.

Q. But you knew there was going to be no "or," you knew it was going to be "and"; isn't that so? You had determined you were going to sell \$70,000,000?

A. Undoubtedly.

Q. That is right, but there is no disclosure where that \$70,000,000 worth of stock is coming from?

A. It doesn't say specifically here.

At the end of 1929 the gross assets of the investment company were reported at \$133,500,583 while the assets of the company at the end of 1932, four months before the sponsorship of the company changed, were reported at only \$40,405,378, a decline for the period of 70%.

3. ALDRED INVESTMENT TRUST

Aldred Investment Trust, a common-law trust, was organized under the laws of Massachusetts on November 7, 1927.³² Its sponsor was the investment banking firm of Aldred & Co., of New York City and Montreal, Canada, whose principal partner was John E. Aldred.³³ The declaration of trust (charter) of Aldred Investment Trust had broad provisions authorizing dealings as principal by the sponsor with the trust.³⁴

John E. Aldred and Aldred & Co. for a long time prior to the formation of the investment company had been interested in the promotion and financing of public utilities and certain industrial companies and had been bankers for such companies.³⁵ Immediately upon the formation of the investment company, the sponsor sold to it, for its portfolio, securities of a then market value of \$6,250,000, and received therefor \$5,000,000 principal amount of the debentures of the investment company together with nondetachable certificates for 50,000 common shares and certificates for 10,000 preferred shares and 50,000 common shares.³⁶ This original portfolio, acquired from the sponsors, consisted entirely of common stocks which the sponsor had owned and in which he had a substantial continuing interest.³⁷ Included among these companies were: Shawinigan Water & Power Co.; Consolidated Gas, Electric Light and Power Co., of Baltimore; Pennsylvania Water & Power Co.; International Power

³² Public Examination, Aldred Investment Trust, Commission's Exhibit No. 3029.

³³ Reply to Commission's questionnaire for Aldred Investment Trust, Part I, item 5.

³⁴ Public Examination, Aldred Investment Trust, Commission's Exhibit No. 3029.

³⁵ Id., at 19093-19102.

³⁶ Id., Commission's Exhibit No. 3030.

³⁷ Id., 19093-19102.

Securities Corporation; and Gillette Safety Razor Co.³⁸ By this sale the sponsors were able to realize a profit of \$2,845,000 above the original cost of the securities to them.³⁹

On November 10, 1927, the sponsors offered publicly the \$5,000,000 of debentures of the investment company in units consisting of one \$1,000 debenture and 10 nondetachable common shares.⁴⁰ The sponsor realized \$4,850,000 as the net proceeds of this offering, which sum it applied on account of its loans payable which at that time amounted to \$8,318,476.⁴¹

The sponsor retained the 50,000 bonus common shares and 10,000 of the \$100 preferred shares, which represented an investment by it of \$1,250,000.⁴² The sponsor retained control of the investment company (and through the investment company retained control of the portfolio securities) by virtue of its ownership of 50,000 of the original common shares and the subsequent receipt of 62,500 additional common shares upon the conversion of the 10,000 preferred shares, a total of 112,500 common shares or over 50% of the total voting power.⁴³

In May 1928, Aldred Investment Trust raised an additional \$6,000,000 by the sale through its sponsors to the public of an additional \$5,000,000 principal amount of debentures with \$1,000,000 of common shares attached.⁴⁴ A substantial part of this newly acquired capital was used to purchase from the sponsors and others, additional blocks of the securities of corporations in which the sponsor was interested and desirous of maintaining control.⁴⁵ Mr. Aldred testified:⁴⁶

Q. Now in the management of your portfolio you more or less maintained large interests and increased those large interests in those special situations right on through the period of the operation of this Trust; isn't that so?

A. I would assume so; yes.

Mr. Aldred further testified:⁴⁷

Q. There was not any real trading done, was there; that is, your management of the trust did not entail sales of securities and the purchase of securities with any real periodic frequency?

A. No. There might have been some incidental purchases and sales but the general policy was to remain static in certain investments.

Q. And in line with that policy of management of this Trust, when this additional money came into it, it was used principally to secure larger holdings of

³⁸ Id., Commission's Exhibit No. 3030.

³⁹ Id., at 19193.

⁴⁰ Id., at 19150, 19158, and Commission's Exhibit No. 3031.

⁴¹ Ibid., and id., at 19149. The loans payable consisted of demand loans of \$3,538,476 and time loans of \$4,780,000 (ibid.).

⁴² Id., Commission's Exhibit No. 3031.

⁴³ Id., at 19125-6, 19131. The sponsor's relative voting power was further increased by the repurchase and retirement by the investment company of certain of the outstanding debentures with common stock attached (id., Commission's Exhibit No. 30341). With respect to this question of control Mr. Aldred testified:

And again the stockholder was yourself who had the complete dominance of that trust? I don't think you want to take any issue on that?

A. Oh, no, no.

⁴⁴ Id., Commission's Exhibit No. 3036.

⁴⁵ Reply to Commission's questionnaire for Aldred Investment Trust, Part VII.

⁴⁶ Public Examination, Aldred Investment Trust, at 19185-6.

⁴⁷ Id., at 19186.

the same type of securities which you had theretofore held, increasing your holdings?

A. More or less so; I would say "yes."

It thus appears that Aldred & Co., the sponsor, by organizing an investment company of which it retained control, used the investment company as an instrument to retain its control and influence over various utilities and industrial corporations and at the same time to release very substantial amounts of capital which such sponsor had found it necessary to tie up in those portfolio companies before the organization of the investment company. It is apparent, too, that the sponsors realized appreciable profits in the sale of these portfolio securities to the investment company.

B. Sales by Sponsors to Investment Companies Subsequent to Organization

The cases cited in the preceding subsection are primarily instances of sponsors of investment companies using such companies as repositories for control or as customers for securities which the sponsors may have had for sale. These cases may or may not have involved distress selling. There were many instances, however, where sponsors used investment companies as purchasers of securities at fictitious prices in order to alleviate the financial distress of the sponsors. The investment companies were helpless to resist such sales since they were under the control of their sponsors. Many serious malpractices were found in connection with these distress sales of sponsors.⁴⁸ Several examples of these sales will be presented.

1. SISTO FINANCIAL CORPORATION

Sisto Financial Corporation was incorporated on August 10, 1929, under the laws of New York.⁴⁹ Its sponsor was the New York brokerage firm of J. A. Sisto & Co.⁵⁰ The original authorized capital of the company was 400,000 shares of common stock.⁵¹ The charter of the company specifically authorized self-dealing by the directors and by the sponsor, with whom a management contract was authorized.⁵² The initial capital of the company was \$5,000,000.⁵³

The initial offering of stock of the company consisted of 100,000 shares and was made by the sponsors, J. A. Sisto & Co.⁵⁴ A total of 80,000 shares were sold to the public at \$53 per share, and 20,000 shares bought by the sponsors for \$50 per share.⁵⁵ The investment

⁴⁸ These transactions have been variously characterized as "dumping," "unloading," and "bailing out." "Dumping" is the practice of selling to a controlled company securities which are otherwise unmarketable at or near the purchase price to the investment company. "Unloading" means reducing or eliminating a sponsor's holdings in a given security by selling such holdings to a controlled company. "Bailing out" is a term frequently used to describe a transaction where a controlled company which receives securities through a dumping or unloading transaction thereby saves the sponsor from financial distress.

⁴⁹ Reply to Commission's questionnaire for Sisto Financial Corporation, Part I, item 1.

⁵⁰ *Id.*, item 5.

⁵¹ *Id.*, item 3, Exhibits A and B.

⁵² *Ibid.*

⁵³ *Id.*, item 3, and supplementary information.

⁵⁴ *Id.*, Part V and supplementary information.

⁵⁵ *Ibid.*

company received \$5,000,000 as the proceeds of its initial offering, \$4,000,000 from the public and \$1,000,00 from the sponsors.

On August 15, 1929, five days after its incorporation, the company entered into a management agreement with the sponsor which provided that the sponsor would pay the organization expenses of the investment company and would receive as its sole compensation as managers 20% of net profits of the company after 8% should be earned and paid annually on a cumulative basis on the stated capital at \$50 per share.⁵⁶ It was further provided that brokerage commissions on purchases and sales for the account of the corporation should be limited to customary New York Stock Exchange rates for purchases on the exchange and the regular and customary rates on transactions in unlisted securities.⁵⁷ The agreement, unless sooner terminated, was to remain in effect until December 31, 1939, and was to be renewable automatically thereafter for 5-year periods, in the absence of notice of termination to be given 6 months prior to the end of each period.⁵⁸

The management agreement was amended twice: on February 19, 1930, to provide that in spite of the reduction in stated value of the investment company stock from \$50 to \$25 per share, the required cumulative earnings of "8% per annum on the capital of the corporation" should continue to refer to the original capital of the company at \$50 per share; on January 27, 1931, to provide similarly because of the further reduction to \$1 per share in the stated value of the capital stock.⁵⁹ It must be noted that these reductions required the investment company to earn 16% cumulatively on the stock at \$25 before management compensation to the sponsor, and 400% accumulating on the basis of the \$1 valuation before such compensation to the sponsors. It would thus appear that under the agreement the sponsors were not entitled to any management compensation in the light of the performance of the company.

During the period from the organization of the investment company in August 1929 to the end of that year (a little over 4 months) the company purchased securities from its sponsors for a total price of \$6,063,000.⁶⁰ The balance sheet of the company as of the year-end carried its security investments at \$5,994,483 at "cost or market, whichever is lower."⁶¹ A substantial portion of these securities were either unlisted or inactively traded.⁶² Many issues were not high-grade securities and no market quotations as of the dates of the transactions were supplied the Commission by the investment company.⁶³

On November 4, 1929, a day of severe market declines, the sponsors sold blocks of securities to the investment company for which the latter paid \$2,373,000.⁶⁴ Included among these securities was \$100,000 principal amount of 6½% bonds of the Imperial Russian Government, which at that time had been in default for over 10 years. These

⁵⁶ *Id.*, Item 7, Exhibits D and E.

⁵⁷ *Ibid.*

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ *Id.*, Part VII.

⁶¹ *Id.*, Item 8.

⁶² *Id.*, Part VII.

⁶³ *Ibid.*

⁶⁴ *Ibid.*

bonds were sold to the investment company for \$9,000.⁶⁵ Another item was 1,000 shares of Shawmut Association, Inc., common stock, which was sold to the investment company for \$21,000, or at \$21 per share the quoted market price of the stock on that day being 17-18.⁶⁶ Another item was 11,800 shares of common stock of Grand Union Company, sold to the investment company for \$199.125 or \$167¼ per share on a day when the quoted price of this stock was 15½-16¾.⁶⁷

On November 21, 1929, the sponsors sold to the investment company \$1,194,000 principal amount of the 6% debentures, due in 1944, for Parmelee Transportation Company. The investment company thus paid the sponsor \$90 for the debentures when the quoted price was \$80-\$82½. On the same day the sponsors sold the investment company 44,787 shares of the common stock of Parmelee Transportation Company at \$20 per share, a total of \$895,740, when the quoted price of this stock was \$16-\$18¼ or at least 6% less than the price paid by the investment company.⁶⁸

It is interesting to observe how the sponsors reversed the process when there was an upturn in the market in the spring of 1930. For example, on February 6, 1930, the sponsors purchased from the investment company \$7,400 principal amount of the 6% debentures, 1949, of the Hygrade Food Products Corporation at 57, a total of \$4,218 when the quoted market price of the debentures was 60-62, a concession to the sponsors of at least 5%.⁶⁹ On March 27, 1930, the sponsors bought from the investment company 10,787 shares of common stock of Parmelee Transportation Company at 20, a total of \$215,308, and 4,000 shares of the same stock at \$19½, a total of \$77,840, or a grand total of \$293,148, when the quoted market price of that stock was 23-24, a concession to sponsors of at least 13%.⁷⁰ On March 31, 1930, the sponsors bought another 7,500 shares of the common stock of Parmelee Transportation Company at 20, a total price of \$149,700 when the quoted market price was 22-23, a concession to sponsors of at least 10%.⁷¹ It does not appear that the sponsors ever repurchased from the investment company the defaulted 6½% bonds of the Imperial Russian Government, due 1919, which they had sold to the investment company in November 1929.

Largely as a result of the foregoing and similar practices, the assets of the company declined from \$6,169,517 at the end of 1929 to \$693,407 at the end of 1932,⁷² \$588,476 at the end of 1935 and \$307,782 at the end of 1937,⁷³ a decline of 95% for the period. The per share asset value of the investment company stock declined from \$37.00 at the end of 1929, to \$13.38 at the end of 1932, rose to \$16.14 at the end of 1935 and declined to \$11.30 at the end of 1937,⁷⁴ a decline of 69% for the period.

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

⁶⁹ *Ibid.*

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² *Id.*, item 8.

⁷³ *Id.*, supplementary information.

⁷⁴ The figures for both total assets and per share asset value reflect repurchases by the investment company of its own capital stock. For a discussion of these repurchases see Pt. Three, Chapter III, pp. 984-5.

2. BEACON PARTICIPATIONS, INC.

Beacon Participations, Inc., a closed-end management type investment company, was incorporated under the laws of Massachusetts on May 11, 1928.⁷⁵ Its sponsors were officers and directors of Beacon Trust Company, of Boston, and Jordan-Lyman Co., Inc., investment bankers, of Boston.⁷⁶ There were three classes of stock authorized by the charter of the company, Class A participating cumulative preferred stock of no par value, Class B participating cumulative preferred stock of no par value, and common [voting] stock.⁷⁷ The common stock was issued to Beacon Trust Company for \$1,000.⁷⁸ The "A" preferred stock was sold to the public for \$2,100,000 through Jordan-Lyman & Company, Inc., who retained \$200,000 as underwriting fee and turned over the difference or \$1,900,000 to the investment company. The entire issue of B preferred stock was sold to the sponsors (the bank) for \$499,000.⁷⁹

On June 1, 1928, Jordan-Lyman & Co., Inc., turned over to the investment company the \$1,900,000 proceeds of the public offering of the Class A stock. Within three days, on June 4, 1928, the investment company purchased from Beacon Trust Company, its sponsor, a note of the Beacon Building Trust Inc., also sponsored and controlled by the officers of Beacon Trust Company, for \$520,000. The directors and officers of the bank, the investment company and the building company all interlocked. This note was a demand note, dated February 2, 1925, and had originally been made in the principal sum of \$545,000, but had been reduced to \$520,000, the purchase price to the investment company, before the purchase date. The note was endorsed to the investment company by the bank *without recourse* although it was the ordinary practice in such transactions to endorse unrestrictively. The transaction was approved by the directors of the investment company on June 21, 1928.⁸⁰

Beacon Building Trust, Inc., the maker of the note, was organized in 1924. Its assets consisted solely of equities in two buildings, the Beacon Building in which the Beacon Trust Company had its principal office, and the Fiske Building at 89 State Street, Boston, in which the Beacon Trust Company had a branch office, and cash which averaged about \$40,000.⁸¹ The entire income of this corporation came from the Beacon Building since the Fiske Building did not earn in any year any excess over its operating expenses. As of June 1928, the market value of the Beacon Building was \$1,895,000, or \$475,000 more than a mortgage of \$1,420,000 on the building.⁸² The value of the Fiske

⁷⁵ Reply to Commission's questionnaire for Beacon Participations, Inc., item 1.

⁷⁶ The sponsors in control of the investment company at the time the replies to the Commission's questionnaire was prepared alleged they had no knowledge of the company's activities prior to this accession to control in 1934. (See reply to the Commission's questionnaire for Beacon Participations, Inc., item 5.)

⁷⁷ Reply to the Commission's questionnaire for Beacon Participations, Inc., item 5.

⁷⁸ Reply to the Commission's questionnaire for Beacon Participations, Inc., Part IV (Brief of Appellant in case of *Spiegel v. Beacon Participations, Inc., et al.*, citing record in that case, p. 10).

⁷⁹ *Ibid.*

⁸⁰ *Ibid.*

⁸¹ *Ibid.*

⁸² *Ibid.*

Building was \$570,000 or \$120,000 over and above a mortgage thereon of \$450,000. There was in addition to the note sold to the investment company a note of the building corporation outstanding in the amount of \$200,000.⁸³ The cash balance of the corporation was \$40,000. The net assets of the building corporation at the time of the sale of its note to the investment company, not including the note so sold, were \$435,000.⁸⁴

On September 26, 1932, one Edward Spiegel, the holder of shares of Class A preferred stock, filed a bill in equity in the Superior Court of Suffolk County, Massachusetts, against the investment company and certain of its officers and directors alleging liability to the plaintiff by the defendants by reason of the transaction involving the sale of the note and on three other counts. The other allegations related to improper trading activities with another corporation owned and controlled by two of the directors, illegal payments of dividends out of capital and an impairment of capital by improper repurchases by the investment company of its own stock at excessive prices. These latter counts will be summarized below. The trial court found for the plaintiff and referred the cause to a master to determine damages and to frame any questions of law for a determination.⁸⁵

After various hearings on procedural matters the master filed a report on August 16, 1934. On September 15, 1934, the court filed its "Findings and Rulings and Order for Decree" whereby the defendant's exceptions and motions were overruled and a final decree was entered against the defendants for substantial sums.⁸⁶

Concerning the sale of the note, the court stated: ⁸⁷

The purchase of such a demand note was a waste of the stockholders' money. The transaction is explicable but not justified by the conflict of interest apparent throughout the history of this company. The existing situation was very unhealthy when the same agents acted for the maker, the buyer and the seller. In practical effect the investors were left without any representation.

The court further stated:

Upon all the evidence before me, I find that the respondent Beacon Participations, Inc., was organized for the purpose, among other things, of buying this note. The note in the hands of the Beacon Trust Company was a hazardous investment, if not an illegal one. A trust company could, with far less safety, retain such a frozen asset, because the depositors had direct claims against the bank. The Participations, however, furnished an ideal "dumping ground" because the shareholders had no direct claims against the corporation. Their only remedy lay in this indirect and difficult proceeding [the stockholders' suit].

After the court handed down its Memorandum of Findings and Rulings, which imposed liability on the directors and officers, the new directors of the investment company, who were nominees of the original directors, settled the claim of the investment company on the note for \$100,000 cash and 10 shares of stock in Beacon Building

⁸³ Ibid.

⁸⁴ Id., at 12, 13.

⁸⁵ *Spiegel v. Beacon Participations, Inc., et al.* (Mass.), 8 N. E. (2nd), 895.

⁸⁶ Ibid.

⁸⁷ Reply to the Commission's questionnaire, Beacon Participations, Inc., Part IV (Brief of Appellant in case of *Spiegel v. Beacon Participations, Inc., et al.*), citing record in that case, p. 13.

Corporation. Beacon Building Corporation had been formed to take over the assets of Beacon Building Trust, Inc., which assets at the time consisted solely of the equity in the property at 31 Milk Street (the Beacon Building), the equity in the Fiske Street property having been extinguished by foreclosure of the first mortgage. Beacon Building Corporation had an authorized capital of 20 shares without par value.⁸⁸

At the time of the settlement the Atlantic Bank, successor to the Beacon Trust Company, had vacated its quarters in the Beacon Building and was liable for the unexpired period of the lease which it had assumed from its predecessor. Moreover, Atlantic Bank had succeeded to the ownership of the 25,000 Class B shares and the 25,000 common shares of the investment company. Thus, at the time of the settlement, Atlantic Bank, the new sponsor of the investment company, also controlled the corporation, Beacon Building Trust, Inc., which was the debtor of the controlled investment company on the \$520,000 note, and which had a claim against the sponsor for the breach of the lease.⁸⁹

As a result of the settlement the investment company sustained a loss of \$420,000 or 80% of its \$520,000 investments. The other allegations of the stockholders' suit, involving as they do the mismanagement of assets by sponsors, may be briefly summarized.

The second of the allegations involved trading activities by the investment company. Messrs. Jordan and Lyman, directors of the investment company, held the controlling interest in Jordan, Lynch & Co., Inc., securities dealers. This was the company which distributed the Class A stock of the investment company to the public. In March 1929 the investment company and Jordan, Lyman & Co., Inc. opened a joint account to trade in securities. Each corporation was to share equally the profits and losses, although the investment company was to advance all the necessary funds to carry on the operations and Jordan, Lyman & Co., Inc., put up no collateral to secure its obligations. A total of \$217,000 was paid for stocks in the account, although the total assets of Jordan, Lyman & Co., Inc., never exceeded \$200,000. After the market collapse in the fall of 1929 the trading account showed substantial losses.

It was not until May 1930 that demand was made on Jordan, Lyman & Co., Inc., for its share of the losses. By that time, however, the latter corporation was hopelessly insolvent. On May 5, 1930, the investment company permitted Mr. Jordan, officer and director of the investment company and of Jordan, Lyman & Co., Inc., to substitute himself for the latter corporation. Mr. Jordan paid \$30,000 cash, which he had borrowed from the sponsor bank, Beacon Trust Company, and assumed the obligation to pay half the balance of the losses, less the \$30,000. This latter amount was all that was ever received from Jordan or Jordan, Lyman & Co., Inc., on this account, the balance of the loss being absorbed by the investment company.⁹⁰

The third allegation of the stockholders' suit related to the illegal payment of dividends out of capital. The court found:⁹¹

⁸⁸ Id., p. 16.

⁸⁹ Ibid.

⁹⁰ Id., at 17, 19.

⁹¹ Id., at 20, 21.

The financial statements of Beacon Participations show that dividends were paid out of capital for the year 1929, up to and including the first quarter of the year 1932. These illegal payments are disclosed by the Spark, Mann & Company reports.⁹² The shrinkage in capital shown by these excerpts from the report could be easily ascertained by businessmen of ordinary intelligence.

The final allegation of the stockholders' bill was that between November 14, 1929, and May 25, 1932, the investment company purchased a total of 54,396 shares of the Class A preferred stock (of the 100,000 shares outstanding) for a total price of \$757,673.46. Included among these purchases were 4,678 shares purchased from Jordan, Lyman & Co., Inc., for \$17.33 per share, a total of \$81,069.⁹³ The court found:⁹⁴

The purchase of 54,396 shares caused a direct loss to the continuing Class A stockholders because thereby the money available for liquidation was distributed unequally. In the second place, the purchases resulted in an illegal interference with the contractual rights of Class A shareholders in regard to voting power.

After the entry of the decree against the defendants on September 15, 1934, the case was appealed to the Supreme Judicial Court of Massachusetts.⁹⁵ On April 1, 1937, the appellate court reversed the decree and remanded the case for further proceedings.⁹⁶ Thereafter further testimony was taken and decrees were entered against the defendants for approximately \$300,000.⁹⁷ Because of the financial condition of the defendants the decrees were subsequently satisfied by the payment by the individual defendants of sums substantially less than the amounts decreed.⁹⁸

3. PRINCE & WHITELY TRADING CORPORATION

The history of Prince & Whitely Trading Corporation supplies instances of mismanagement of assets of two types, both resulting from efforts by the sponsors to bail themselves out of financial difficulties. The first abuse was the dumping or unloading of securities on the investment company by the sponsor and the second involved the lending of money to the sponsors by the investment company. The sale of portfolio securities to the investment company will be discussed at this point as the loans are discussed later in this chapter.⁹⁹

Prince & Whitely Trading Corporation, a closed-end unrestricted management investment company¹⁰⁰ sponsored by Prince & Whitely, New York brokerage firm,¹⁰¹ was incorporated under the laws of Delaware on August 31, 1929.¹⁰² On February 20, 1931, the name of the company was changed to Phoenix Securities Corporation.¹⁰³ On

⁹² Spark, Mann & Co. was the firm of certified public accountants which audited the books of the investment company annually. (Ibid.)

⁹³ Id., at 23.

⁹⁴ Ibid.

⁹⁵ *Spiegel v. Beacon Participations, Inc., et al.*, 8 N. E. (Mass.), 895.

⁹⁶ Id., at 915.

⁹⁷ Reply to Commission's questionnaire for Beacon Participations, Inc., supplementary information.

⁹⁸ Ibid.

⁹⁹ See pp. 2676-79, *infra*.

¹⁰⁰ Reply to Commission's questionnaire for Phoenix Securities Corporation, item 19.

¹⁰¹ Id., item 5.

¹⁰² Id., item 1.

¹⁰³ Ibid.

September 3, 1929, the investment company and its sponsors entered into an underwriting agreement whereby the sponsors purchased the initial issue of the investment company's stock, consisting of 328,000 shares of \$3 convertible Series A preferred stock without par value.¹⁰⁴ This stock was offered publicly in units consisting of one share of preferred stock and two shares of common stock at \$75 per unit.¹⁰⁵ The public paid \$24,600,000 for its participation, of which the sponsor received \$2,100,000—8½% of the offering price—as underwriters' fees and turned over the balance of \$22,500,000 to the investment company as net proceeds of the offering.¹⁰⁶ Under the terms of the underwriting agreement the sponsor paid \$2,500,000 for the remaining 200,000 shares of common stock and agreed to purchase warrants to buy 100,000 shares of the \$3 convertible preferred stock, Series A, at \$50 per share and for 400,000 shares of common stock for \$12.50 per share up to September 1, 1939.¹⁰⁷ For this contribution of 10% of the contributed capital, which was only \$400,000 more than its gross underwriting fee, the sponsor received 17% of the voting stock of the investment company and thus had practical control of the investment company.¹⁰⁸ On September 17, 1929, the investment company received the \$25,000,000 proceeds from the sale of the stock, on which it commenced business.¹⁰⁹ Thereafter the original sponsor, Prince & Whitely, managed the investment company until October 9, 1930, when the sponsor was adjudicated bankrupt.¹¹⁰

From the date the investment company commenced business until the date of bankruptcy of its sponsor, the sponsor had sold to the company securities for a total of \$11,560,899.76. The sponsor had also borrowed large sums from the investment company. Both the sales to and the loans from the investment company represented an effort by the sponsor to bolster its failing financial condition and avoid bankruptcy.

The following is a list of the securities sold by the sponsor to the investment company, of corporations whose securities it had underwritten or with which it was connected, the cost thereof to the invest-

¹⁰⁴ Public Examination, Prince & Whitely Trading Corporation, at 9443 et seq., and Commission's Exhibits Nos. 910 and 540.

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*

¹⁰⁷ *Id.*, at 9447, 9450-1. Reply to the Commission's questionnaire for Phoenix Securities Corporation, Exhibit 1-5. No warrants were sold to the public. The liquidating value of the preferred stock was \$55 per share, but the warrants were exercisable at \$50 per share. The preferred stock was convertible into common on the basis of 2 shares of common for one of preferred. Both the common and preferred had one vote per share. (*Id.*, at 9451-2.) These warrants would have made it possible for Prince & Whitely to increase its voting power, but in fact, these warrants were never exercised. (*Id.*, at 9452.)

¹⁰⁸ *Id.*, at 9452.

The board of directors of Prince & Whitely Trading Corporation consisted solely of the partners of Prince & Whitely (*Id.*, at 9442), and in order to continue such succession, the management contract, dated September 3, 1929, provided that if any director were elected to the Board of Directors of the corporation without the approval of Prince & Whitely, the management contract could be terminated by Prince & Whitely. (*Id.*, Commission's Exhibit No. 911.) The prospectus contained the following statement (*id.*, Commission's Exhibit No. 540):

The firm of Prince & Whitely will deal freely with the Corporation as Bankers or otherwise and will assume full responsibility for the fairness of any transaction between them.

¹⁰⁹ *Id.*, at 9457.

¹¹⁰ *Id.*, at 9503.

ment company, and the market value thereof at the time of the bankruptcy of the sponsor:¹¹¹

Company	Securities	Cost	Market value *
Hahn Department Stores, Inc.—			
Preferred.....	40,100	\$3,203,931.75	\$2,460,000
Common.....	41,000	747,142.50	389,500
The Autocar Company—common.....	79,618	2,677,690.32	None
Atlas Stores—			
Preferred.....	45,000	1,452,500.00	None
Common.....	19,220	641,140.25	243,653
Greenfield Tap & Die Corporation—common.....	46,077	669,482.79	478,049
W. C. Foster & Co., bonds and notes.....	\$364,917.65	584,917.65	None
L. A. Young Spring and Wire Co.—common *	15,400	553,967.00	315,700
National Dairy Products—common.....	7,372½	412,222.19	306,980
Whitefield Citrus Corporation—			
Preferred.....	5,400	266,034.71	None
Common.....	107,438		
Lindsay Nunn Publishing Co.....	\$141,000	139,700.00	None
Bonds and preferred.....	2,000		
Total.....		11,560,899.76	

* Market quotations were secured from published sources, such as the *Annalist* and the *New York Times*. Where "none" is indicated, no quotation was found within the period from October 1, 1930, to October 18, 1930.

* Mr. Hoyt owned over 50 percent of the W. C. Foster & Co. which was a financial company in the business of lending money against collateral consisting of county claims for taxes and general taxes (Public Examination, Prince & Whitely Trading Corporation, at 9605).

It appears that the investment company acquired the stock of Greenfield Tap & Die Corporation because Prince & Whitely had had a joint account in that stock, with James W. Causey & Co.¹¹² On October 17, 1929, one month after the investment company began business, Prince & Whitely sold to the investment company 41,077 shares of Greenfield Tap & Die Corporation stock at \$19.13 per share, for a total of \$785,829.64. On that day there were no published transactions in that stock, but on the day previous, October 16, 1929, 200 shares were sold at a price of \$18 per share.¹¹³ Thereafter, from October 29, 1929, through July 1, 1930, the investment company made additional purchases aggregating 5,000 shares for \$83,653.15.¹¹⁴ The investment company expended a total of \$869,482.79 in acquiring its holdings of Greenfield Tap & Die Corporation stock.¹¹⁵ One week after the bankruptcy of Prince & Whitely the market value of the 46,077 shares of Greenfield Tap & Die Corporation, which cost the investment company \$869,482.79, was \$241,904.25.¹¹⁶

In the acquisition of the stock of The Autocar Company, the investment company purchased almost the entire commitment of Prince & Whitely in the trading account of that stock, in which the sponsor

¹¹¹ *Id.*, Commission's Exhibit No. 913 (Exhibit 2, p. 7).

¹¹² *Id.*, at 9474.

¹¹³ *Id.*, Commission's Exhibit No. 913 (Exhibit 2, appendix VI).

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

¹¹⁶ *Ibid.*

had a 60% interest.¹¹⁷ On December 30, 1929, the investment company purchased \$900,840 worth of the stock of The Autocar Company.¹¹⁸ On April 24, 1930, the investment company completed its purchases of The Autocar Company stock amounting to 79,818 shares for the total sum of \$2,677,860.32.¹¹⁹ Since the investment company purchased 79,818 shares of The Autocar Company when the 60% interest of Prince & Whitely in the trading account of that stock amounted to 80,035 shares,¹²⁰ it is evident that the sponsor utilized the investment company to fulfill its commitment. By October 1930, six months after the investment company in the stock of The Autocar Company, the value of that stock based on a fair value of latter's assets was \$319,000,¹²¹ as compared with the cost of \$2,677,860.32 to the investment company.

The largest single investment of Prince & Whitely Trading Corporation was made in the stock of Hahn Department Stores, Inc., which Prince & Whitely underwrote jointly with Lehman Brothers and in which these underwriters conducted a trading account. On December 12, 1928, about one year before the organization of the investment company, Prince & Whitely and Lehman Brothers offered to the public 227,000 shares of preferred and 454,000 shares of common stock of Hahn Department Stores, Inc.¹²² From its organization until October 9, 1930, the day Prince & Whitely failed, the investment company had purchased, net, \$3,203,931 of the common stock of Hahn Department Stores, Inc., and \$747,142 of the preferred stock from Prince & Whitely. The prices which the investment company paid were those at which Prince & Whitely had committed itself before the market collapse of October 1929.¹²³ The underwriters desired to maintain an active market in the stock of Hahn Department Stores, Inc., and for this purpose Prince & Whitely was installed as the record manager of a trading account in the stock.¹²⁴

Eventually the investment company became virtually the only purchaser of the preferred stock. On August 5, 1930, the investment company purchased 300 out of the 400 shares reported to be sold on the New York Stock Exchange, and on August 7, 1930, 800 out of 1,000 shares.¹²⁵

On August 29, 1930, no sales were reported on the Exchange but on that day 23,000 shares of the Hahn Department Stores, Inc., were sold by the investment company to Prince & Whitely.¹²⁶ On September 5, 1930, only 100 shares were traded in on the Stock Exchange, but on that day, Prince & Whitely resold the 23,000 shares to the investment company. Thus, these shares were not in the portfolio of the investment company on August 31, 1930, the fiscal year end and this sale apparently enhanced the cash position of Prince & Whitely Trad-

¹¹⁷ *Id.*, at 9479 et seq., and Commission's Exhibit No. 913 (Exhibit 2, appendix III).

¹¹⁸ *Ibid.*

¹¹⁹ *Ibid.*

¹²⁰ *Ibid.*

¹²¹ *Id.*, at 9485. On August 31, 1935, after the investment company had passed into the second group, which controlled it after Prince & Whitely, the loss on The Autocar Company stock amounted to \$2,358,000 (*Id.*, at 9486).

¹²² *Id.*, at 9492 et seq.

¹²³ *Id.*, at 9506.

¹²⁴ *Id.*, at 9494-5.

¹²⁵ *Id.*, at 9496.

¹²⁶ *Id.*, at 9496-7.

ing Corporation.¹²⁷ Between September 8, 1930, and September 10, 1930, all transactions in this stock were made by the investment company.¹²⁸

The purchase of all these portfolio securities from the sponsor represented an amount equivalent to about 45% of the contributed capital of the investment company.¹²⁹ At or shortly after the bankruptcy of the sponsor, there was no available market nor market quotations for 7 of the 13 items, and the remaining items for which the company had paid \$6,427,887 had quoted market values of a total of \$4,192,882.

4. UTILITY AND INDUSTRIAL CORPORATION

Utility and Industrial Corporation, a closed-end management type investment company incorporated under the laws of Delaware on February 9, 1929, was sponsored and managed by the investment banking firm of H. M. Byllesby and Company.¹³⁰ H. M. Byllesby and Company had organized Standard Gas & Electric Company in 1910 and had retained the voting stock of that company. By 1929 Standard Gas & Electric Company and its affiliated companies had become one of the largest groups of utility companies in the United States.¹³¹ As the Standard Gas & Electric Company had expanded, H. M. Byllesby and Company had expanded the scope of its activities from engineering and management to include investment banking.¹³²

In its capacity as investment banker for the Standard Gas & Electric system H. M. Byllesby and Company traded actively in the securities of companies in the system. The trading transactions included purchases as well as sales, in order to create an active resale market and thus facilitate the marketing of new issues.¹³³ As a result of these operations H. M. Byllesby and Company had by 1929 accumulated large amounts of these securities. By November 1929, the firm owed about \$9,500,000 to various banks, presumably as a result of its market operations in these stocks and the stock of other utilities for which it was the banker.¹³⁴

By the early part of 1929 H. M. Byllesby and Company was faced with the necessity of curtailing its mounting bank debt. H. M. Byllesby and Company could have raised the money to pay the bank loans by selling utility stocks and paying the loan with the proceeds. This, however, might have impaired Byllesby's control of the various utilities, would certainly have represented a loss to Byllesby and might have depressed further the market prices of all the securities in

¹²⁷ *Id.*, at 9498.

¹²⁸ *Id.*, at 9499.

¹²⁹ This does not include of course the sums misused by the sponsor in other ways, such as loans, etc.

¹³⁰ Reply to Commission's questionnaire for Utility and Industrial Corporation, Part I.

¹³¹ Summary Report of Federal Trade Commission on Economic, Financial, and Corporate Phases of Holding and Operating Companies of Electric and Gas Utilities (1935), 70th Congress, 1st Session, Document 92, Part 72-A, p. 92 et seq. The utilities controlled by Standard Gas & Electric Company at the end of 1929 were organized into 12 groups, 11 in the United States and the remaining group consisting of properties in the states of Sonora and Sinaloa, Mexico.

¹³² *Ibid.*

¹³³ *Ibid.*

¹³⁴ Derived from supplementary information supplied the Commission for Utility and Industrial Corporation.

the system, especially Standard Gas & Electric Company. To avoid these consequences, and at the same time to liquidate the bank loans, Byllesby organized Utility and Industrial Corporation. By so doing the utility stocks could be sold to a controlled company at favorable prices, at no disadvantage to the sponsors, with no effect on the market price, and control of the utility stocks could be retained through control of the investment company. Thus the funds contributed by the public to an investment company could be used by the sponsors of the investment company to bail out of the bank loan situation without disturbing the sponsors' control of its utility companies.

At the same time, the fact that the investment company held substantial blocks of the utility stocks made it easier for the sponsors to maintain higher market prices for such stocks, first, because the investment company would pay whatever price for the stocks the sponsor required, and second, by having the investment company hold quantities of the stock its floating supply was reduced and the market was easier for the sponsors to "stabilize."

An initial offering circular of Utility and Industrial Corporation stated, among other things, that the company proposed "to hold and dispose of controlling or minority interests in and to operate and supervise public utilities."¹³⁵ From its inception Utility and Industrial Corporation was used as an instrument to assist its sponsor in the latter's utility activities.

The investment company raised a net total of \$32,750,000 of contributed capital from the sale of 700,000 shares of convertible preferred stock and 1,000,000 shares of common stock.¹³⁶ As of December 31, 1938, the market value of the net assets of the investment company was \$2,184,196, a decline of about 93% from the net contributed capital.¹³⁷ On the same date, the preferred stock, entitled upon liquidation to \$30 per share plus accrued dividends (which at that date amounted to \$6,534,000) had an asset value of \$3.34. The common stock had no asset value and had paid no dividends since organization.¹³⁸ A substantial part of these severe losses suffered by the investors in this company is traceable to the management policies pursued by the sponsors, H. M. Byllesby and Company—policies which were characterized by extensive dealings with the company by the sponsors as principals and which were followed in pursuance of the original undisclosed concept of the company as an aid to the sponsors rather than as an independent business venture.

¹³⁵ Reply to Commission's questionnaire for Utility and Industrial Corporation, Pt. I.

¹³⁶ The public contributed \$31,500,000 for the purchase of all the preferred stock and 80% of the common stock; H. M. Byllesby and Company purchased the balance of the common stock for \$3,500,000. Since the sponsor retained \$2,250,000 as its underwriting commissions its net cash contribution to the investment company was \$1,250,000.

Of the 700,000 shares of convertible preferred stock which were issued 919 shares were converted into an equal number of common shares. At December 31, 1929, there were outstanding 1,000,919 shares of common stock. In addition, warrants for the purchase of 1,000,000 shares of common stock on or before February 1, 1944, at \$17.50 per share were issued to H. M. Byllesby as compensation for their management of the investment company.

¹³⁷ Derived from supplementary information supplied the Commission for Utility and Industrial Corporation. The company to the end of 1938 repurchased a total of 45,681 shares of preferred stock at a cost of about \$452,000.

¹³⁸ *Ibid.* Dividends on the preferred stock, totaling \$3,651,737, were paid up to April 30, 1942, and none since.

Immediately upon the formation of the investment company the sponsors sold to the company portfolio securities for about \$10,000,000 at a profit to the sponsors of about \$1,800,000—\$250,000 more than the contribution by the sponsors for its controlling interest.¹³⁹ Thereafter, between 1930 and 1933, in a declining market, additional blocks of securities were sold by Byllesby to the investment company until Utility and Industrial Corporation had eventually paid to its sponsors a total of \$22,180,451.76 for securities which had cost H. M. Byllesby and Company \$21,889,641.11.¹⁴⁰ The capital losses (realized and unrealized) of \$30,000,000 suffered by the investment company to the end of 1938 resulted principally from the securities sold to the investment company by the sponsors as principal. A number of the companies whose securities were sold by the sponsors to the investment company were on the verge of insolvency at the time of sale and went into receivership or reorganization shortly after the purchases.¹⁴¹ Moreover, these securities were sold by the sponsors to the investment company at prices greatly in excess of their asset values, reflecting the artificial market prices fixed by the market operations of H. M. Byllesby and Company.

Although the offering circulars of the investment company indicated that the sponsors would sell securities to the investment company, they failed to disclose the following material facts: (1) that in addition to owning the securities the sponsors were intimately connected with the portfolio companies; (2) that the sponsors were maintaining a market in the securities sold or to be sold, which thus affected the sale price to the investment company; (3) that through the investment company purchases the sponsors were enabled to retain control over a large public utility system with little investment or risk; (4) that the purchase by the investment company of the securities other than in the Standard Gas & Electric system was for the purpose of securing banking business of those companies for the sponsors; (5) the true asset value of the securities purchased; (6) the perilous financial condition of many of the companies whose securities were purchased or intended to be purchased by the investment company.

a. Investments in Standard Gas & Electric Corporation, Standard Power and Light Company and Affiliates

The initial block of securities sold by the sponsors to the investment company, at the latter's inception, consisted in the main of securities of Standard Power and Light Company, Standard Gas & Electric Corporation and its subsidiaries, Northern States Power Company, Louisville Gas and Light Company, Southern Colorado Power Corporation and Mountain States Power Company, all companies of the public utility system for which H. M. Byllesby and Company were the organizers, bankers, and managers.¹⁴² The sponsors maintained the prices of these securities through market opera-

¹³⁹ *Ibid.*

¹⁴⁰ *Ibid.*

¹⁴¹ See *infra*.

¹⁴² See *supra*.

tions so that the prices paid by the investment company, while approximately the published market prices, reflected the inflated prices resulting from the trading activities in such stocks by the sponsors. It was this initial sale that gave the sponsors the money to pay the bank loans, retain control of the utility system and further stabilize the market in the utility system stocks.

During 1929 and 1930 the market value of the portfolio of Utility and Industrial Corporation declined substantially. The stock of the Standard Gas & Electric Company (one of the top companies) was quoted at \$243¾ on September 27, 1929. The high for this stock in March 1931 was \$88¾. By the end of 1930 it had fallen to \$69¾. Despite the fact that this trend was quite evident by the end of 1930, the annual report of the investment company as of that date published in February 1931 stated, with reference to this stock, "Developments of the past year have not changed or modified the opinion of your directors as to the ultimate profit which they believe will be realized from the investments in your Corporation's portfolio."¹⁴³

The income of Standard Gas & Electric Company declined steadily over this period. The consolidated net income of the holding company declined from \$18,731,000 for 1930 to \$14,964,000 in 1931. Moreover, this latter figure reflected certain bookkeeping reductions of operating costs, without which the net operating income would have been even less.

Despite these adverse factors H. M. Byllesby and Company continued to sell securities of this company to the investment company through 1931, 1932, and 1933. In 1935 Standard Gas & Electric Company and certain of its affiliates were placed in reorganization proceedings under Section 77B of the Bankruptcy Act.

b. Investment in Deep Rock Oil Corporation

Another sale which the sponsors made to the investment company was 6,000 shares of 7% preferred stock of Deep Rock Oil Corporation (the name of which was Shaffer Oil & Refining Co. to April 1, 1930), an affiliate of Standard Gas & Electric Company. The purchase price was about \$600,000.¹⁴⁴ By December 31, 1929, the investment company carried this investment at the market value of about 50% of its cost¹⁴⁵ and by December 31, 1938, carried the investment at \$54,000, a decline of over 90% from original cost.¹⁴⁶ H. M. Byllesby and Company, because of its intimate association with Deep Rock Oil Corporation, knew or had cause to know that at the time of the sale of stock to the investment company the portfolio company was, as later described by Mr. Justice Roberts, of the United States Supreme Court, "insufficiently capitalized, was top heavy with debt, and was in perilous financial condition."¹⁴⁷ It appears that the sale was made at a time when the Deep Rock Oil Corporation, which, as further characterized by Mr. Justice Roberts, was "on the precipice of bankruptcy and in dire need of cash."¹⁴⁸

¹⁴³ Reply to Commission's questionnaire for Utility and Industrial Corporation, Part I.

¹⁴⁴ Reply to Commission's questionnaire for Utility and Industrial Corporation, Pt. VII.

¹⁴⁵ Id., Pt. I.

¹⁴⁶ Id., supplementary information.

¹⁴⁷ *Taylor et al. v. Standard Gas & Electric Co. et al.*, 306 U. S. 307 (1939).

¹⁴⁸ Ibid.

Deep Rock Oil Corporation was incorporated in 1919 as Shaffer Oil & Refining Company under the sponsorship of H. M. Byllesby and Company and one C. B. Shaffer. In consideration of properties transferred to the company at its organization, the company issued to Mr. Shaffer 80,000 of 120,000 shares authorized of \$1 par common stock, the entire authorized issue of 50,000 shares of \$100 par preferred stock, \$9,500,000 cash, and a note for \$1,000,000 of H. M. Byllesby and Company and Standard Gas & Electric Company. The company also authorized the issuance of first-mortgage bonds in the principal amount of \$15,000,000. H. M. Byllesby and Company formed a syndicate which sold \$12,000,000 principal amount of the bonds to the public, and the remaining \$3,000,000 principal amount of the bonds were pledged to secure the interest and sinking fund requirements of the publicly owned bonds, which amounted to \$2,000,000 annually.

H. M. Byllesby and Company received the remaining 40,000 shares of the common stock. The business of the company was producing, refining, and selling oil, gasoline, and other petroleum products from properties located in Oklahoma, Kansas, Texas, and Arkansas.

Deep Rock Oil Corporation commenced business with about \$6,600,000 cash. Its total assets were appraised at approximately \$16,000,000. However, from its inception it was, as stated by one of the officers of Standard Gas & Electric Company, "two jumps ahead of the wolf,"¹⁴⁰ with working capital of only \$6,600,000, a bonded indebtedness of \$12,000,000 with annual interest and sinking-fund requirements of \$2,000,000. Shortly after its organization, the company issued \$2,000,000 of notes, an additional burden on the company.

The common stock of the company was placed in a voting trust, both Mr. Shaffer and Standard Gas & Electric Company being represented among the voting trustees. Mr. Shaffer actually managed the company until 1921, when he sold his common stock to Standard Gas & Electric Company, surrendered his preferred stock to the company, and thus left the company in complete control of Standard Gas & Electric Company.

Almost immediately the company issued additional short-term notes in the principal amount of \$3,500,000. Thereafter, between 1921 and 1924, the company borrowed additional sums on notes, some of which were discounted or subsequently taken up by Standard Gas & Electric Company. By 1926, the balance due by Deep Rock Oil Corporation to Standard Gas & Electric Company was over \$14,800,000.

In 1926 Standard Gas & Electric Company proceeded to place part of this indebtedness with the public. In order to improve the balance sheet of Deep Rock Oil Corporation and thus make the proposed issue more attractive to the public, Standard Gas & Electric Company purchased 80,000 shares of a new issue of preferred stock for which it credited Deep Rock Oil Corporation with \$7,223,333.33. Standard Gas & Electric Company then purchased \$7,500,000, principal amount, 2-year, 6% notes of the oil company for \$7,273,750, which were sold to the public through a syndicate managed by H. M.

¹⁴⁰ Ibid. (p. 310).

Byllesby and Company. By these transactions the indebtedness of the oil company to Standard Gas & Electric Company was reduced to a few hundred thousand dollars. However, the position of Deep Rock Oil Corporation did not improve materially. By the spring of 1928 the indebtedness of the oil company to Standard Gas & Electric Company on the notes and open accounts amounted to more than \$11,000,000. Since the 2-year notes were maturing further financing was necessary. Therefore the balance sheet of Deep Rock Oil Corporation had to "again be put in such shape that notes could be sold" to the public.¹⁵⁰

The capital structure of Deep Rock Oil Corporation thereupon was revised to provide for the issuance of 50,000 shares of preferred stock and 580,000 shares of common stock. Standard Gas & Electric Company cancelled the indebtedness of the oil company in the amount of \$11,086,195.85 and received 152,448 shares of the common stock of the oil company. By converting 90,000 shares of the preferred stock and 40,000 shares of class A stock into common stock it received a total of 442,448 shares of the common stock of the oil company.¹⁵¹ Thereafter Deep Rock Oil Corporation issued \$10,000,000, principal amount, 6% gold notes, which were sold to the public through a syndicate managed by H. M. Byllesby and Company. The proceeds were used to retire the 2-year notes and the outstanding mortgage bonds.

This refinancing did not improve the position of Deep Rock Oil Corporation as to working capital. Because of this inadequacy the open account of the oil company with Standard Gas & Electric was again increased steadily until it amounted to \$9,342,642.37 by 1933 when the oil company was placed in receivership.¹⁵²

These advances by the parent to the oil company were not, however, entirely for operating purposes. A substantial part of these funds was used to pay dividends on the preferred stock of the oil company. Until 1926 no dividends of any kind had been paid.¹⁵³ The charter of the oil company provided, however, that in the event of certain dividend arrearages on the preferred stock the holders thereof should receive a vote equal with the holders of the common shares.¹⁵⁴ By advancing funds to pay preferred dividends, therefore, Standard Gas & Electric Company was able to prevent preferred stockholders from receiving a vote and thereby disturbing its control of the oil company.

It will be recalled that it was in 1929 when the oil company was in such precarious financial condition that H. M. Byllesby sold Utility and Industrial Corporation 6,000 shares of 7% preferred stock for \$600,000. In 1933 when Deep Rock Oil Corporation went into reorganization under Section 77B of the Bankruptcy Act, the investment was written down by the investment company to \$30,000—a 95% loss. At December 31, 1938, this investment was carried at \$54,000, or a loss of \$546,000.

¹⁵⁰ Ibid. (p. 316).

¹⁵¹ *Taylor et al. v. Standard Gas & Electric Co. et al.*, 96 Fed. (2nd) 693.

¹⁵² Ibid. (p. 698).

¹⁵³ 306 U. S. 316.

¹⁵⁴ Ibid. (p. 320).

c. Investments in Union Power Corporation and Federal Public Service Corporation

In 1930 and 1931 H. M. Byllesby and Company sold to Utility and Industrial Corporation for \$1,259,479, securities of two public utility holding companies for which the sponsors of the investment company were the bankers, Union Power Corporation and its subsidiary, Federal Public Service Corporation. The total investment, represented on the balance sheet of the investment company as of June 30, 1935, as common stock of the successor company, American Utilities Service Corporation, had a market value at that date of \$4,988. The unrealized loss on this investment was, therefore, \$1,254,491 or over 99%. These two portfolio companies from their inception had complex and top-heavy capital structures with large funded debt.¹⁵⁵

Union Power Corporation was incorporated in Delaware on April 12, 1929, as Utilities Development Corporation. It issued 46,580 shares of Class A stock and 60,000 of Class B stock. On December 1, 1928, it had issued \$1,478,000 principal amount "6% convertible gold bonds," due December 1, 1943.

Federal Public Service Corporation was organized on April 26, 1927, by the same persons who later organized Union Power Corporation.¹⁵⁶ Its sole purpose was to act as an intermediary holding company for operating utility companies. The outstanding capital stock of this company at December 31, 1929, consisted of 100,000 shares of no par value common stock and 35,455 shares of 6½% cumulative preferred stock. On December 1, 1927, the company issued \$10,500,000 principal amount, "first lien gold bonds," due December 1, 1947, which were secured by a pledge of securities of subsidiaries. Between July 1, 1929, and July 1, 1930, the company also issued \$7,000,000 unsecured "three-year convertible 6% gold notes," due July 1, 1932.

All the outstanding common stock of Federal Public Service Corporation was owned by Union Power Corporation¹⁵⁷ and constituted practically the entire assets of the latter.¹⁵⁸ After 1928 most of the outstanding voting stock of Union Power Corporation was acquired by H. M. Byllesby and Company to whom the stock had been issued for "banking services" rendered to Union Power Corporation and Federal Public Service Corporation.¹⁵⁹

In May 1930 Union Power Corporation received a cash advance from H. M. Byllesby and Company of \$250,000 for which it issued a note.¹⁶⁰ During November and December 1930 this note, together with 66,811 shares of Class B stock and 15,000 shares of Class A stock of Union Power Corporation, was transferred to Utility and Industrial Corporation. The following table shows the cost of these securi-

¹⁵⁵ Proceedings before the Securities and Exchange Commission, In the matter of Federal Public Service Corporation (1935), p. 14.

¹⁵⁶ *Id.*, at 23, 24.

¹⁵⁷ *Id.*, at 417.

¹⁵⁸ *Ibid.*

¹⁵⁹ *Id.*, at 62 et seq. For a discussion of the control of Union Power Corporation see the Commission's Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part I, pp. 143-5.

¹⁶⁰ *Id.*, at 528.

ties to the sponsors and the prices at which these securities were sold to the investment company:¹⁶¹

	Cost to Byllesby and Co.	Sale price to Utility and Industrial
Class A	\$189, 791	\$189, 801
Class B	283, 340	534, 488
Note	250, 000	250, 000
Total	723, 131	974, 289

Simultaneously with these transactions, H. M. Byllesby and Company sold to Utility and Industrial Corporation 2,038 shares of 6½% preferred stock of Federal Public Service Corporation for \$173,230.¹⁶² In September 1931 H. M. Byllesby and Company sold to the investment company for \$357,000, 6% gold notes of Federal Public Service Corporation in the principal amount of \$420,000.¹⁶³

In December 1930, after H. M. Byllesby and Company had sold some of the securities of Federal Public Service Corporation to the investment company, the portfolio corporation was not in a financial condition to meet its notes.¹⁶⁴ From that time on the earnings of both Federal Public Service Corporation and Union Power Corporation decreased. By the end of 1931, Utility and Industrial Corporation had written down to \$3 its investment in Union Power Corporation, for which it had paid \$974,289.¹⁶⁵ By May 1932, on the eve of the maturity of its 6% gold notes, Federal Public Service Corporation was placed in receivership. In 1934, Union Power Corporation was placed in bankruptcy. In addition to its bonded indebtedness Union Power Corporation owed unsecured claims of about \$570,000, of which over \$280,000 were held by Utility and Industrial Corporation.

In October 1934, pursuant to a plan of reorganization, American Utilities Service Corporation was organized to succeed Federal Public Service Corporation.

d. Investment in Seaboard Investment Trust (Subsequently known as Washington & Suburban Companies)

Another instance of an investment made by Utility and Industrial Corporation for the purpose of helping the banking business of its sponsor, with resultant loss to the investment company, was the investment in Seaboard Investment Trust. The investment company assumed the commitment of its sponsor to purchase 25,000 shares of common stock of Seaboard Investment Trust for a total of \$1,000,000. The investment company ultimately sustained a loss of \$976,000 on this investment.

¹⁶¹ Id., at 530-532.

¹⁶² Derived from supplementary information supplied the Commission for Utility and Industrial Corporation.

¹⁶³ Ibid.

¹⁶⁴ Ibid.

¹⁶⁵ Derived from supplementary information supplied the Commission for Utility and Industrial Corporation.

Seaboard Investment Trust, subsequently known as Washington & Suburban Companies, is a common-law trust organized under the laws of Massachusetts on April 1, 1929, by a syndicate composed of H. M. Byllesby and Company, The Harris Forbes Corporation, American Founders Corporation, Chase Securities Corporation, and Schoellkopf, Hutton and Pomeroy. The syndicate was acting for the account of Central Public Service Corporation.¹⁶⁶ Central Public Service Corporation was primarily interested in acquiring control of Washington Gas Light Company, a public utility operating in the District of Columbia and environs, and thus removing Washington Gas Light Company from the possibility of acquisition by Utilities Power & Light Corporation, another large public utility holding company.¹⁶⁷ The syndicate participants, as bankers for Central Public Service Corporation, each agreed to contribute \$1,000,000 so that Central Public Service Corporation could buy the stock of the Washington Gas Light Company. The members of the syndicate thereupon transferred their commitments to their various controlled investment companies, which in turn supplied the cash and received the stock in Seaboard Investment Trust (which will be hereinafter referred to as Washington & Suburban Companies). Utility and Industrial Corporation received 25,000 shares, the commitment of H. M. Byllesby and Company, for which it paid \$1,000,000.¹⁶⁸

It appears that the financial position of Washington & Suburban Companies was not strong. It had been obliged to borrow \$10,000,000 from banks in order to complete the purchase of the Washington Gas Light Company stock.¹⁶⁹ By October 1929, six months after its organization, it had accumulated an operating deficit of \$118,888.¹⁷⁰

By the terms of the original agreement between the syndicate and Central Public Service Corporation, the latter was obligated to find purchasers for or to repurchase the shares of Washington & Suburban Companies from the syndicate members, on or before April 30, 1931, at \$48 (an \$8 profit per share above the price to the syndicate).¹⁷¹ On March 15, 1931, the obligation of Central Public Service Corporation to repurchase the Washington & Suburban Companies' stock was extended for one year—until April 30, 1932.¹⁷² Thereafter the sponsors of Central Public Service Corporation organized the Westfield Trust, a Massachusetts trust, which repurchased the 125,000 shares of the Washington & Suburban Companies at \$48—including the 25,000 shares owned by Utility and Industrial Corporation. Instead of paying for the stock in cash, however, the Westfield Trust issued notes collaterally secured by the repurchased Washington & Suburban Companies' stock and guaranteed by Central Public Service Corporation. Utility and Industrial Corporation thus received \$1,200,000 of the notes—the exact repurchase price.¹⁷³ When these notes matured on April 30, 1932, Westfield Trust defaulted and the guarantor, Central

¹⁶⁶ For a discussion of this company see Part Three, Ch. II, p. 566.

¹⁶⁷ *Ibid.*

¹⁶⁸ *Ibid.*

¹⁶⁹ *Ibid.*

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

Public Service Corporation, was unable to fulfill its guaranty. Accordingly, on July 21, 1932, the assets of the Westfield Trust were sold at auction and bought in by the note holders for the face amount of the notes.¹⁷⁴ The book value of the notes held by Utility and Industrial Corporation was \$1,288,172.¹⁷⁵ In lieu of the notes Utility and Industrial Corporation received 1,200 common shares of Washington & Suburban Companies, with a carrying value of \$1,290,666.46.¹⁷⁶

On July 15, 1936, Utility and Industrial Corporation sold the stock of Washington & Suburban Companies for \$23,940¹⁷⁷—a loss of about \$976,000 or 98% of its investment.

From its inception Utility and Industrial Corporation borrowed heavily from banks. During the years 1931 to 1933 the investment company borrowed approximately \$20,000,000 from banks and pledged its portfolio securities to secure these loans.¹⁷⁸ The proceeds of these loans were used to bail the sponsors, H. M. Byllesby and Company, out of bank indebtedness, and to assist various ventures in which the sponsors, or sponsors' associates, were interested.

H. M. Byllesby and Company had been heavily indebted to banks at the time the investment company was organized.¹⁷⁹ This indebtedness was gradually reduced through advances made by the investment company to the Byllesby firm and through purchases of securities by the investment company from the Byllesby firm as principals.¹⁸⁰ During October and November 1929, the investment company lent H. M. Byllesby and Company \$3,000,000. These loans were repaid by December 31, 1929.¹⁸¹

¹⁷⁴ Ibid.

¹⁷⁵ Derived from supplementary information supplied the Commission for Utility and Industrial Corporation.

¹⁷⁶ Ibid.

¹⁷⁷ Ibid.

¹⁷⁸ Derived from supplementary information supplied the Commission for Utility and Industrial Corporation.

Some of these loans were demand loans, others were for 90-day periods. The following table shows the amounts of loans outstanding, the amount of collateral pledged, the total investments, and the percentage of investments represented by the pledged collateral at year-ends for the period 1930-1935:

Year-end	Notes payable	Amount of pledged collateral (at market)	Investments (at market)	Percentage of investments pledged
1930.....	\$4,001,003	\$9,665,850 (cost)	\$36,937,263 (cost)	26
1931.....	4,183,608	6,127,500	16,115,761	38
1932.....	3,500,000	6,508,050	8,867,135	76
1933.....	2,790,000	4,153,524	5,169,784	80
1934.....	2,765,000	3,464,173	3,907,920	89
1935.....	643,602	2,194,602	3,484,167	63

¹⁷⁹ Supra.

¹⁸⁰ The following table shows the amount of bank loans of H. M. Byllesby and Company from 1929 to 1936 (supplementary information supplied the Commission for Utility and Industrial Corporation):

November 15, 1929.....	\$9,500,000.00
September 25, 1930.....	9,150,000.00
October 21, 1931.....	6,902,863.97
January 1, 1932.....	5,989,065.47
January 1, 1933.....	1,948,500.00
November 30, 1934.....	1,767,350.00
April 1, 1935.....	3,788,380.00
May 1, 1936.....	1,623,476.00

¹⁸¹ Ibid.

During 1930 Utility and Industrial Corporation borrowed over \$4,000,000 to purchase securities from the Byllesby firm, the proceeds of which sales the latter applied to its indebtedness.¹⁸² Thus the investment company was incurring indebtedness to bail its sponsor out of debt.

In addition to these direct transactions, the investment company made advances to companies or persons in which H. M. Byllesby and Company was interested or with whom they were affiliated. For example, the investment company lent \$500,000 to Mercantile Discount Corporation, whose manager was a business associate of the Byllesby firm. The loan was ultimately repaid, but the investment company subsequently invested \$1,264,193 in the Class A stock of Mercantile Discount Corporation. In 1931 this stock was sold by the investment company at a small loss.¹⁸³

On May 5, 1930, Utility and Industrial Corporation lent \$23,810 to the La Cia Hidros, S. A., a water company operating in Tampico, Mexico, managed and operated by H. M. Byllesby and Company.¹⁸⁴ The investment company also purchased from H. M. Byllesby and Company stock and bonds of this company for \$982,537.50.¹⁸⁵ H. M. Byllesby and Company thus sold to Utility and Industrial Corporation its entire interest in this utility company. In 1932 the property of this water company was taken over by the Mexican government and Utility and Industrial Corporation wrote down its investment in the company to \$1.¹⁸⁶

On December 12, 1931, Utility and Industrial Corporation lent \$292,280 to Victor Emanuel and Thomas A. O'Hara. The loan was evidenced by a 90-day note and collaterally secured by securities of Standard Gas & Electric Company, for which company and its subsidiaries and affiliates H. M. Byllesby and Company was the organizer, manager, and banker. Victor Emanuel at this time was president and director of Standard Power & Light Company, which controlled Standard Gas & Electric Company. The note was settled in May 1935, by the payment to the investment company of \$50,000 in cash and securities with a then market value of \$88,640,¹⁸⁷ or a loss of \$153,640.

In summary, Utility and Industrial Corporation was organized by H. M. Byllesby and Company as a facility and an adjunct to the latter's business rather than as an independent business venture, and has been used as such throughout its existence. The capital initially contributed had shrunk as a result of this management policy, from \$32,750,000 at the time of its organization in February 1929, to net assets of \$2,184,196 at market, on December 31, 1938. At December 31, 1938, the preferred stock, which was cumulative as to dividends, had an asset value of \$3.34 per share. There were dividend arrearages on the preferred stock, at December 31, 1938, of \$6,534,000. The common stock obviously had no asset value whatsoever.

¹⁸² *Ibid.*

¹⁸³ *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.*

¹⁸⁶ *Ibid.*

¹⁸⁷ *Ibid.*

5. NIAGARA SHARE CORPORATION

Niagara Share Corporation was organized on May 6, 1925 under the laws of Delaware as a holding company for the Schoellkopf family utility interests, which family at all times (particularly to the end of 1929) owned or controlled substantially in excess of 50% of the total stock of that company outstanding.¹⁸⁸ In 1929 Niagara Share Corporation of Maryland was organized further to consolidate the Schoellkopf family interests, and succeeded substantially to the holdings of the original Niagara Share Corporation.¹⁸⁹ Into these companies, which will hereafter be treated as a continuing entity, there were placed by the Schoellkopf family and by the public cash and property of the total value of \$150,196,736.¹⁹⁰ At December 31, 1935, the assets of this investment company had a market value of only \$39,536,900.¹⁹¹

The charters of the original and successor companies expressly sanctioned contracts or transactions in which the directors were directly or indirectly interested as principals.¹⁹²

The original function performed by Niagara Share Corporation¹⁹³ was to secure to the Schoellkopf family control over Buffalo, Niagara & Eastern Power Corporation.¹⁹⁴ Not until 1926 was a diversified list of securities added to the portfolio, largely acquired by the sale to the public of preferred and common stocks.¹⁹⁵ In June 1929, Niagara Hudson Power Corporation was organized, absorbing Buffalo, Niagara & Eastern Power Corporation, so that the Schoellkopf interest was exchanged for approximately 13% of the new holding company and various of the family holding companies no longer served any purpose.¹⁹⁶ Accordingly, the creation of the new investment company in 1929 served to simplify the family holding¹⁹⁷ while the position of the investment company in Niagara Hudson Power

¹⁸⁸ Public Examination, Niagara Share Corporation, at 20728.

¹⁸⁹ *Id.*, at 20750-5.

¹⁹⁰ *Id.*, Commission's Exhibit No. 3203.

¹⁹¹ *Id.*, at 20874.

¹⁹² Derived from summary statement supplied the Commission for Niagara Share Corporation (Del.) and reply to the Commission's questionnaire for Niagara Share Corporation of Maryland, Pt. I.

¹⁹³ Reply to Commission's questionnaire for Niagara Share Corporation of Maryland, Pt. I.

¹⁹⁴ Public Examination, Niagara Share Corporation, at 20727-8. Niagara Share Corporation (Del.) received its initial capital from subscriptions under rights granted to the shareholders of Niagara Falls Power Company, substantially owned by the Schoellkopf family. Through its ownership of the stock of Niagara Share Corporation and of Niagara Falls Power Company, the Schoellkopf family owned over 50% of the common stock of Buffalo, Niagara & Eastern Power Corporation. This control was further solidified by the placing of the Schoellkopf family holdings of Buffalo, Niagara & Eastern Power Corporation in Bennie Securities Corporation and such holdings of Niagara Share Corporation in Niagara Securities Corporation. These two companies were substantially owned by the Schoellkopf family and their securities were not readily marketable. (*Ibid.* and *id.*, at 20750-1.)

¹⁹⁵ *Id.*, at 20728-9.

¹⁹⁶ *Id.*, at 20729.

¹⁹⁷ Since the formation of this company, Bennie Securities Corp., Niagara Securities Corp., Schoellkopf Securities Corp., and the original Niagara Share Corp. have all been dissolved and their assets absorbed by Niagara Share Corporation of Maryland. (*Ibid.*)

Corporation at all times constituted approximately 70% of the investment company's capital.¹⁹⁸

Although the Schoellkopf family at all times owned the majority of the outstanding shares of the investment company, the public also made substantial contributions. These contributions were obtained by the offer of exchange offers to shareholders in companies absorbed by this investment company as well as by cash subscriptions to preferred stock and debentures.¹⁹⁹ Nevertheless, the policy motivating the foregoing activities was apparently dictated by the peculiar needs of the Schoellkopf family.

Another activity of the Schoellkopf family was the investment banking corporation of Schoellkopf, Hutton & Pomeroy, Inc. The president of Schoellkopf, Hutton & Pomeroy until 1935 was Jacob F. Schoellkopf, Jr., also the president of the investment company.²⁰⁰ All of the shares of Schoellkopf, Hutton & Pomeroy, Inc., were owned by Seeheim Corporation, which was in turn owned by Jacob F. Schoellkopf, Jr., and his two sisters.²⁰¹

This Buffalo banking house, which was prominent in the affairs of Niagara Share Corporation, sold 208,023 shares of common stock of the original investment company for a total of \$5,490,249.50,²⁰² headed a syndicate which underwrote 15,000 shares of its preferred stock in 1926,²⁰³ and participated in a \$15,000,000 debenture offering in May 1930.²⁰⁴ American Alliance Investing Corporation was an investment company which was sponsored by Schoellkopf, Hutton & Pomeroy, Inc., in 1928 and which included upon its board of directors Jacob F. Schoellkopf, Jr., and two other directors of Niagara Share Corporation.²⁰⁵ On August 5, 1929,²⁰⁶ Niagara Share Corporation acquired the \$8,310,407 of assets of American Alliance Investing Corporation and American Alliance Management Co., Inc., for 187,321 common shares and 516 preferred shares of its own stocks.²⁰⁷ American Alliance Investing Corporation was organized for investment in foreign securities, but the consolidation was deemed desirable to effect economies in operating costs.²⁰⁸

The banking house of Schoellkopf, Hutton & Pomeroy, Inc., from time to time borrowed sums of money from Niagara Share Corporation,²⁰⁹ and also accumulated a substantial holding of shares of the investment company. In August 1930, after the bond flotation

¹⁹⁸ Reply to the Commission's questionnaire for Niagara Share Corporation of Maryland, Pts. I and II.

¹⁹⁹ Public Examination, Niagara Share Corporation, Commission's Exhibits Nos. 3201 and 3203.

²⁰⁰ *Id.*, at 20723-4.

²⁰¹ *Id.*, at 20770-1.

²⁰² *Id.*, Commission's Exhibit No. 3201.

²⁰³ *Ibid.* These shares were issued to net the investment company \$92.

²⁰⁴ *Id.*, Commission's Exhibit No. 3203. These debentures were issued for \$14,850,000 to net \$14,233,450.

²⁰⁵ Public Examination, Niagara Share Corporation, at 20736-42.

²⁰⁶ Keane's Manual of Investment Trusts, 1930.

²⁰⁷ Public Examination, Niagara Share Corporation, Commission's Exhibit No. 3201.

²⁰⁸ *Id.*, at 20736-42.

²⁰⁹ *Id.*, at 20771.

above referred to,²¹⁰ the investment company purchased 286,171 shares of Niagara Share Corporation common stock at approximately \$12 a share and 48,000 shares of Niagara Securities Corporation common stock at about \$18 a share²¹¹ from the banking house for a total of \$4,298,052.²¹² Although the sale of these shares to Niagara Share Corporation by Schoellkopf, Hutton & Pomeroy was allegedly made at \$2 or \$3 a share below the prevailing market price, it was admittedly at a profit to the banking house.²¹³ This transaction provided the banking house with ready cash during a period of depressed business conditions and permitted it to pay off loans due to the investment company of at least \$2,100,000 as well as some \$1,200,000 due to the Marine Trust Company of Buffalo.²¹⁴

The foregoing repurchase of its own shares by the investment company was made in anticipation of the approval by the board of directors of a proposal to acquire all of the stock of Schoellkopf, Hutton & Pomeroy, Inc., through an exchange offer.²¹⁵ At this point it should be noted that in 1930 the Schoellkopf, Hutton & Pomeroy Securities Corporation was formed to take over from the Seeheim Corporation, the stock of Schoellkopf, Hutton & Pomeroy, Inc., and the officials of the latter were afforded a participation in the new company in anticipation of this deal.²¹⁶ By this transaction Seeheim Corporation received 6,182 shares of Schoellkopf, Hutton & Pomeroy Securities Corporation in exchange for all of the stock of the banking house while Jacob F. Schoellkopf, Jr., and his associates received 3,400 shares thereof at \$5 a share.²¹⁷ Thus, for a total of \$17,000 they received more than a one-third interest in a banking house appraised for purposes of the sale at \$14,372,565.²¹⁸

On August 8, 1930, the board of directors did approve the acquisition, for which the investment company gave 958,171 shares of its common stock (representing about 191,000 shares of the present stock) valued at \$15 a share, or a total of \$14,372,565.²¹⁹ Inasmuch as the book value of the assets of the banking house was only \$4,672,565, the remaining \$9,700,000 constituted the "good will" value of the business.²²⁰ The nature of the so-called negotiations concerning this transaction was disclosed in the following testimony of Mr. Schoellkopf:²²¹

²¹⁰ Mr. Schoellkopf denied any connection between this offering of bonds and the repurchase of common stock. (Id., at 27776-7.)

²¹¹ The holdings of Niagara Securities Corporation consisted almost entirely of shares of Niagara Share Corporation. (Id., at 27773.)

²¹² Id., at 27772-3.

²¹³ Id., at 27776.

²¹⁴ Id., at 27788-9. The investment company had previously requested collateral for its unsecured loan. (Id., Commission's Exhibit No. 3206.)

²¹⁵ Id., at 27773-4.

²¹⁶ Id., Exhibit A.

²¹⁷ Ibid.

²¹⁸ Id., at 27797.

²¹⁹ Id., at 27796-7.

²²⁰ Id., at 27798-9. On August 11, 1930, Schoellkopf, Hutton & Pomeroy, Inc., declared a \$189,000 dividend (Id., at 27791), and on August 31, 1930, only \$491,000 in cash was listed among the assets of that company (Id., at 27778-9). If this premium of \$9,700,000 had been prorated over the assets of Schoellkopf, Hutton & Pomeroy, Inc., as at June 30, 1930, the shares of Niagara Share Corporation subsequently repurchased would have been written up from the market value of \$14.25 a share to about \$37 a share.

²²¹ Id., at 27803-4.

Q. What conversations did you have, Mr. Schoellkopf, with the committee regarding the price that Niagara [Share Corporation] of Maryland should pay for Schoellkopf, Hutton [and Pomeroy, Inc.]?

A. I think my conversation consisted entirely of one sentence, and that was that if they wanted Schoellkopf, Hutton & Pomeroy, we would accept and they would have to pay a million shares in exchange for the 30,000 shares of Schoellkopf, Hutton & Pomeroy.

Q. Whom were you representing in that instance—acting as president of Niagara Share?

A. No; I was representing my ownership and my two sisters' ownership of that 30,000 shares.

Q. How many times in your life, Mr. Schoellkopf, have you put a price on something and got it right away without any haggling?

A. I don't know that I have had any similar transactions. Lots of times I have sold stocks without any haggling.

Q. Yes; that was because somebody set a price on the stock. You set a price of one million shares on your investment-house business, and your cousins and Cory and DeGraff consented and gave it to you, practically.

A. They didn't give it to us. The board of directors did.

Q. Didn't you say earlier today that what the committee decided you knew the board of directors would decide?

A. I said I had every reason to believe so. In any event, it was purely an exchange of one security for another.

Although the investment company and the banking house were admittedly engaged in substantially the same business,²²² a valuation was placed upon the "good will" of the latter at approximately 208% of its real asset. This "good will" value was based upon the alleged earning power of the banking house²²³ for which purposes a statement of earnings had been prepared by Arthur E. Surdam, a public accountant, at the request of Russell J. H. Hutton, vice president of Schoellkopf, Hutton & Pomeroy, Inc.²²⁴ This statement showed total earnings for the five years ending December 31, 1929, at \$5,152,500, or an average of about \$1,030,500 a year,²²⁵ so that the purchase price on this basis was roughly 14 times the average annual income for that period. The officers of the banking house were retained under a five-year contract at salaries ranging from \$50,000 to \$10,000 per annum.²²⁶

However, this earning statement had been adjusted, under instructions from Mr. Hutton, to give effect to the elimination from expenses of administration expenses paid and to restore to earnings previous appropriations to contingent reserves for the depreciation of securi-

²²² *Id.*, at 20781.

²²³ *Id.*, at 20800.

²²⁴ *Id.*, at 20807-8.

²²⁵ *Id.*, Commission's Exhibit No. 3209-10. It was further represented that the net earnings for the first six months of 1930, computed upon the same basis, were \$541,113. (*Ibid.*)

²²⁶ *Id.*, at 20827-9, 20837, and Commission's Exhibit No. 3209. These salaries, which were specified as \$50,000 to J. F. Schoellkopf, Jr., \$40,000 to R. J. H. Hutton, \$20,000 to Horace B. Pomeroy, and \$10,000 to Charles G. Terry, were thereafter reduced voluntarily. (*Ibid.*)

ties.²²⁷ Without these adjustments, the net earnings for the five-year period were \$2,123,578, or an average of only \$425,000 a year.²²⁸

The theory upon which these adjustments and eliminations were made was that nonrecurring charges should not be reflected in an earning statement for the purpose of computing the going value of the company.²²⁹ Thus, the substitution of fixed salaries for the salary and bonus system previously employed permitted the elimination of administrative commissions which absorbed more than 40% of the net income.²³⁰ While the statement included items of realized profits, it did not take into consideration unrealized depreciation²³¹ for which reserves had been established in the unadjusted reports.²³² These two items, administrative commissions and reserves for depreciation, accounted for practically all of the difference between the two methods of computing earnings for the five-year period.²³³

While care was taken to include the foregoing as nonrecurring expenses, no effort was made to segregate possible nonrecurring profits. Thus, gross profits from bond and stock sales, a major source of profit during the period, presumably included all profits resulting from the sale of investments—a source of profit which naturally dried up as investments were liquidated. Similarly, dividends were dependent upon the continuation of dividend payments and the retention of the securities in the portfolio.²³⁴

While the owners of Schoellkopf, Hutton & Pomeroy, Inc., were giving up an alleged earning power of approximately \$1,000,000 a year for stock-paying dividends of about \$400,000 a year (and earning \$600,000 a year), the deal was rationalized by them as providing them a more certain income as individuals.²³⁵ This uncertainty of continuing income of Schoellkopf, Hutton & Pomeroy, Inc., is of particular significance in the light of the circumstances of the transaction. The computation of the sale price for Schoellkopf, Hutton & Pomeroy, Inc., was predicated upon the earnings of that company for the five best years in modern investment banking history in this country. The methods employed to inflate these earning figures have already been explored, and it is significant that a substantial part thereof was not derived from essential investment banking operations.²³⁶

At the time of this acquisition of Schoellkopf, Hutton & Pomeroy, Inc., it owed sizable sums to the investment company and to its bank, the payment of which would not only deprive that banking house of

²²⁷ *Id.*, at 20812-3. An estimated provision for federal and state taxes based upon 1930 tax rates was substituted for the provision made on the books and audit statements for each of the years shown. (*Ibid.*)

²²⁸ *Id.*, at 20810-11. On the basis of these earning figures Schoellkopf, Hutton & Pomeroy, Inc., capitalized its income at 34 times.

²²⁹ Derived from supplementary information supplied the Commission by Niagara Share Corporation.

²³⁰ *Ibid.* These commissions were more than 40% of the total profits. J. F. Schoellkopf resigned as an officer and director of the banking house in October 1935, and thereafter the officers were remunerated only on a profit-sharing basis.

²³¹ *Ibid.*

²³² *Ibid.*

²³³ Public Examination, Niagara Share Corporation, Commission's Exhibit No. 3210.

²³⁴ *Id.*, Commission's Exhibits Nos. 3211, 3212.

²³⁵ Derived from supplementary information supplied the Commission by Niagara Share Corporation.

²³⁶ Public Examination, Niagara Share Corporation, Commission's Exhibit No. 3211.

a source of income but would liquidate its principal assets and deprive it of most of its working capital. Without such capital and in the face of the business depression which had already stagnated the investment banking business, it was not to be assumed that even normal banking operations would be profitable at any time in the near future. By selling this enterprise to the investment company the bank loan could be paid off, new working capital would be provided, substantial salaries could be paid, and shares in an investment company could be substituted for the more uncertain prospects of the investment banking business. Last, but by no means least, was the substantial premium paid for the going or good-will value of Schoellkopf, Hutton & Pomeroy, Inc., of approximately 208% of its net asset value. The dual positions of influence occupied by Mr. Schoellkopf and his associates must have gone far to make this deal possible.

Within a year after this acquisition the \$9,700,000 of "good will" was written off the books of Niagara Share Corporation of Maryland and during the succeeding five-year period the banking house, under the ownership of the investment company but under the same management as theretofore, experienced a net loss of \$510,791.²³⁷

In the fall of 1935 when the investment banking business showed signs of improvement, it was concluded by the management of Niagara Share Corporation of Maryland that the passage of the Public Utility Holding Company Act of 1935 made it expedient to part with control over Schoellkopf, Hutton & Pomeroy, Inc.²³⁸ Accordingly, on November 7, 1935, the stockholders of the investment company approved a plan of recapitalization of the banking house calling for the creation of 32,300 shares of a new 5½%, participating, preferred stock of the par value of \$3,230,000, representing the approximate value of its assets, exclusive of the so-called "good will" previously written off, and the issuance of a new common stock.²³⁹ The investment company surrendered its previously held common stock to the banking house for which it received 30,000 of the new preferred shares, was given 2,300 preferred shares as a stock dividend, and purchased 301,400 new common shares at 10¢ a share.²⁴⁰ These common shares were thereupon distributed to the shareholders of the investment company on the basis of one share of Schoellkopf, Hutton & Pomeroy, Inc., for each five shares of Class B common stock of Niagara Share Corporation of Maryland.²⁴¹ This distribution was accordingly equivalent to a 2¢ per share dividend by the investment company on the basis of the price paid for the new common stock of the banking house. However, this distribution also placed in the hands of the Schoellkopf family the major part of the "good will" or earning power which the banking house presumably still possessed,²⁴² and for which the invest-

²³⁷ Id., at 20837-9.

²³⁸ Id., at 20839.

²³⁹ Id., at 20840-1.

²⁴⁰ Derived from supplementary information supplied the Commission by Niagara Share Corporation.

²⁴¹ Derived from summary statement supplied the Commission for Niagara Share Corporation (Del.), and reply to the Commission's questionnaire for Niagara Share Corporation of Maryland, Pt. I.

²⁴² All profits over and above the 5½% dividend due on the preferred stock was to be divided equally between the preferred and common stocks of Schoellkopf, Hutton & Pomeroy, Inc. (Id., Pt. I [Annual Report, 1935].)

ment company had paid a substantial premium.²⁴³ The next year, 1936, the banking house made approximately \$1,000,000²⁴⁴ and the officers were again paid on a bonus basis.²⁴⁵

A stockholder's action, filed in the state of New York, County of Erie, attacked various of the purchases of securities (particularly the purchase of Schoellkopf, Hutton & Pomeroy, Inc.) by Niagara Share Corporation of Maryland "as being conducted and consummated in fraud and bad faith," and as resulting in waste and loss to the defendant corporation in the total sum of \$66,545,105.19.²⁴⁶ The holding of courts, both at the original trial and on appeal, found these transactions to be within the lawful powers of the investment company, its officers and directors.²⁴⁷

6. CONTINENTAL SHARES, INC.

Continental Shares, Inc., was a closed-end investment company incorporated under the laws of Maryland on March 1, 1926.²⁴⁸ Its promoters and sponsors were Cyrus S. Eaton, senior partner of the investment banking firm of Otis & Company of Cleveland, Ohio, and

²⁴³ Public Examination, Niagara Share Corporation, at 20811-2, and derived from supplementary information supplied the Commission by Niagara Share Corporation. Mr. Schoellkopf resigned as an officer and director of Schoellkopf, Hutton & Pomeroy, Inc., in October 1935. (Ibid.)

²⁴⁴ Public Examination, Niagara Share Corporation, at 20868.

²⁴⁵ Derived from supplementary information supplied the Commission by Niagara Share Corporation. In addition, Niagara Share Corporation acquired Marine Union Investors, Inc., and Union Rochester Share Corporation, both being obtained by exchanges of capital stocks in July and September 1930, respectively. Public Examination, Niagara Shares Corporation, Commission's Exhibit No. 3203 and derived from summary statement supplied the Commission for Niagara Share Corporation (Del.), and reply to the Commission's questionnaire for Niagara Share Corporation of Maryland, Pt. I. At the time of acquiring Marine Union Investors, Inc., seven directors were common to both boards, including Jacob F. Schoellkopf, Jr., president of Niagara Share Corporation, and George F. Rand and Seymour H. Knox, chairman of the board and president, respectively, of Marine Union Investors, Inc. (Derived from supplementary information supplied the Commission for Niagara Share Corporation.) The alleged purpose of this acquisition was to effect economies in operation. (Public Examination, Niagara Share Corporation, at 20865-6.) Messrs. Schoellkopf, Rand, and Knox were also directors of Union Rochester Share Corporation which was organized in July 1929 as a finance and securities company to take over the investment business of Union Trust Company of Rochester, N. Y. (Derived from supplementary information supplied the Commission for Niagara Share Corporation.)

²⁴⁶ See *Winter v. Anderson et al.*, 242 App. Div., N. Y., 430.

²⁴⁷ Public Examination, Niagara Share Corporation, at 20880-1, and Exhibit A. Other transactions involved in this suit were the acquisition by Niagara Share Corporation of Schoellkopf Securities Corporation, a Schoellkopf family corporation, as a result of which the investment company assumed and paid outstanding bonds of the par value of \$366,000; the purchase of a 45% interest in the Pompeian Company, manufacturers of cosmetics, for \$1,375,000, while other participants paid only \$625,000 for a 55% interest; losses from loans totaling \$8,380,000 by the investment company (with the 50% guarantee of Forest Oil Company) to Niagara Oil Corporation, owned equally by the investment company and Forest Oil Corporation; alleged losses from the acquisition of shares of Niagara & Eastern Power Corporation (later exchanged for stock of Niagara & Hudson Power Corporation) by the investment company from Bennie Securities Corporation; and alleged losses from investments of \$79,250 in U. S. Daily Publishing Corporation, and \$350,000 in Ford Hotels Company, Inc. (Ibid.)

²⁴⁸ Summary statement filed with the Commission for Continental Shares, Inc.; see also Public Examination, Continental Shares, Inc., at 21072, 21338, 21737.

his associates. Mr. Eaton had and has been active in the promotion and financing of various industrial enterprises, being particularly identified with the steel, utilities, and rubber industries.²⁴⁹ When Continental Shares, Inc., was organized its stated purpose was to engage in large scale industrial financing rather than investment in a diversified portfolio of securities.²⁵⁰

The initial capital of the investment company was raised by the public offering of 130,000 shares of common stock at \$52 per share, which netted the investment company \$50 per share, and 10,000 founders shares at \$1.00 per share.²⁵¹ At subsequent dates between August 18, 1927, and January 31, 1931, the investment company sold to the public 158,229 shares of preferred stock, 240,000 shares of convertible preferred stock and 2,429,229½ additional shares of common stock. The investing public paid a total of \$113,652,634 and the company received as net proceeds the sum of \$111,003,269.²⁵² By the end of 1927 the gross assets of the investment company were reported at \$14,152,046²⁵³ and by the end of 1930 at \$156,499,787.²⁵⁴ By June 22, 1933, when the company went into receivership, the total assets of the investment company were reported at \$16,670,855.²⁵⁵

During the period prior to October 13, 1930, Otis & Company, of which Mr. Eaton was the principal partner, had become heavily indebted and various creditors—principally banks—were pressing for payment.²⁵⁶ By the early part of October 1930, officials of the New York Stock Exchange had become aware of the condition of Otis & Company and a consultation was held between members of the firm and officials of the Exchange on the night of October 13, 1930.²⁵⁷ At this conference, the Exchange officials advised the firm that unless the firm's depleted capital were replenished by \$12,000,000, the firm would not be permitted to open for business on the next morning, October 14. Ferdinand Eberstadt, a partner of Otis & Company, and in charge of the New York Office of that firm in 1930, testified before the Committee on Banking and Currency of the United States Senate:²⁵⁸

Mr. GRAY [Committee Counsel]. Is it not a fact that negotiations had been had, or rather were, the members of your firm had been brought before the governing committee of the New York Stock Exchange and were advised on the night of the 13th of October that they would not be permitted to open the doors unless certain obligations were taken care of?

Mr. EBERSTADT. That is not a fact.

²⁴⁹ Ibid.

²⁵⁰ Public Examination, Continental Shares, Inc., Commission's Exhibit No. 3250.

²⁵¹ Id., Commission's Exhibit No. 3256.

²⁵² Ibid.

²⁵³ Id., Commission's Exhibit No. 3260.

²⁵⁴ Id., Commission's Exhibit No. 3263.

²⁵⁵ Id., Commission's Exhibit No. 3266.

²⁵⁶ Id., at 21271.

²⁵⁷ Hearings, Committee on Banking and Currency, United States Senate, 72nd Cong., 1st Sess., pursuant to Sen. Res. 64, pp. 969-970.

²⁵⁸ Ibid.

Mr. GRAY. Was there a consultation between the members of the firm and the governing committee on the night of the 13th of October?

Mr. EBERSTADT. That is correct.

Mr. GRAY. And did you take part in it?

Mr. EBERSTADT. I did.

Mr. GRAY. And what was the ultimatum of the Stock Exchange to your firm?

Mr. EBERSTADT. I did not understand it as an ultimatum but the position by the Stock Exchange was that, I think it was \$12,000 of new capital—

Mr. GRAY (interposing). \$12,000,000.

Mr. EBERSTADT. \$12,000,000 of new capital—

Mr. GRAY. Yes.

Mr. EBERSTADT. —should be put into the firm.

Mr. GRAY. Is it not a fact that you were told that unless that \$12,000,000 in new capital went into your firms' office on the morning of the 14th, you would not be permitted to open?

Mr. EBERSTADT. I don't remember whether we were told that or not. I think, certainly, that was a fair assumption from the meeting. * * *

The meeting closed with the statement that the \$12,000,000 would be put in there.

In the meantime, anticipating the need for additional funds for Otis & Company, and possibly the intended action of the Stock Exchange, Mr. Eaton and his associates adopted the following scheme to raise the funds. Foreign Utilities, Ltd., a holding company controlled by Mr. Eaton,²⁵⁹ sold a large block of securities to the investment company, which borrowed the money to pay for the securities so purchased. With the proceeds which thereby came to Foreign Utilities, Ltd., and through it to him, Mr. Eaton raised the necessary funds to keep Otis & Company in business.

The details of the transaction were as follows:

On October 8, 1930, the board of directors of Continental Shares, Inc., approved the purchase from Foreign Utilities, Ltd., of a list of securities for \$56,958,409 of which \$35,000,000 was to be paid in cash and the balance was to be paid in 1,040,000 shares of common stock of Continental Shares, Inc., valued for purposes of the transaction at \$21.114 per share.²⁶⁰ The securities sold to the investment company consisted of practically the entire portfolio of Foreign Utilities, Ltd., and were as follows:²⁶¹

²⁵⁹ Mr. Eaton and his wife owned 26% of the stock of Foreign Utilities, Ltd. (Public Examination, Continental Shares, Inc., at 21761, 21218.)

²⁶⁰ Id., Commission's Exhibit No. 3289 and No. 3290; id., at 21246, 21283.

²⁶¹ Id., Commission's Exhibit No. 3296.

The profit to Foreign Utilities, Ltd., on this transaction is not ascertainable from information available to this Commission. However, according to the contract of October 10, 1930, the profit on one item, the "B" stock of United Light & Power Corporation sold to the investment company for \$31,154,599, was over \$17,000,000, or more than 50% of the original purchase price to the investment company. (Id., at 21772.)

	Number of common shares	Price	Purchase price under contract Oct. 10, 1930
Bancohio Corporation.....	1,800	35	\$63,000.00
Bank of Nova Scotia.....	600	320	192,000.00
Bank of Toronto.....	500	238	119,000.00
Canadian Bank of Commerce.....	3,500	240	840,000.00
Central United Bank.....	621	66	40,986.00
Cleveland Trust Co.....	1,844	385	709,940.00
Cliffs Corporation.....	84,351	115	9,700,365.00
Corporation Securities Co. of Chicago.....	4,850	20	97,180.00
Dominion Bank.....	649	228	147,972.00
Firestone Tire & Rubber Co.....	126,950	16	2,031,200.00
Fidelity National Bank.....	867	250	216,750.00
B. F. Goodrich Co.....	93,800	18½	1,747,025.00
Imperial Bank.....	466	235	109,510.00
Insull Utility Investments, Inc.....	4,858	56	242,900.00
International Paper & Power "A".....	25,000	113¼	281,250.00
International Paper & Power "B".....	171,400	6	1,028,400.00
International Paper & Power "C".....	251,000	5	1,255,000.00
James MacLaren, Ltd.....	450	500	225,000.00
National Acme Co.....	9,600	9¼	88,800.00
Republic Steel Corporation.....	4,888	24	117,312.00
Sherwin Williams Co.....	3,100	76	235,600.00
Union Trust Co. of Cleveland.....	3,600	74½	268,200.00
United Light & Power "B".....	394,987	78½	31,154,599.62
United States Rubber Co.....	40,000	14½	580,000.00
Youngstown Sheet & Tube Co.....	44,646	120	5,357,520.00
Youngstown Sheet & Tube Co., unstamped.....	1,100	99	108,900.00
			56,958,409.62

At the time of the transaction Continental Shares, Inc., lacked the required \$35,000,000 cash to complete the purchases.²⁶² Accordingly, it borrowed \$30,000,000 from the Chase National Bank of the City of New York and \$5,000,000 from the Union Trust Company of Cleveland, Ohio.²⁶³ The securities to be purchased, together with \$28,000,000 of securities already owned by the investment company, were pledged as collateral with the two banks for the loans.²⁶⁴

As the transaction was actually consummated, the purchase price of the securities was reduced to \$45,400,000 by a reduction in the quantity of stock of Continental Shares, Inc., to be delivered by the investment company from 1,040,000 to 280,000 and the valuation thereof from \$21.114 to \$10 per share, but the cash payment was \$40,100,000 instead of \$35,000,000 as originally authorized and a loan of \$2,500,000 due the investment company from Foreign Utilities, Ltd., was cancelled.²⁶⁵

Foreign Utilities, Ltd., with the proceeds of the sale of its portfolio securities paid off to Otis & Company its indebtedness of \$11,610,618, and in addition paid in to Otis & Company the sum of

²⁶² Id., at 21288-90.

²⁶³ Ibid. and Commission's Exhibit No. 3292.

²⁶⁴ Id., at 21288, et seq.

²⁶⁵ Id., at 21254, 21300, and Commission's Exhibit No. 3296.

\$21,856,048 to establish a credit balance in that amount with that firm.²⁶⁶ With respect to this transaction Mr. Eaton testified:²⁶⁷

Q. But you say that you put the capital up and you did it through using money of Foreign Utilities?

A. Yes.

Q. How did you arrange that?

A. Foreign Utilities, that is a corporation, couldn't be a partner in Otis & Company, so they loaned that money to me on these conditions, that they would receive eight percent on it and to have a twenty percent interest in the profits of Otis & Company, and Otis & Company had made nearly \$10,000,000 in 1929, and a twenty percent—

Otis & Company used this new money to pay off bank loans²⁶⁸ and thus satisfy the requirement of the New York Stock Exchange.

Mr. Eaton denied that there was a connection between the sales to the investment company by Foreign Utilities, Ltd., the loan to Otis & Company and the difficulties of Otis & Company with the New York Stock Exchange.²⁶⁹ However, an interoffice memorandum to Albert H. Wiggin, chairman of the board of The Chase National Bank of the City of New York from a member of the staff of that bank dated October 10, 1930, stated:²⁷⁰

There has been considerable conversation about the firm (Otis & Company) for some time past; more of it today when they had \$11,500 M of loans called * * * Eberstadt (partner of Otis and Company) says they have already \$7,500 M cash on the way for partial payment * * * He says the \$30 MM loan will clean up their biggest debit account which is Foreign Shares or Foreign Securities Company (meaning Foreign Utilities, Ltd.) * * * They have been buying utility securities and owing Otis * * * The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis * * * Eberstadt says he is satisfied that they have no other debt balances which are large enough to cause them any uneasiness.

The effect of this plan of selling these securities to the investment company, which had to borrow the money to pay for them, resulted in receivership for the investment company. W. R. Burwell, former president of the investment company, testified:²⁷¹

Q. And it was the failure of Continental Shares to pay off the \$30,000,000.00 loan from the Chase Bank and the loan of \$5,000,000.00 from Union Trust Company that resulted in the foreclosure on Continental's collateral in June 1933, isn't that right?

A. Yes.

Q. So that if Continental Shares had not borrowed that \$35,000,000.00 from the banks in October 1930, it would have had no difficulty in retaining its Portfolio throughout the depression, isn't that right?

A. That is quite true, yes.

Q. That is, it was the borrowing of this \$35,000,000.00 that put Continental Shares into trouble, isn't that right?

A. Exactly so, with the decline in the market, of course, that is understood.

²⁶⁶ Id., at 21279, 21232, 21795, and Commission's Exhibit No. 3312.

²⁶⁷ Id., at 21795.

²⁶⁸ Id., at 21279-80, 21333-4.

²⁶⁹ Id., at 21787-9.

²⁷⁰ Id., Commission's Exhibit No. 3302.

²⁷¹ Id., at 21326.

Q. And even with the declining market, if Continental Shares had not had these large bank loans, it would have been able to survive the depression, isn't that right?

A. If it had no loans, obviously there would have been no question about it.

7. CHAIN & GENERAL EQUITIES, INC.

Chain & General Equities, Inc., was organized under the laws of Delaware on February 5, 1929, under the sponsorship of Childs, Jeffries & Co., Inc., a Massachusetts corporation.²⁷² The declared purpose of the investment company was to invest its assets in diversified security holdings, chiefly in chain store stocks.²⁷³ The total capital paid into the company was \$8,000,000²⁷⁴ which, at September 30, 1931, when control was purchased by one Wallace Groves, a promoter, had declined to \$1,978,077.09.²⁷⁵

The charter of Chain & General Equities, Inc., permitted the directors of the investment company to deal with the company or with any other corporation in which any one of its directors was a stockholder, director, or officer.²⁷⁶ In three such transactions under the Childs, Jeffries & Co., Inc. sponsorship and in the first transaction under the Groves sponsorship the losses sustained were particularly severe.

Childs, Jeffries & Co., Inc., underwrote the preferred stock issue of Green Stores, Inc., in July 1928, and Paul D. Childs, a sponsor and the president of the investment company, was a director of both Green Stores, Inc., and its successor, McLellan Stores, Inc.²⁷⁷ In March 1929, the investment company purchased 2,200 shares of common stock of Green Stores, Inc., for \$325,600, which stock was thereafter exchanged for 6,600 shares of Class A common stock of McLellan Stores, Inc.²⁷⁸ Subsequent acquisitions of McLellan Stores, Inc., common stock brought these holdings of the investment company to a total of 10,106 shares at a total cost of \$534,750. The sale of these holdings realized only \$83,880.57, resulting in a loss of \$450,869.43, or 84% of the total investment.²⁷⁹

From March 7 through July 11, 1929 Chain & General Equities, Inc., purchased 3,000 preferred shares of Metropolitan Chain Stores, Inc. for \$210,050.²⁸⁰ Of these shares 1,000 were purchased from Childs, Jeffries & Co., Inc., for \$63,000 pursuant to a contract providing that the investment company could compel its sponsor to take back the shares within 15 months at the sale price plus 10% interest while the sponsor could elect during that period to take the shares back if interest was paid and profits were shared equally with the investment

²⁷² Reply to Commission's questionnaire for Chain & General Equities, Inc., Pt. 1.

²⁷³ *Ibid.*

²⁷⁴ Public Examination, The Equity Corporation, at 1733.

²⁷⁵ *Id.*, Commission's Exhibit No. 9. This decline in assets includes \$942,000 expended for repurchases.

²⁷⁶ Reply to the Commission's questionnaire for Chain & General Equities, Inc., Pt. 1. It is interesting to observe in this connection that Childs, Jeffries & Co., Inc., the sponsor, was an investment banker and that all but one of the directors of the investment company were investment bankers. (Public Examination, The Equity Corporation, at 1724-5.)

²⁷⁷ Public Examination, The Equity Corporation, at 1777.

²⁷⁸ *Id.*, at 1777-8.

²⁷⁹ *Id.*, at 1778-9.

²⁸⁰ *Id.*, at 1764.

company.²⁸¹ After six months the sponsor requested the investment company to extend the sponsor's obligation to repurchase for a year because of pressure from the banking creditors of the sponsor.²⁸² This extension was granted although within two weeks the investment company sold 700 of these shares for \$1,769.50 and a week later sold the rest of the shares for \$75.²⁸³ The position of the investment company in this transaction is related in the testimony of Mr. Childs:²⁸⁴

Q. And the fact of the matter was that you put yourself in this position, as far as the trust was concerned, that if the price of the stock went down, the only thing that they had was the personal obligation of Childs, Jeffries & Company, a corporation, which was separate and distinct from the New York Corporation, isn't that so?

A. That is right.

Q. And that personal liability of the corporation ultimately turned out to be practically valueless, isn't that so?

A. Yes, sir.

When Childs, Jeffries & Co., Inc., failed, the investment company was left with a loss of \$61,155.50 on an investment purchased from its sponsor for \$63,000, while the loss suffered upon the entire investment in this situation was \$202,199.68, or 96% upon the total commitment.²⁸⁵

On February 18, 1930, Chain & General Equities, Inc., purchased 16,000 new shares of the common stock of Chain Store Fund, Inc., at the net issue price to that company of \$25.50 a share plus interest from October 24, 1929, from Childs, Jeffries & Co., Inc. This comprised a part of 200,000 shares which that firm had undertaken to sell to the public at \$27 a share.²⁸⁶ Mr. Childs, a director and president of Chain & General Equities, Inc., was at that time also a director of Chain Store Fund, Inc.²⁸⁷ Chain Store Fund, Inc., terminated its activities six or eight months after its organization and Chain & General Equities, Inc., received in liquidation \$196,000 in cash and 15-year bonds of Drug Trade, Ltd., in the principal amount of \$44,000.²⁸⁸ These bonds were ultimately sold for \$16,500, resulting in a total loss upon a \$414,586.66 investment of \$202,084.66.²⁸⁹

On September 23, 1941, Wallace Groves contracted to purchase from Chain & General Equities, Inc., 467,938 shares of its newly authorized common stock for approximately \$940,000. On November 4, 1931, Mr. Groves assumed control of the investment company, and simultaneously with the payment aforesaid he caused the investment company to purchase 642,517 shares of the common stock of Interstate Equities, Inc., another investment company which he controlled, for \$1,325,000. The sale was at about \$2.06 per share, while the stock was quoted on the New York Curb Exchange at \$1 per share, and its book value was

²⁸¹ Id., Commission's Exhibits Nos. 229, 230.

²⁸² Id., at 1769-70.

²⁸³ Ibid.

²⁸⁴ Id., at 1767.

²⁸⁵ Id., at 1765-6, 1772.

²⁸⁶ Id., at 1754-61.

²⁸⁷ Poor's, Banks, etc., 1932, at 1000.

²⁸⁸ Public Examination, The Equity Corporation, at 1757-9.

²⁸⁹ Ibid.

43 cents per share.²⁹⁰ Bayer & Clawson, auditors, later determined that the stock was entirely without asset value at the date of sale.²⁹¹ Nevertheless, Mr. Groves was enabled to finance his acquisition of Chain & General Equities, Inc., by this transaction, which employed 45% of the total gross assets of Chain & General Equities, Inc., and provided a net profit to him of over \$270,000.²⁹²

8. CHAIN STORE STOCKS, INC.

Chain Store Stocks, Inc., a closed-end investment company sponsored by Shields and Company, New York brokers, was incorporated under the laws of Delaware on December 3, 1928.²⁹³ The investment company was to concentrate its investments in the stocks of corporations which owned and operated chain stores, a type of security in which the sponsor specialized.²⁹⁴ The initial capital contributed by the public to the corporation amounted to \$10,416,000.²⁹⁵

On December 13, 1928, the board of directors of the investment company ratified a purchase from the sponsor of 7,500 shares of the common stock of Walgren Company at \$88 per share, a total of \$660,000.²⁹⁶ On that date the quoted price for this stock was 80 bid, 84 asked, a minimum overcharge of \$30,000.²⁹⁷ Paul Shields, president of the investment company on the date of the transaction, testified that the disparity in price arose because of the lapse of time between the transaction and its confirmation by the board of directors.²⁹⁸

On the same day as the preceding transaction, December 13, 1928, the board of directors of the investment company ratified the purchase from the sponsors of 6,000 shares of the common stock of Peoples Drug Stores, Inc., at \$87 per share, a total of \$522,000.²⁹⁹ The quoted market price on the date of this transaction was \$82.³⁰⁰ Mr. Shields testified as to this transaction:³⁰¹

Q. And that was at \$87 per share, our records indicate that the price—it may have been the low for that day, of \$82 per share—was there similar discussion with respect to that?

A. That is right.

Q. Shields and Company?

A. And a little different in Peoples, as I recall it, the market was very much narrower than it was in Walgren and the sales, and there were fewer sales in the stock.

That was a very desirable block of stock, and it would have been impossible to have bought it in the market.

²⁹⁰ Id., at 1820.

²⁹¹ Ibid.

²⁹² For full details of this transaction, see Part Three, Ch. II, p. 181 et seq.

²⁹³ Public Examination, Chain Store Stocks, Inc., Commission's Exhibit No. 1620.

²⁹⁴ Id., at 15608, and Commission's Exhibit No. 1621.

²⁹⁵ Id., at 15612-3, 15622.

²⁹⁶ Id., at 15633.

²⁹⁷ Id., at 15634.

²⁹⁸ Ibid.

²⁹⁹ Id., at 15634-5.

³⁰⁰ Ibid.

³⁰¹ Ibid.

Mr. Shields had apparently considered this self-dealing aspect. He further testified:³⁰²

Q. * * * Now, I would like to discuss with you a little bit, eliminating any personal element, but just talking hypothetically, as to what your ideas are as to the advisability of a situation where the investment trust purchases stock from sponsors as principal?

A. Well, in the light of all of the circumstances, I don't think that there is any question but that it shouldn't be done. I think, for instance, there it was done under most favorable circumstances, and yet I know if I had it to do over again I wouldn't assume that responsibility.

Q. Even though he may be actuated by the finest motives and not try to take advantage of the situation, he always has a pecuniary interest?

A. That is right.

Mr. Shields concluded:³⁰³

A. Yes; I think that when you judge all of the trusts who did deal that way, assuming that all of their intentions were honorable, the results haven't been particularly satisfactory.

The original policy of concentrating its investments in chain store securities was abandoned and a more diversified portfolio purchased. By September 23, 1930, when Atlas Corporation purchased control of the company the assets of Chain Store Stocks, Inc., had shrunk from the original capital of \$10,146,000 to \$3,407,167.³⁰⁴

C. Sales by Insiders to Secure, Maintain, or Increase Control of Portfolio Companies

One of the uses which sponsors made of the investment companies that they organized or acquired was as repositories for control of various portfolio companies. This use and the general technique which implemented it was the familiar holding-company device. The most frequent instances are found in connection with control of public utility companies. The cases of Italian Superpower Corporation, Aldred Investment Trust, and Blue Ridge Corporation, related earlier in this section,³⁰⁵ are illustrations. In each of those cases, persons who desired to secure, to facilitate, or otherwise to maintain control of public utility companies or systems' organized investment companies or investment holding companies, sold the capital securities of those companies to the public, and used the proceeds of the public distribution of securities to purchase securities from themselves or otherwise. Having retained control of the investment company, the sponsors were thus able to obtain or retain control of the given utility situation through the employment of the publicly contributed funds.

1. CENTRAL STATES ELECTRIC CORPORATION

Central States Electric Corporation was incorporated under the laws of Virginia in 1912 principally for the purpose of taking control

³⁰² Id., at 15636-7.

³⁰³ Id., at 15639.

³⁰⁴ Id., at 15622.

³⁰⁵ See *supra*.

of the Cleveland Electric Illuminating Co., an operating utility company.³⁰⁶ As recited in its charter, the corporation was to acquire 60% or more of the outstanding common stock of the Cleveland Electric Illuminating Company and to deal generally in securities.³⁰⁷ Until 1922 Cleveland Electric Company stock constituted the only portfolio security of the Central States Electric Corporation.³⁰⁸

The sponsor of the investment company, Harrison Williams, had acquired in 1920 a substantial interest in The North American Company, a public utility holding company, and in 1922 the investment company sold 108,000 shares of the Cleveland Electric Illuminating Co. common stock to The North American Company.³⁰⁹ With part of the proceeds of this sale together with the proceeds of a bank loan of \$1,920,000, Central States Electric Corporation bought 59,384 shares of the common stock of The North American Company.³¹⁰ This was about 20% of the outstanding common stock. As a result of these transactions, Central States Electric Corporation in 1922 became an investment holding company.

Mr. Williams by 1924 had acquired over 90% of the voting stock of Central States Electric Corporation and continued to hold at least this percentage until January 1929.³¹¹ As The North American Company grew in size and issued additional common stock, principally stock dividends, Central States Electric Corporation sought to maintain its relative voting power by acquiring additional blocks of this stock. In order to do so the investment company sold increasing amounts of its senior securities to the public. At the end of 1926 when the total assets of the investment company amounted to about \$37,800,000, Central States Electric Corporation held 700,502 shares of the outstanding common stock of The North American Company, or about 17% of such stock.³¹²

Mr. Williams was able through this and similar devices to maintain a dominant voice in the affairs of The North American Company and to direct the development and expansion of Central States Electric Corporation and its subsidiaries, American Cities Power & Light Corporation and Electric Shareholdings Corporation and to participate in the formation of other investment company subsidiaries, including Shenandoah Corporation and Blue Ridge Corporation, both formed in the summer of 1929.³¹³

2. CONTINENTAL SHARES, INC. AND COMMONWEALTH SECURITIES, INC.

Cyrus S. Eaton, an investment banker of Cleveland, used this holding company method in connection with efforts to secure or main-

³⁰⁶ Reply to the Commission's questionnaire for Central States Electric Corporation, Pt. I.

³⁰⁷ Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1204.

³⁰⁸ Public Examination, Central States Electric Corporation, at 12289-90.

³⁰⁹ *Id.*, at 12301-6.

³¹⁰ *Ibid.*

³¹¹ *Id.*, at 12393-6, and Commission's Exhibit No. 1205.

³¹² *Id.*, at 12401-6, and Commission's Exhibit Nos. 1206 and 1213.

³¹³ See *supra*, this section for discussion of Blue Ridge Corporation. A discussion of various aspects of the history of Central States Electric Corporation will be found in Part Three, Ch. V, pp. 1683-1708.

tain control in the steel and in the rubber industries. The investment companies were Continental Shares, Inc., a part of whose history has been related previously in this section,³¹⁴ and Commonwealth Securities, Inc.³¹⁵ An illustration of this use is the participation in the fight against a merger in the steel industry.

In the spring of 1930, Mr. Eaton was interested in preventing the execution of a merger between Youngstown Sheet and Tube Company and Bethlehem Steel Corporation, both of which were among the largest steel producing corporations in the country.³¹⁶ Mr. Eaton's opposition took the form of a "proxy fight". The result was that, in attempting to secure voting common stock of the Youngstown Sheet and Tube Company to be voted against the proposed merger, Mr. Eaton caused the two investment companies to purchase large amounts of the stock. Through his control of the investment companies, Mr. Eaton could cause the stock which they owned in the Youngstown Sheet and Tube Company to be voted against the merger.³¹⁷

On March 21, 1930, the respective executive committees of Continental Shares, Inc., and Commonwealth Securities, Inc., each authorized the purchase of \$1,500,000 of additional shares of the Youngstown Sheet and Tube Company common stock. These acquisitions were made through a joint purchasing account with Otis & Company, Mr. Eaton's firm. At the end of 1930, the combined investment of the two investment companies in the stock was more than \$9,000,000. Purchases for the joint account were made at prices as high as \$148 per share,³¹⁸ 4 points below the highest price the stock ever reached. Some of the stock was acquired from Foreign Utilities, Ltd., largely owned by Mr. Eaton and his family.³¹⁹ A substantial part of the stock was sold by the investment company in September 1932, when the stock was selling at \$4 per share.

In the later stages of the proxy fight by Mr. Eaton against the merger, judicial proceedings were instituted.³²⁰ As a result expenses in connection therewith became an additional element of cost of the proxy fight. Commonwealth Securities, Inc., apparently was not caused to share the burden of these legal expenses, but Continental Shares, Inc., paid a total of \$328,028 during the years 1930, 1931, and 1932 toward these expenses. In addition to these expenses, the attorneys in the case made a charge of \$500,000 which the receiver for Continental Shares, Inc., refused to allow, but which was subsequently settled by the payment of \$68,000 by the receiver. On December 29,

³¹⁴ See *supra*, pp. 2616-2621.

³¹⁵ Continental Shares, Inc., was organized under the laws of Maryland on March 1, 1926. (Reply to Commission's questionnaire, Continental Shares, Inc., Item 1.) Commonwealth Securities, Inc., also sponsored by Cyrus S. Eaton, was incorporated under the laws of Delaware in June 1923 and became a public corporation in the latter part of 1928. (Reply to Commission's questionnaire, Commonwealth Securities, Inc., Item 1.) These corporations possessed combined assets of \$168,000,000.

³¹⁶ Public Examination, Continental Shares, Inc., at 21895 and 21500-2.

³¹⁷ Hearings, Subcommittee of Committee on Education and Labor, U. S. Senate, 75th Cong., 3d Sess., Pt. 23, p. 9856; Public Examination, Continental Shares, Inc., Commission's Exhibit No. 3392.

³¹⁸ Public Examination, Continental Shares, Inc., Commission's Exhibit No. 3263.

³¹⁹ *Id.*, Commission's Exhibit No. 3296 and p. 21218.

³²⁰ *Wick et al. v. Youngstown Sheet and Tube Company et al.*, 46 Ohio App. 253, 188 N. E. 514.

1930, the court enjoined the merger.³²¹ Appeal was taken, but before it could be heard Bethlehem Steel Corporation exercised its option under the agreement and cancelled the deal.

3. ELECTRIC POWER ASSOCIATES, INC.

Electric Power Associates, Inc., a closed-end management investment company, was organized on February 8, 1929, under the laws of the State of Maryland under the joint sponsorship of W. C. Langley & Co., an investment banking and brokerage firm, and Sanderson & Porter, consulting engineers.³²² The investment company received capital contributions of \$10,135,000 in cash and securities from the first distribution of its stock and subsequently obtained \$15,200,000 in cash from another offering of its securities—a total of \$25,335,000.³²³

From its inception, the investment company was linked by the management to American Water Works and Electric Company, Inc., top holding company of an extensive public utility system.³²⁴ No disclosure of the interests and affiliation of the investment company's sponsors, officers, and directors with American Water Works and Electric Company, Inc., was published, and it was not until two years after the formation of the investment company and the first sale of its stock to the public that its heavy investment in the public utility holding company was revealed to stockholders.

The engineering firm of Sanderson & Porter had been associated with American Water Works and Electric Company, Inc., since 1914 when the firm was engaged to assist in the reorganization of American Water Works and Guarantee Company, Inc., predecessor of American Water Works and Electric Company, Inc.³²⁵ The firm and its members acquired a large amount of the stock of the holding company and H. Hobart Porter became its president and a director and Seton Porter became a director.³²⁶ The law firm of Sullivan & Cromwell, of New York City, was counsel for the holding company and one of its members, Wilbur L. Cummings, was a director of the holding company and several subsidiaries. Members of that firm were large stockholders of American Water Works and Electric Company, Inc.³²⁷ W. C. Langley & Co. did not acquire an interest in the public utility until 1922 when the senior partners of the firm, particularly Chester Dale, began purchasing substantial amounts of its stock.³²⁸ Chester Dale also became a director of the public utility and several subsidiaries.³²⁹ In 1925, W. C. Langley & Co. became the principal bankers for the public

³²¹ *Wick et al. v. Youngstown Sheet and Tube Company et al.*, supra.

³²² Reply to the Commission's questionnaire for Electric Power Associates, Inc., Pt. I, Items 1 and 5.

³²³ See *infra*.

³²⁴ Poor's Public Utilities, 1929, p. 1219.

³²⁵ Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³²⁶ Poor's Public Utilities, 1929, p. 1223, and supplementary information supplied the Commission for Electric Power Associates, Inc.

³²⁷ Poor's Public Utilities, 1929, p. 1221, and reply to the Commission's questionnaire for Electric Power Associates, Inc., Pt. VII, Table 31.

³²⁸ *Ibid*.

³²⁹ *Id.*, Pt. VII, Table 31. Dale resigned as director in 1938. (Annual Report for American Water Works and Electric Company, 1937, filed with the Securities and Exchange Commission, p. 16.)

utility holding company and its subsidiaries.³³⁰ The holdings of the partners of Sanderson & Porter, W. C. Langley & Co., and Sullivan & Cromwell in American Water Works common stock amounted to more than 500,000 shares out of a total of 1,400,000 outstanding at the time Electric Power Associates, Inc., was formed.³³¹

These affiliations with and interests in American Water Works and Electric Company, Inc., were reflected in the composition of the first board of directors of Electric Power Associates, Inc., as well as in the sponsors' participation in the distribution of the investment company's securities. The first directors of the investment company were H. Hobart Porter, Seton Porter, and Edwin V. Sanderson, of Sanderson & Porter, Chester Dale and William C. Langley, of W. C. Langley & Co., and Wilbur L. Cummings, of Sullivan and Cromwell.³³²

In February 1929, 400,000 shares of voting common stock of no-par value and 400,000 stock-purchase warrants were issued by the investment company.³³³ Of this common stock 120,000 shares were given to the sponsors in exchange for 38,000 shares of American Water Works and Electric Company, Inc., common stock, valued at \$3,135,000.³³⁴ The sponsors also received the entire 400,000 stock-purchase warrants,³³⁵ each of which carried the right to purchase a share of common stock from the investment company at \$27 a share until 1944.³³⁶ The remainder of the common stock, 280,000 shares, was distributed to the public through W. C. Langley & Co. at an initial offering price of \$27 per share.³³⁷ The investment banking firm received an underwriting commission on this distribution of \$2 a share.³³⁸ Thus, the investment company received a net contribution of \$7,000,000 in cash and the investment banking firm received \$560,000 in gross commissions.

In the offering circular, dated February 1929, with respect to the issue of common stock, W. C. Langley & Co. stated the purpose of the investment company as follows:³³⁹

Electric Power Associates, Inc., will be formed under the laws of the State of Maryland with broad powers of operation. It may, among other things, buy, sell, hold, or exchange securities, participate in syndicates, underwritings, and in other financial transactions, control, manage, or operate companies. It is the present intention of the management to confine its activities chiefly to companies in the electric light and power, gas, and water business.

³³⁰ Id., supplementary file, item 13.

³³¹ Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³³² Id., Pt. I, Exhibit 9-1.

³³³ Id., Pt. V and Pt. II, Exhibit A, Schedule 19. In February 1933, the common stock was given a par value of \$1 per share. (Id., Pt. I, Exhibit 3 (b)-4.)

³³⁴ Id., Pt. VII, Table 32. The transfer was made through Electric Utilities, Inc., a company wholly owned by the sponsors. The American Water Works stock was valued at \$82.50, for purposes of transfer—the market price at the time of the exchange. The price of the common stock of the investment company received in exchange was equivalent to \$26.13 a share. This was \$0.87 a share less than the public offering price, or a total of \$104,400 less than the price of the stock to the public. (Ibid.)

³³⁵ Ibid.

³³⁶ Id., Pt. I, Exhibit 3a, p. 14.

³³⁷ Id., Pt. V, Item 41, and Pt. I, Exhibit 6-1.

³³⁸ Ibid.

³³⁹ Id., Pt. I, Exhibit 9-1.

This statement of purpose would seem to imply that the investment company intended to diversify its activities, with particular specialization in the public utility field. An investor who relied upon this statement would have no reason to believe that the sponsors intended to invest in a single special situation in which the sponsors themselves were vitally interested. Such, however, was the case. Substantially the entire proceeds of the common stock issue, together with some borrowed money, were used to purchase shares of American Water Works and Electric Company, Inc., common stock in addition to the stock of American Water Works and Electric Company, Inc., that was transferred to the investment company by the sponsors at its formation. The investment company acquired 62,000 shares of American Water Works and Electric Company, Inc., common stock at a cost of approximately \$7,250,000, which, together with the original 38,000 shares of this stock, represented a total investment of \$10,379,535 in the single company.³⁴⁰ The investment company spent only \$880,000 in acquiring other portfolio securities.³⁴¹ The investment in American Water Works and Electric Company, Inc., amounted to 92% of the investment company's portfolio.

While the offering circular contained the statement that the sponsors would acquire 120,000 shares of Electric Power Associates, Inc., common stock and all the 400,000 warrants in exchange for portfolio "securities of a market value in excess of \$3,000,000," no mention was made of the fact that these securities consisted of shares of common stock of a single company, American Water Works and Electric Company, Inc.³⁴² Yet it may not be doubted that the management had every intention of carrying out such an investment policy,³⁴³ although it was denied that the management had this preconceived design.³⁴⁴

In June 1929 the investment company sold 400,000 shares of its non-voting Class A stock of no-par value at \$40 a share.³⁴⁵ The spon-

³⁴⁰ *Id.*, Pt. III, Table 2a. All the portfolio securities of Electric Power Associates, Inc., at June 30, 1929, cost \$11,259,052. (*Ibid.*) Electric Power Associates, Inc., had apparently made bank loans in order to acquire some of the portfolio securities, the aggregate cost of which was more than the net contributions of \$10,135,000 received by the company. (*Id.*, Pt. II, Exhibit A.)

³⁴¹ *Id.*, Pt. III, Table 2a. The remainder of portfolio securities of Electric Power Associates, Inc., consisted of diversified securities costing \$879,517. (*Ibid.*)

³⁴² *Id.*, Pt. I, Exhibit 9-1. It was explained that since the transfer was effected by delivering to the investment company the stock of Electric Utilities, Inc., which held the American Water Works and Electric Company, Inc., stock, technically it could not be said that American Water Works and Electric Company, Inc., securities were transferred to the investment company. (Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.) No reason was proffered, however, as to why the substantial effect of the transaction was not disclosed.

³⁴³ The firm of Sanderson & Porter was primarily an engineering concern and not investment bankers or dealers in securities. (*Ibid.*) It was interested in underwritings, however, with respect to enterprises in which the firm had an interest or was affiliated with the management. (*Ibid.*)

³⁴⁴ *Ibid.* It was also denied that Electric Power Associates, Inc., was formed with the intention of making it the sponsors' intermediate holding company for the American Water Works system. (*Ibid.*) Whatever the intention, the fact is that Electric Power Associates, Inc., became the largest holder of stock of American Water Works and Electric Company, Inc.

³⁴⁵ Reply to the Commission's questionnaire for Electric Power Associates, Inc., Pt. V, Item 40. In February 1933, the Class A stock was given a par value of \$1 per share. (*Id.*, Pt. I, Exhibit 3 (b) 4.)

sors jointly underwrote the issue at a commission of \$2 a share or an aggregate of \$800,000.³⁴⁶ The net proceeds received by the investment company for this new issue of stock amounted to \$15,200,000.³⁴⁷ A substantial portion of the new capital received by the investment company was immediately used to buy additional American Water Works common stock.³⁴⁸ Approximately \$6,370,000 of the \$15,200,000 was used in this manner, so that by December 31, 1929, Electric Power Associates, Inc., held over 176,000 shares of American Water Works and Electric Company, Inc., common stock, over 10% of the voting stock of the holding company.³⁴⁹ Its investment in the holding company at that time constituted approximately two-thirds of the total assets of the investment company.

In the letter to common stockholders offering subscription rights to the new issue of Class A stock, no disclosure was made concerning the investment policies of Electric Power Associates, Inc. The stockholders were merely advised that the value of their stock had materially increased and that the increase of capital was desired "in order that the company may be in a position to take immediate advantage of opportunities for further investment."³⁵⁰

On January 3, 1930, the first annual report of Electric Power Associates, Inc., issued, of course, after the public had been induced to invest in the investment company, gave the first intimation that the management was primarily interested in special situations. The report stated:³⁵¹

This Company was organized on February 8, 1929, something less than eleven months ago, not as an Investment Trust to acquire and hold a highly diversified

³⁴⁶ *Id.*, Pt. V, Item 40. The total underwriting fees of the sponsors aggregated \$1,360,000.

³⁴⁷ Common stockholders were given the right to subscribe for the Class A stock at \$40 per share, although preemptive rights were explicitly waived in the corporate charter. (*Ibid.* and *Id.*, Pt. I, Exhibit 3a, p. 18.) The stockholders subscribed for the entire issue. (*Ibid.*) During the two weeks preceding the offering to stockholders the market price of the common stock advanced from \$37 to \$54. The asset value of the common stock, however, ranged from \$31 to \$35. (*Id.*, supplementary file, Item 1.) The sale of the Class A stock, while below market, increased the asset value of the common stock and diluted the asset value of the Class A stock. Had the option warrants, exercisable at \$27 a share, been exercised thereafter, a further dilution would have resulted. This potential dilution through possible exercise of the warrants at \$27 a share of common stock (which had voting rights) after the public had paid \$40 a share for Class A stock (ranking equally with the common stock except that it had no voting rights) was not disclosed to investors (*Id.*, Pt. I, Exhibits 9-3, 9-4, 9-5; and supplementary information supplied the Commission for Electric Power Associates, Inc.)

It is noteworthy that the sponsors purchased none of the Class A stock when it was offered. (*Id.*, supplemental file, Item 13.) A small number of shares were taken down by some of the partners of W. C. Langley & Co. and Sanderson & Porter, but not by Messrs. Langley, Dale, Cummings, Seton Porter, H. Hobart Porter, or Sanderson. (*Ibid.*) At December 31, 1935, the sponsors held 10,865 shares of Class A stock of record but none beneficially. (*Id.*, Pt. V, Item 52.) It may also be observed that an underwriting commission of \$2 per \$40 share of stock was charged by the sponsors for the distribution of stock to persons who were already stockholders (no particular sales effort required to locate new buyers) and when the market price of the equally ranking common stock was about \$54.

³⁴⁸ Reply to Commission's questionnaire for Electric Power Associates, Inc., Pt. III, Tables 2a and 2b.

³⁴⁹ *Id.*, Pt. III, Table 2B. Electric Power Associates, Inc., as of December 31, 1929, had invested \$16,751,195 according to its books, in American Water Works common stock. At this time its total assets amounted to \$26,501,490. (*Ibid.* and *id.*, Pt. II, Exhibit A.)

³⁵⁰ *Id.*, Pt. I, Exhibit 9-3.

³⁵¹ *Id.*, Pt. I, Exhibit 9-1.

list of securities, but with the intention of making long-term investments of relatively large amounts in the common stocks of public utilities which stocks the management felt would increase in value over a period of time. Funds not so invested have been used to acquire as temporary investments a variety of other preferred and common stocks (largely of public utilities).

Even in this report the heavy investment in American Water Works and Electric Company, Inc., was not indicated. The stock of that company was merely listed among 20 other securities in the report, 14 of which were public utility securities. The amount of the securities of each company held by the investment company was not set forth.

Not until January 24, 1931, almost two years after the investment company's first distribution of its stock, in the investment company's annual report for 1930, were the stockholders of the investment company made aware of the extent to which Electric Power Associates, Inc., had invested in American Water Works and Electric Company, Inc.³⁵² From that report an investor could ascertain for the first time that about two-thirds of the securities held by the investment company, on the basis of market value, were American Water Works and Electric Company, Inc., common shares—\$10,029,415 at market and \$16,477,000 at cost.³⁵³

However, no disclosure whatsoever was made to stockholders in the investment company's reports as to the participation of the investment company in another activity of the sponsors concerning American Water Works and Electric Company, Inc.—a trading account in American Water Works common voting trust certificates.

In order to insure their continuance as the management of American Water Works and Electric Company, Inc., in January 1931 the sponsors executed a voting trust agreement, naming H. Hobart Porter, Chester Dale, and Wilbur L. Cummings as voting trustees.³⁵⁴ Common stockholders of the utility holding company were requested to deposit their stock with the trustees in exchange for trust certificates. Electric Power Associates, Inc., placed all of its American Water Works stock with the trustees.³⁵⁵

On April 15, 1931, approximately 62% of the outstanding shares of common stock of the utility had been deposited with the trustees. Between February 20, 1931, and April 23, 1931, a trading account in the voting trust certificates of American Water Works and Electric Company, Inc., was formed in order "to stabilize" the market for the certificates, since there appeared to be a better market in the common

³⁵² *Id.*, Pt. I, Exhibit 8-2.

³⁵³ *Ibid.* and *Id.*, Pt. III, Table 2c. An investor would also learn for the first time of another large investment—\$2,937,750 in market value and over \$4,000,000 in cost—in securities of United States Electric Power Corporation with which W. C. Langley & Co. was associated as member of an underwriting and sponsoring group and as stockholder. (Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.) William C. Langley was also a director of United States Electric Power Corporation. (Reply to the Commission's questionnaire for Electric Power Associates, Inc., Pt. VII, Table 31.) At December 31, 1935, this investment was worth only \$45,250 at market value. (Reply to Commission's questionnaire for Electric Power Association, Inc., Pt. III, Table 2b.)

³⁵⁴ *Id.*, Supplemental file, Item 11.

³⁵⁵ *Id.*, Pt. III, Tables 2d and 2e.

stock than in the certificates.³⁵⁶ Electric Power Associates, Inc., participated in this joint trading account to the extent of a 33 $\frac{1}{3}$ % interest.³⁵⁷

On behalf of the investment company, 10,000 shares were purchased and 4,500 shares were sold.³⁵⁸ When the account was closed the investment company had sustained a loss of \$26,670.³⁵⁹

The holdings of American Water Works and Electric Company, Inc., had been purchased at increasing prices.³⁶⁰ The original 38,000 shares of American Water Works common stock transferred to the investment company by the sponsors were taken at the market price of \$82.50 a share. Subsequently this stock was purchased at prices as high as \$140 a share and authorization was even given by the directors to purchase additional shares at prices as high as \$180 per share.³⁶¹ The market price of this stock fell sharply after October 1929. The investment company, however, did not abandon its policy of buying blocks of this stock. By the end of 1933 the additional acquisition of 77,000 shares increased the investment company's holdings of American Water Works common stock to 253,193 shares at a total cost of \$17,980,922.³⁶² At the same time, the balance sheet value of this investment had declined to approximately \$3,500,000.³⁶³ At the end of 1935, the investment company held 255,193 shares at a cost of \$17,996,809 and the market value amounted to \$5,646,145.³⁶⁴ The unrealized loss in this single investment at that time amounted to \$12,350,664.³⁶⁵

During the period from December 1929 to 1935, the common stock of American Water Works and Electric Company, Inc., represented an average of 72.1% of the investment company's total investments at cost and an average of 69.3% of its investments at market value. In 1933, Electric Power Associates, Inc., became the largest stockholder of American Water Works and Electric Company, Inc.,³⁶⁶ and has so continued.³⁶⁷

The sponsors have denied that Electric Power Associates, Inc., was formed as an intermediate holding company for a public utility system controlled by the sponsor group. With respect to the continual purchase of common stock of American Water Works and Electric Company, Inc., by Electric Power Associates, Inc., throughout the period from inception to 1933, the sponsors have sought to explain that the

³⁵⁶ Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³⁵⁷ Reply to the Commission's questionnaire for Electric Power Associates, Inc., Pt. VI, Item 64b.

³⁵⁸ *Ibid.*

³⁵⁹ *Ibid.*

³⁶⁰ Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³⁶¹ *Ibid.*

³⁶² Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³⁶³ *Ibid.*

³⁶⁴ *Id.*, Pt. III, Table 2h.

³⁶⁵ *Ibid.*

³⁶⁶ Report of Committee on Interstate and Foreign Commerce, House Report No. 827, Part 3 (73d Congress, 2d Session), p. 61.

³⁶⁷ As of March 1933. (Annual Supplement to Registration Statement (Form U58), filed by American Water Works and Electric Company, Inc., with the Securities and Exchange Commission, 1937, p. 43.)

directors became "more bullish" on the utility's common stock as its price went higher and that, when the price declined, they purchased more stock in order to average down the cost of the investment.³⁶⁸ This explanation implies that the management which at inception stated its intention to "buy, sell, hold, or exchange securities, participate in syndicates, underwritings, and in other financial transactions, control, manage, or operate companies" chiefly "in the electric light and power, gas, and water business," had subsequently and at various intervals independently decided each time that the purchase of stock of American Water Works and Electric Company, Inc. (out of the hundreds of utility securities available), was most profitable for the investment company.

It is significant that whereas the sponsor group held about 600,000 shares of American Water Works common when Electric Power Associates, Inc., was formed,³⁶⁹ four years later on October 6, 1933, the sponsor group held only 348,515 shares and Electric Power Associates, Inc., held 252,693 shares—both holdings totalling 601,208 shares.³⁷⁰ The report of the House Committee on Interstate and Foreign Commerce of the 73rd Congress concerning holding and operating utility groups stated that an analysis of the stock holdings of the American Water Works and Electric Company, Inc., at that time "indicates that the control of the company hinges around the interests of Electric Power Associates, Inc."³⁷¹

4. PETROLEUM CORPORATION OF AMERICA

Petroleum Corporation of America, which has been previously discussed in this report,³⁷² is another illustration of the use of the publicly contributed funds of an investment company to further the operations of sponsors. It will be recalled that this investment company, incorporated under the laws of Delaware on January 16, 1929, was sponsored by Harry F. Sinclair, a prominent figure in the oil industry, and Blair & Company, Mr. Sinclair's bankers, and their associates.³⁷³ The purpose of organizing this investment company was to effect certain mergers and consolidations in the oil industry, in pursuance of certain plans of Mr. Sinclair.³⁷⁴ The paid-in capital of the investment company was about \$101,000,000, derived from the proceeds of the sale of its capital securities to the public.³⁷⁵

Following its organization, Petroleum Corporation of America made various purchases and sales of securities and engaged in syndicate participations, in all cases involving securities of companies in the oil business.

The purchase by Petroleum Corporation of America, principally from the sponsors and their associates, of shares of Prairie Oil & Gas

³⁶⁸ Derived from supplementary information supplied the Commission for Electric Power Associates, Inc.

³⁶⁹ *Ibid.*

³⁷⁰ House Report No. 827, Part 3 (73d Congress, 2d Session), pp. 61-2.

³⁷¹ *Id.*, at 61.

³⁷² See Part Three, Ch. II, pp. 227-309, and this Chapter, pp. 2513-2514, *supra*.

³⁷³ Reply to Commission's questionnaire for Petroleum Corporation of America, Pt. I.

³⁷⁴ See Part Three, Ch. II.

³⁷⁵ *Ibid.*

Company and Prairie Pipe Line Company for a total of over \$46,000,000 not only was the instrument of the merger which was sought by the sponsors between those two corporations and the Sinclair Consolidated Oil Corporation, but resulted in various profits to the sponsors. At the time the merger was completed, however, the shares of these companies had declined to a price less than one-third of their cost to the investment company. On October 5, 1929, the investment company purchased from Sinclair Consolidated Oil Corporation 35,000 shares of Vacuum Oil Company at the approximate market price of \$120 a share. Since this stock has been bought by Sinclair Consolidated Oil Corporation for only \$75 a share, it represented a profit to the sponsor of \$45 a share, or about \$1,575,000.³⁷⁶

The investment company also undertook a 25% participation in a syndicate managed by its sponsors in the shares of Tidewater Associated Oil Company with the idea of acquiring a sufficient interest in that company to effect a merger with Sinclair Consolidated Oil Corporation. The investment company purchased 1,078,123 shares of the Tidewater Associated Oil Company for \$23,147,300. The market began to decline before the operations were completed, and a payment of one-third of the total commitment was wiped out by this decline. The investment company defaulted on the balance, and the one-third payment thereupon became a total loss.

The investment company and Interstate Equities Corporation, another investment company which was partially controlled by one or more of the sponsors, entered a syndicate, in which each had a 25% participation, for the proposed purchase of 700,000 shares of Rio Grande Oil Company. Ultimately the acquisition was abandoned, but not before the syndicate had lent \$2,812,500, collaterally secured by 225,000 shares of stock of the Rio Grande Oil Company, which security became substantially less than the amount of the loan after the market in these shares declined. Consolidated Oil Corporation, the successor to Sinclair Consolidated Oil Corporation, obtained the stock by purchasing the note at a substantial discount, which discount represented the loss to the investment company.³⁷⁷

As a result of these portfolio policies, which were very beneficial to the sponsors, the investment company and its investors lost large sums of money. The investing public in January 1929 had paid \$110,500,000 for the shares of the investment company. At December 31, 1935, the net assets of the investment company were \$34,413,892. The sum of \$14,469,332 had been paid by the corporation for repurchases of its own stock, and the sum of \$7,059,575 has been paid as dividends to stockholders. After giving effect to these deductions, the aggregate loss to the stockholders, both realized and unrealized, was \$54,058,000. The net loss to the stockholders at December 1935 was approximately 50% on the basis of asset values and 59% on the basis of market values, without allowance for dividends received, and 41.4% and 49.5%, respectively, after allowance for dividends received.³⁷⁸

³⁷⁶ Ibid.

³⁷⁷ Ibid.

³⁷⁸ Ibid.

D. Sales of Securities to Insiders at Discount—Founders Associates

Another type of transaction which was not unusual was the sale of securities by investment companies to sponsors or affiliated persons at discounts from the market price. One example of this type of transaction will be cited.

On February 4, 1929, American Founders Corporation sponsored the formation of Founders Associates, a Massachusetts trust,³⁷⁹ for the following three purposes: (a) to give the officers and employees of the companies of the United Founders Corporation group an opportunity to acquire through the purchase of Founders Associates stock an interest in securities of the group to be held by Founders Associates;³⁸⁰ (b) to provide a profit-sharing plan for the officers and employees of the companies of the United Founders Corporation group³⁸¹ in lieu of paying them larger salaries;³⁸² and (c) to provide for the officers and employees of the companies of the group, who might purchase an interest in Founders Associates, leverage in their investment therein through the subscription by the companies of the United Founders Corporation group to preferred stock issued by Founders Associates.³⁸³ To accomplish these purposes the management of the group caused to be issued or sold to Founders Associates securities of the companies of the group at discounts aggregating \$52,000 from the prevailing market and provided the opportunity for Founders Associates to participate in the formation of new companies of the United Founders Corporation group.³⁸⁴

Apparently Founders Associates was intended largely as a means of benefiting senior members of the management of the group. First, the stock was non-voting, control vesting in the senior officers of the group as trustees.³⁸⁵ Second, the terms of subscription of the employees of the group varied depending upon whether they were senior or junior employees.³⁸⁶ Third, the senior officers were permitted to subscribe for a very substantial part of the common stock, although the companies of the group themselves were called upon to furnish the major part of the funds of the Founders Associates.

³⁷⁹ Public Examination, American General Corporation et al., Commission's Exhibit No. X3417-D.

³⁸⁰ Id., at 24144.

³⁸¹ Ibid., and Commission's Exhibit No. X4658.

³⁸² Id., at 22099.

³⁸³ Ibid.

³⁸⁴ Id., at 24150, and Commission's Exhibit No. X3662.

³⁸⁵ Control of Founders Associates vested in the secretary and treasurer of American Founders Corporation and the active presidents of the affiliated companies who were designated trustees of Founders Associates. (Id., Commission's Exhibit No. X3714-D.)

³⁸⁶ There were two Founders Associates stock subscription agreements dated February 7, 1929, one of which was applicable to the subscriptions of senior employees and officers, and the other to the subscription of junior employees. These subscription agreements differed in that the senior employees and officers were privileged to tender their shares to American Founders Corporation at their current liquidating asset value, whereas, the junior employees might sell their shares only with the permission of the executive committee of the American Founders Corporation. (Id., at 24145-9, Commission's Exhibit Nos. X3417 [at p. 16], X3417-7 and X3417-D.)

Founders Associates received \$577,755 for the issuance and sale of the securities.³⁸⁷ However, 30% of its common stock was issued to six of the senior officers of the group for \$60,000 and approximately 55% of the common stock was issued to seventeen officers (including those six officers) for \$109,000.³⁸⁸ Since the initial portfolio acquired by Founders Associates was purchased at prices prevailing in November and December, 1928³⁸⁹ and at a price \$52,000 less than the current market value,³⁹⁰ the seventeen officers, all of whom by the terms of their subscription agreement were privileged to tender the stock to American Founders Corporation at a price equal to current liquidating value, received an immediate value of \$27,500 in excess of the cost to them.³⁹¹ Because the companies of the United Founders Corporation group were supplying the preferred stock capital to Founders Associates, the senior officers of the group who had the control of Founders Associates, as well as the largest interest in its common stock, were in effect trading in the securities of the group in part with funds supplied by companies of the group and could (and, in fact, did) terminate their interest by tendering their holdings of the common stock of Founders Associates to American Founders Corporation at its liquidating value.³⁹²

The \$577,755 capital raised by Founders Associates was largely invested and reinvested in the companies of the United Founders Corporation group.

In the course of its operations from February 1929 to November 15, 1935, when it was liquidated,³⁹³ Founders Associates lost \$277,590.46

³⁸⁷ Founders Associates issued the following securities (id., Commission's Exhibit No. X3417, at pp. 15 and 16) :

7,200 shares of \$50 par preferred stock-----	\$360,000.00
39,368 shares common stock-----	217,755.00

Notes: The preferred stock was purchased by American Founders Corporation on behalf of the companies of the United Founders Corporation group as follows (id., Commission's Exhibit No. X3417-A) :

American Founders Corporation-----	2,610 shares
Second International Securities Corporation-----	1,656 shares
United States & British International Company, Ltd-----	1,224 shares
American & General Securities Corporation-----	1,224 shares
Founders General Corporation-----	648 shares
Investment Trust Associates-----	288 shares

International Securities Corporation of America, at the time of the organization of Founders Associates, had investment restrictions which forbade it to secure the securities of companies less than four years old. (Id., Commission's Exhibit No. X3401.)

The common shares were issued: 3,000 shares to affiliated companies, 36,368 shares to officers and employees of the companies of the group (id., Commission's Exhibit No. X3417-A).

³⁸⁸ Id., at 24150-1, and Commission's Exhibit No. X3417 (pp. 37-38).

³⁸⁹ Id., at 24150.

³⁹⁰ Ibid.

³⁹¹ Id., at 24151.

³⁹² Information relative to the final disposition of the 21,800 shares sold to seventeen senior officers of the group at \$5 per share is available with respect to nine officers. By December 31, 1930, five of these nine had sold their total holdings, consisting of 5,200 shares, or about 24% of the total of 21,800 shares to Founders General Corporation for an aggregate amount of \$107,352 or a profit of \$81,352 or an investment of \$26,000. The remaining four officers reporting to the Commission retained their 6,750 shares, or approximately 31% of the 21,800 shares, until a later date, mostly until liquidation of Founders Associates in 1935, and sustained a loss of \$26,451.52 on an investment of \$33,750 (Id., Commission's Exhibits Nos. X3417 [pp. 37-38 and 47-48], X3936, X3948, 4318, and 4323.)

³⁹³ In the liquidation the \$174,178.75 remaining assets were distributed as follows (Id., Commission's Exhibit No. X3417 at pp. 13, 21) : 21,933 shares of United Founders

or 48% of its paid-in capital,³⁹⁴ largely on transactions in securities of the remaining companies of the group.³⁹⁵

E. Purchases and Sales of Portfolio Securities to Support the Market for the Benefit of Insiders

There were a number of instances where investment companies made heavy purchases of portfolio securities in which their sponsors were interested in order to bolster or maintain the market price of those securities. The frequent result of this type of transaction was that the available resources of the investment company proved inadequate to maintain the price of the securities against adverse influences and the market collapsed in spite of the investment company purchases. With the decline in market price the investment company would lose all or a substantial part of its investment.

This type of practice was found particularly among investment companies whose sponsors were affiliated with or interested in commercial banks during the years 1929-1933.

1. THE CHICAGO CORPORATION

The Continental Chicago Corporation, a closed-end investment company, was incorporated under the laws of Delaware on September 11, 1929.³⁹⁶ Its sponsors were Field, Glore & Company, investment bankers of Chicago, and Continental Illinois Company, security affiliate of the Continental Illinois National Bank & Trust Company, of Chicago.³⁹⁷ These same sponsors also sponsored The Chicago Corporation, incorporated in Delaware on February 9, 1929, and Chicago Investors' Corporation, incorporated in Delaware on August 3, 1927.³⁹⁸ In December 1930, the Continental Chicago Corporation absorbed by merger The Chicago Corporation, and in December 1932 the new corporation merged with Chicago Investors' Corporation.³⁹⁹ At that time the name of the new corporation became The Chicago Corporation.⁴⁰⁰ In September 1929, before the various mergers, the combined paid-in

common stock having a current market value of \$20,562.19 were distributed to the officers and employees of the United Founders Corporation group still holding Founders Associates common stock, and the remaining assets, consisting of \$153,616.56 cash and 14,000 shares of General Investment Corporation common stock valued at \$3 for the block, were distributed to United Founders Corporation and American Founders Corporation on their holdings of 3,096 preferred and 25,289 common shares.

³⁹⁴ The shrinkage of Founders Associates is accountable as follows (id., Commission's Exhibit No. X3417 at pp. 6, 10, 15-9) :

Cost of preferred and common capital shares repurchased and retired.....	\$71,985.79
Cash dividends paid.....	54,000.00
Total.....	125,985.79
Write-down of investments, net realized depreciation in portfolio at Nov. 15, 1935, and net profit and loss realized on sales of investments.....	239,029.81
Net operating loss exclusive of profits and losses on investments.....	33,561.65
Net operating loss.....	277,590.46
Total capital decrease.....	403,576.25

³⁹⁶ Id., Commission's Exhibit No. X3417-B, Schedule 4.

³⁹⁷ Reply to Commission's questionnaire for The Chicago Corporation, Part I.

³⁹⁸ Ibid.

³⁹⁹ Ibid.

⁴⁰⁰ Ibid.

⁴⁰¹ Ibid.

capital, raised through public sale of capital securities to the public,⁴⁰¹ was \$139,371,000.

One of the principal investments made by this group of investment companies was in the capital stock of the Continental Illinois Bank and Trust Company. Since these three investment companies were at all times under common sponsorship until they became merged under the same sponsors the transactions in the bank stock will be discussed as though made by a single entity.

In April 1929, the first purchases of the bank stock were made by The (old) Chicago Corporation from its sponsor, Continental Illinois Company—2,500 shares at \$650 per share, and 3,840 shares at \$658 per share, a total cost to the investment company of \$4,259,000.⁴⁰²

The next substantial purchase of the bank stock was in 1931. It appears that one McVeagh, a Chicago capitalist had pledged a block of the bank stock as collateral security for a series of notes which had been marketed by A. G. Becker & Company. The market price of the stock had declined to the point where it was deemed advisable to liquidate the indebtedness represented by the notes. The stock—9,484 shares in all—was thereupon sold to The Chicago Corporation for \$201 per share, a total of \$1,906,284. By the terms of the sale, Mr. McVeagh was given an option to repurchase the stock at \$225 per share (24 points above the selling price to the investment company) at any time within three months from the date of sale,⁴⁰³ and at \$250 within six months. The option to repurchase was not exercised.

The maximum investment of \$14,646,861 in the stock of Continental Illinois National Bank & Trust Company occurred in 1930 and 1931 and represented approximately 28% of the total average assets, at the market, upon a consolidated basis. The fact that 15,041 shares, or approximately 55% of the total bank shares purchased, were acquired at an average cost price in excess of \$500 a share indicates that this activity was principally in 1929 and 1930. The shrinkage as at December 31, 1935, on the net investment was 70%. Of the total decline of \$45,323,000 in assets of The Chicago Corporation for 1929 through 1935, the depreciation sustained in the bank stock constituted about 17%.

In addition to portfolio purchases The Chicago Corporation had a 25% participation with the Continental Illinois Company in a syndicate formed January 2, 1930, to purchase a maximum of 17,000 Continental Bank shares. In 1932 The Chicago Corporation took down 3,678 bank shares from the syndicate at an average cost of \$608.96 a share. The Chicago Corporation also purchased 44,801 bank shares and sold 41,915 bank shares in a trading account. When the account was closed in 1933 there remained 2,886 bank shares at an average net cost of \$86.19 a share.

2. CENTRAL-ILLINOIS SECURITIES CORPORATION⁴⁰⁴

Central-Illinois Securities Corporation furnishes another instance of an investment company engaged in purchases of securities for the pur-

⁴⁰¹ Ibid.

⁴⁰² Reply to the Commission's questionnaire, Table 32.

⁴⁰³ Public Examination, The Chicago Corporation, at 9814 et seq.

⁴⁰⁴ The history of this investment company has been discussed previously in this report. See Part Three, Ch. II of this part of the report, pp. 142-181.

pose of supporting the market price of the sponsors' securities. Central-Illinois Securities Corporation, an investment company of the closed-end management type, was organized under the laws of Delaware on October 1, 1929, and its sponsors were Central Trust Company of Illinois, a commercial bank of Chicago and the security affiliate of that bank, Central-Illinois Company.¹⁰⁶ The sponsors provided for their control of the investment company at the inception by purchasing from it \$3,000,000 of common stock which represented 43% of the total voting power of the corporation's stock. At the same time they raised \$12,000,000 by the public sale of allotment certificates representing units of preferred and common stock, for \$12,600,000. The major investments of the corporation were in the stock of a utility holding company, which is not relevant to the discussion here, and investments in the stock of the sponsor bank and the successor bank.

From the date of its incorporation, the investment company had purchased stock of its sponsoring bank, Central Trust Company of Illinois, for approximately \$500,000. By June 1931, this stock had depreciated in value to about \$300,000. On June 9, 1931, the officers and directors of the investment company who were sponsors, or the sponsors' nominees, agreed, in order to facilitate a merger between the Central Trust Company and the Chicago Trust Company to form the Central Republic Bank and Trust Company, to have the investment company purchase for \$800,000 an additional block of 20,000 shares of the National Bank of the Republic of Chicago, which had shortly before been merged with the Chicago Trust Company. George Woodruff was president of the former bank. This was more than 30% higher than the current market price of these shares. Subsequently, the banking situation became critical and the investment company bought in the open market additional stock of the successor bank to the extent of about \$400,000, admittedly for the purpose of checking the decline in the market price of the stock. As a result, by June 1, 1932, the investment company owned 8,142 shares of the successor bank which was acquired at an original cost of \$1,749,133. In the latter part of June 1932 the Reconstruction Finance Corporation lent \$40,000,000 to the Central Republic Bank and Trust Company. Despite this assistance the bank was forced to cease operating as a bank of deposit on October 5, 1932 and subsequently, under the name of Central Republic Trust Company, it was placed in receivership.

As a result the investment company lost all its investment in the bank stock, for which it had paid \$1,749,133, except for \$105,416 which it received as a distribution and liquidation on shares which it owned on Central Republic Company, which made its net loss \$1,643,717. In addition to this loss the investment company was forced to set up a reserve of \$814,200 to provide for the double liability which attached to the bank stock under the laws of Illinois. This increased its loss to the sum of \$2,457,917 or above 140% of the cost of its investment in this stock.

¹⁰⁶ *Ibid.*

IV. LOANS BY INVESTMENT TRUSTS AND INVESTMENT COMPANIES

A. Introduction

While the amount of money lent by investment trusts and investment companies in comparison with total investments of such companies was not large,¹ loans by these companies presented many abuses and, for the greater part, improper uses of investment companies by their sponsors. In many instances, loans made by investment trusts and investment companies, except for call loans, were made not in response to the business interests of the company but to advance the personal interests of officers, directors, or dominant stockholders or of corporations in which these influential individuals were interested.

Table 75, shows the aggregate balances of receivables as reported by 151 general management investment companies.² To illustrate, 16 companies of the 151 companies reported having an aggregate of \$2,160,955 loans, notes, and accounts receivable on its books at the month-end for which they reported for the year 1927.

In the aggregate, loans outstanding increased from \$2,160,955 at the end of 1927 to \$70,729,419 by the end of 1928 and thereafter decreased to \$69,152,868 at the end of 1929, and finally, to \$7,838,432 by the end of 1935. The reduction between the peak at 1928 and 1935 figures, of course, is only a net figure because while some of these balances were decreasing during this period others were increasing through the grant of entirely new loans.³

¹ Notes and accounts receivable of investment companies proper, outstanding at year-ends, varied from 8.3% of total assets of management companies at the year-end 1928 to 0.4% at the year-end 1936. The receivables do not include call loans or advances to parents and subsidiaries.

See Pt. Two, Ch. II, p. 68, and Tables 29 and 30, pp. 131-5.

² This material is based upon a summarization of Schedules Nos. 3, 4, 5, and 10, included as part of the questionnaire sent to general management trusts, supplemented by certain limited information obtained from individual company reports and various manuals. The material relates to 151 general management investment companies which filed replies, and is derived from the balances of loans, notes, and accounts receivable reported by them as having been outstanding at the year-ends 1927 through 1935. The summary does not include those companies which are classified as investment holding companies.

Schedules Nos. 3, 4, 5, and 10 contain balances at year-ends in the following accounts:

<i>Schedule No.</i>	<i>Title</i>
3	Call Loans made to Officers, directors, etc.
4	Notes and Accounts Receivable from Directors, Officers, and/or Employees.
5	Notes and Accounts Receivable from others.
10	Advances to Parents and/or Subsidiaries.

³ The decrease shown for the period 1928-1935 should not be accepted as resulting from the repayment of these balances entirely, for although many balances were actually paid-off, it is also definitely known that many were written-off and represented a total or partial loss to the investment company. Although inadequate sources of information precluded ascertainment of the extent of these write-offs, a cursory examination of accounts in questionnaire replies which were sufficiently informative indicate that the writing-off of receivables in whole or in part was fairly prevalent in fact and would justify the conclusion that write-offs constituted a substantial percentage of the total reduction.

TABLE 75.—Summary of loans and accounts receivable as reported by 151 general management investment companies in investment trust study questionnaire as of year-ends 1927-35

	Call loans made to officers, directors, etc.		Notes and accounts receivable from directors, officers and/or employees		Notes and accounts receivable from others		Advances to parents and/or subsidiaries		Total notes and accounts outstanding	
	Amount	Number of companies having loans	Amount	Number of companies having loans	Amount	Number of companies having loans	Amount	Number of companies having loans	Amount	Number of companies having loans and accounts receivable outstanding
1927.....			\$51,875.00	(1)	\$1,944,889.39	(13)	\$164,191.87	(2)	\$2,160,955.96	(16)
1928.....	\$6,000,000.00	(1)	63,287,072.80	(5)	1,442,296.31	(17)	50.45	(2)	70,729,419.56	(25)
1929.....	150,000.00	(1)	17,945,193.79	(7)	32,458,748.58	(36)	9,498,925.84	(3)	59,152,868.21	(47)
1930.....	1,583,734.85	(2)	12,667,066.29	(12)	28,791,331.32	(46)	1,156,771.93	(3)	44,198,904.39	(63)
1931.....	279,295.84	(2)	1,173,933.24	(9)	25,519,850.45	(51)	2,399,362.12	(6)	29,372,441.66	(68)
1932.....			1,261,630.48	(12)	18,183,667.10	(51)	2,787,876.44	(8)	22,233,173.02	(71)
1933.....			1,123,206.75	(11)	14,632,576.13	(52)	2,513,267.34	(8)	18,269,040.22	(71)
1934.....			905,826.72	(10)	8,109,425.12	(52)	2,830,626.84	(9)	11,845,878.68	(71)
1935.....			879,615.95	(7)	5,117,051.16	(42)	2,341,765.51	(10)	7,838,432.62	(59)

NOTE.—The figures in parentheses indicate the number of companies having loans on their books for the year indicated, not the number of loans. One company had as many as 104 loans included in the balance.

Table 75 also reveals that a substantial part of the total loans and advances of the 151 companies examined were admittedly extended to officers, directors, and employees of the companies.⁴ The item, "Call Loans made to Officers, Directors, etc." in the replies to the Commission's questionnaire refers directly to such loans. "Advances to Parents and/or Subsidiaries" require no further explanation except that attention is directed to the sudden increase as of the end of 1929 over 1927 and 1928. It is not improbable that this increase may have resulted from an effort to aid a distressed parent, subsidiary, or affiliated person.

"Loans and Accounts Receivable from Directors, Officers, and/or Employees" reached a peak at the end of 1928 when 5 companies showed a total of \$63,287,072 of such receivables, a part of which undoubtedly resulted from the purchases by directors, officers, and employees of the capital stock of their respective companies on notes or open accounts. The extent to which such purchases were made has not been determined. By the end of the following year, 1929, this \$63,287,072 had decreased to \$17,045,193 and further decreased thereafter to a low of \$379,615 by the end of 1935. How much of this shrinkage was a result of actual cash liquidation of the accounts and how much write-offs or cancellations could not be ascertained from the material available, although there are known instances where substantial write-offs occurred.⁵

⁴ Table 75 also discloses that while the gradual reduction of balances outstanding in loans and accounts receivable would indicate a general policy of contraction in the period 1928-1935 with respect to loaning funds on the part of the management, actually the practice became more prevalent. At the end of 1928, 25 companies reported loans and accounts receivable on their books aggregating \$70,729,419. By the end of the following year, 1929, this dollar amount had decreased to \$59,152,868, but the number of companies with such loans had increased to 47.

Even after 1929, when expansion in all lines of business ceased, those controlling loanable funds adopted a policy of extreme caution, but the above trend continued. Thus by the end of 1934, companies having loans and securities outstanding had nearly tripled from 25 in 1928 to 71.

Moreover, the number of companies making new loans continued to increase from year to year. These companies are numerically tabulated below:

Companies which reported loans and accounts receivable at the year-ends indicated but which had no such balances due at the close of the previous year

Year ending—	Total	Number companies with balances due of—	
		More than \$5,000	Less than \$5,000
1928.....	14	14	—
1929.....	32	30	2
1930.....	28	21	7
1931.....	17	9	8
1932.....	15	11	4
1933.....	18	10	8
1934.....	16	9	7
1935.....	9	6	3

Thus 28 companies are reported as having notes and accounts receivable outstanding at the end of 1930, which had no such balances due at the end of 1929, whereas Table 75 reveals an increase of only 16 such companies. This would indicate that 12 companies reporting at the end of 1929 disposed of the amounts due in one way or another during 1930.

⁵ If a company extended a loan during any given year, which was repaid or written off within the same year, no record of the transaction appears in the questionnaire. Moreover,

Balances reported as "Notes and Accounts Receivable from Others" constitute much the greater part of the total of all four classifications in all years except 1929. For this reason, and also because of the ambiguity of the titles, more detailed consideration was given this classification in an effort to ascertain whether the designation "Others" included any substantial items which, although not directly advanced to officers, directors, or employees of the trust, nevertheless represented receivables due from associated persons or firms.

To this end the year 1930 was used as a test. The Commission's questionnaire Schedule No. 5 entitled "Notes and Accounts Receivable from Others" discloses that at the end of 1930, 46 of the 151 companies under consideration reported an aggregate amount of \$28,791,331 of such items outstanding. This title, taken at its face value, would suggest that this huge sum was due from unrelated interests. After examination into the background and affiliations of the borrowers of these funds, it developed that the \$28,791,331 was due from the following:

1. From directly or indirectly affiliated individuals or firms	\$16,393,734
2. From sponsors	3,250,869
Sub-total	19,560,603
3. From individuals and firms regarding whose affiliations only a limited knowledge is available. This item does not disclose any direct or indirect relationship with the trust	8,819,071
4. Identity of borrowers not ascertained	411,655
Total	28,791,331

It may be that a substantial part of the \$8,819,071 shown above as being due from "Individuals and firms regarding whose affiliations only a limited knowledge is available," and the \$411,655 due from unidentified borrowers was also loaned to affiliated interests. Contained therein are several very large items which were so classified because the affiliations of the borrowers could not be definitely determined.

It will be seen from the above that the designation "Loans to Others" attached to the \$28,791,331 falls far short of conveying a true indica-

it is impossible to determine from the material available whether the balances shown at year-ends represent the original amount of the loan, a balance reduced by payments, or a written-down balance. Nor is it possible to determine whether a balance that disappears entirely between year-ends has been paid off or written off in many cases.

Specific examples of large loans made and repaid within the same year which were consequently not reported, and also of loans or advances which resulted in substantial write-offs are found in the cases of Blue Ridge Corporation, M. & T. Securities Corporation, and Burco, Inc. On March 18, 1930, Blue Ridge Corporation lent to its parent, Shenandoah Corporation, the sum of \$6,500,000. Thereafter, additional loans were made, but all were repaid during the year. The company reported no loans outstanding at the end of 1929 and only \$71,679 of sundry items at the end of 1930, with the result that the \$6,500,000 is not included in the figures discussed herein.

Instances of substantial write-offs are known to have occurred on the books of M. & T. Securities Corporation and Burco, Inc. At the end of 1930 there was reported as outstanding on the books of M. & T. Securities Corporation loans and accounts receivable in the amount of \$1,769,024.99. In 1933, \$821,074.45 of this sum was charged off as uncollectible. Again, at the end of 1930, Burco, Inc., reported notes receivable amounting to \$800,000, of which \$300,000 was due from A. J. Silver. This note was also written off on the company's books in the following year.

tion of the loaning policy of these companies. Of this amount, \$19,560,603, or 68% of the total consisted of loans to affiliated interests. In some instances this affiliation was found in the presence of one or more directors or officers on the board of both the borrower and lender; in other instances, one company had an investment in the other or both borrower and lender had a common sponsorship and were obviously dominated by the same group or individual. Again, it was discovered that many loans were taken over from sponsor banks. In some cases, loans were actually made to directors of the investment company, and at least \$3,870,283 consisted of margin accounts of officers and directors of the investment company or sponsor which had been assumed by the company.

Therefore, if the classifications of loans and accounts shown on schedules Nos. 3, 4, 5, and 10 of the Commission's questionnaire were recast for the year 1930 in the light of this additional information, the picture would appear as follows as compared with the manner in which these balances were actually reported in the questionnaire:

Loans and Accounts Receivable Year Ending 1930

PER QUESTIONNAIRE SCHEDULES NOS. 3, 4, 5, 10		RECLASSIFIED	
To officers, directors, and employees.....	\$14,250,801	To officers, directors, employees, and other affiliated interests	\$34,968,176
To parents and/or subsidiaries.....	1,156,771		
	15,407,573		
To others	28,791,331	To others.....	9,230,727
	44,198,904		44,198,904

If the circumstances just discussed with respect to the year 1930 are accepted as representative of the treatment accorded similar items in other years, it follows that about 79% of all loans, accounts, and notes receivable reported by these 151 companies at all year-ends over the period 1927-1935 were due from officers, directors, employees, and other directly and indirectly affiliated interests.*

* This discussion does not constitute a complete coverage of the loan operations of this group of 151 companies. Rather, the facts and figures presented in the foregoing pages are sufficiently complete to indicate only a trend of such operations. In addition, all actual loans and advances may not necessarily have been reported as such by the various companies because the reporting company regarded them as belonging in some other accounting category. These would, of course, not be included in the figures presented in this report. An example of such an instance would be found in the case of a company which maintained a current account with its fiscal agent. Generally this account was opened by a cash deposit or retention by the fiscal agent of a part of the proceeds from sales of capital stock as a cash balance due the company. From this balance was deducted the cost of securities purchased for the company's account by the fiscal agent, and to it was added proceeds received from sales of securities executed for accounts of the company, interest and dividends collected, etc.

Frequently this practice resulted in a substantial part of the company's funds continuously remaining on deposit with the fiscal agent, who more often than not was an investment banker or broker and not a licensed bank of deposit. In such cases, the company usually carried these funds on its books and published reports as "funds on deposit" or by

State laws under which investment companies were organized failed to give any real protection to investors against loans to insiders. It was not until 1935 that the State of Delaware, which, with Maryland, chartered the great majority of investment companies, enacted a provision prohibiting loans to officers.⁷

No corporation created under this Chapter shall make any loan of money to any officer of such corporation, nor shall any loan be made to a stockholder upon the security of the stock of the corporation, and if any such loan be made, the officer or officers who make it or assent thereto shall be jointly and severally liable until the repayment of the sum so loaned with interest. Nor shall any corporation take as security for any debts a lien upon any part of its capital stock, unless such lien shall be necessary to prevent loss upon a debt previously contracted. Provided, however, that the provisions of this Section shall not apply to corporations organized exclusively as Building and Loan Associations.

It is to be noted that in this law no criminal penalties are provided and it does not apply to employees. There are no restrictions upon loans to stockholders other than the prohibition against the use of the stock of the investment company as collateral, and it does not apply to loans to persons and organizations with which officers, directors, and stockholders are affiliated or in which they are interested.

Nor did the laws of Maryland, in which 26 out of 160 corporations examined were organized, provide any adequate protection against improper loans. This law merely provides that if loans are made to officers or directors, the officers or directors participating in the making of the loan shall be liable to the corporation to the extent of any loss that may result. This section has no criminal penalties and apparently does not apply to loans which are made to companies, organizations affiliated with officers and directors, or in cases in which the interests of officers and directors are being served. This law provides:⁸

Second: If any loan of money shall be made by any corporation to any stockholder or director therein, the officer or officers or director or directors who shall make it or assent thereto shall be jointly and severally liable for all the debts of said corporation to the extent of the loss that may result from such loan; but this paragraph second shall not apply to any building or homestead association, or any corporation whose principal business under its charter is to loan money on real or personal property, or to any corporation receiving and authorized to receive money on deposit or to any life insurance company lending money to any of its policyholders on their policies.

Third: In the event of the insolvency of the corporation, the liability of the directors and officers under this Section shall be collectible by the receiver or other person winding up its affairs, as an asset of said corporation.

some similar designation, and did not regard them as loans or advances to the fiscal agent, notwithstanding the facts that although subject to withdrawal, these deposits were not subject to check and the fiscal agent had the use of the money.

A specific case in point will be found in United States & Foreign Securities Corporation. At the end of 1929 this company had a balance on deposit with the sponsor, Dillon, Read & Co., amounting to \$10,109,247.01. This was reported to stockholders and in the questionnaire merely as "cash on deposit." Hence it is not included in the figures contained in this report.

⁷ Revised Code of Delaware, 1935, Chapter 65, Article I, Section 36.

⁸ Annotated Code of Maryland, 1924, as amended, Article 23, Section 87. The provisions of other state laws will not be examined here since they only affect about 20% of the companies and have varying provisions in respect to the power to lend money.

Charters of companies also facilitated loans to insiders. A total of 65 out of 160 charters of investment companies examined granted power to the companies to lend their funds, generally, on call or on time, with or without collateral, and charters of another 33 companies made no mention of the lending of money at all. The charters of only 13 companies restricted the power to lend by providing certain requirements as to collateral security. A few had restrictions on the amount of loans that could be made to any one company or person, or the type of collateral that could be taken, and only 10 out of the 160 companies prohibited loans to officers, directors, employees, and connected organizations. Consequently, the great majority of the charters afforded no protection to the investor against improper loans.

In the case of Liberty Share Corporation, which as of the end of 1930 lent \$4,200,000 out of total assets of \$14,600,000 to officers, directors, and employees of itself and its sponsor to permit them to speculate in stocks on margin,⁹ the articles of incorporation were drawn in such a way that its directors were permitted to be interested in contracts or transactions with the company, and transactions with a director were permitted even though the vote of such director may have been necessary to effect such contract and even though the interest of such director was not disclosed to the other directors or stockholders. The provision in the charter of Liberty Share Corporation is as follows:¹⁰

No contract or transaction between the corporation and any of its directors or any other individual, firm, association, or corporation shall be affected by the fact that the directors of the corporation are interested in, or are officers of other firm or association or corporation and any director individually may be a party to and may be interested in any contract or transaction of the corporation, and no contract or transaction of the corporation with any individual, firm, association or corporation shall be affected by the fact that any director of the corporation is a party to or interested in such contract or transaction or in any way connected with such individual, firm, association, or corporation even though the vote of such director may have been necessary to effect such contract or transaction and even though the interest of such director was not disclosed to the other directors or stockholders. * * *

1. PURPOSES FOR WHICH LOANS WERE MADE

In general, sponsors of investment companies caused their companies to make loans to insiders for a diversity of purposes. In some of the examples which are given below insiders used the money secured from the company to speculate in stocks on margin. Liberty Share Corporation lent, as of the end of 1930, \$4,200,000 of its then total assets of \$14,600,000 to officers, directors, and employees of itself and of its sponsor, who used the loans for the most part to speculate in stocks on margin. At its formation M. & T. Securities Corporation contemplated making loans to insiders, although this purpose was not disclosed to stockholders. Many of these loans by

⁹ See *Infra*.

¹⁰ Certificate of Consolidation forming the Liberty Share Corporation (Reply to Commission's questionnaire for Liberty Share Corporation, Item 8 (7) (c)).

M. & T. Securities Corporation to officers and employees were undermargined at their inception.

Loans were also made by companies to carry their sponsors where underwritings of the investment company failed. In Chapter II of this part of the report it was shown how Chatham Phenix Corporation, security affiliate of Chatham Phenix National Bank & Trust Company, undertook to underwrite 2,000,000 shares of the capital stock of Chatham Phenix Allied Corporation, an investment company it sponsored, for \$50,000,000. The underwriting was not successful and only \$32,000,000 of the capital stock of the investment company was sold. The sponsor had represented to the public that all the stock was sold. To make up the default the sponsor borrowed \$18,000,000 from the investment company itself without security. The bank, controlled by the same group as the security affiliate and the investment company, honored a check for \$50,000,000 drawn on it by the sponsor payable to the trust, which was only honored because of the \$18,000,000 loan by the investment company.¹¹

The lending of money by an investment company to its sponsor in an attempt to prevent the sponsor's bankruptcy or expulsion from the New York Stock Exchange is found in the case of Prince & Whitely Trading Corporation, sponsored by Prince & Whitely, former members of the New York Stock Exchange. In August 1930 the auditors of the New York Stock Exchange informed Prince & Whitely that its free capital did not amount to 5% of its assets, which was required of all members of the stock exchange. Being unable to borrow the necessary funds from banking sources, Prince & Whitely borrowed \$1,500,000 from its sponsor company. No security was given for the note other than the endorsement of the partners of Prince & Whitely and loans made through various intermediary corporations to the brokerage house. In order to avoid any explanation of the item in the annual report a series of bookkeeping entries were made whereby for 11 days a subsidiary corporation of Prince & Whitely was the repository of the note. Subsequently, a substantial part of the note was lost. Continental Shares, Inc., also in effect, lent Otis & Company over \$21,000,000 in 1930 as part of the payment for a purchase of \$45,400,000 in securities from one of Cyrus Eaton's companies to assist Otis & Company when it needed \$12,000,000 to retain membership on the New York Stock Exchange.

Sponsors used funds siphoned out of investment companies for financing private enterprises. In 1931 Atlantic and Pacific International Corporation had \$2,000,000 in cash besides certain securities in its portfolio. Arthur J. Morris, president of the Morris Plan Corporation of America made several efforts to secure this cash for his banks, one of which efforts finally was enjoined as the result of a suit by a protective committee. Mr. Morris finally secured the money by selling the stock of the investment company to another company, Merton Assets Corporation, which borrowed the money from the investment company. The loan was not repaid but by a series of exchanges of stocks the loan was eliminated.¹²

¹¹ See Part Three, Ch. II, p. 115 et seq.

¹² See Part Three, Ch. IV, pp. 1120-38.

In connection with the various abuses perpetrated by Donald P. Kenyon in the case of 31 investment and other companies with assets over \$14,000,000 over which he secured control was the practice of causing a large number of loans to be made to himself, either directly or indirectly. By the end of July 1936 Kenyon had borrowed \$326,514 from these companies, which represented 81% of the assets of Monthly Income Shares of New Jersey and 83% of the assets of Monthly Income Shares of New York. Although such loans were violations of the charters of both companies, in the case of another company, United Standard Oil Fund of America, Inc., assets were completely depleted by loans which Kenyon caused to be made to himself and controlled corporations.¹³

Sponsors used money they borrowed from their investment companies to finance their trading operations at low interest rates. For example, United States & International Securities Corporation and Dillon, Read & Co., its sponsor, formed a joint account to acquire securities of various railroads. The company agreed to supply all the capital for the account and charged Dillon, Read & Co. less than current interest rates for the amounts it advanced. The maximum accommodation to the sponsor was \$7,000,000, which was approximately 26% of the average net assets of the investment company at market. Upon the termination of the account, Dillon, Read & Co. sold the greater part of its unsold portion of the securities in the account to United States & Foreign Securities Company, the parent of the lender, and with the proceeds paid off its indebtedness to the subsidiary. The subsidiary then bought from its parent the stocks previously held by Dillon, Read & Co. The depreciation in some of the securities accounted for approximately 60% of the entire shrinkage in the company's assets for the period 1928-1935.¹⁴ National Securities Investment Company also lent Sidney Z. Mitchell, chairman of the board of directors of Electric Bond & Share Company (in whose companies 59% of the funds of the company were invested) over \$6,000,000 at 4% in a joint trading account at a time when call money rates were very much higher.¹⁵ In order to assist Goldman, Sachs & Co., investment bankers, in financing the initial offerings of Shenandoah Corporation, its sponsors, Central States Electric Corporation and The Goldman Sachs Trading Corporation in July 1929 each lent to the bankers the sum of \$6,250,000 or a total of \$12,500,000. Both loans were made by these companies, to Goldman, Sachs & Co. without interest and without collateral. In order to make the loan, Central States Electric Corporation and The Goldman Sachs Trading Corporation were each required to borrow the sum of \$6,250,000 from Manufacturers Trust Company, for which interest was paid at the rate of 3%. A similar procedure was followed for the organization of Blue Ridge Corporation. Shenandoah Corporation in this case lent \$15,000,000 to Goldman, Sachs & Co. to assist in the underwriting of the original shares of Blue Ridge Corporation common stock. This loan was also made without interest and without collateral. While the loan was repaid in accordance with the terms, the investment company was required to borrow the sum of \$15,000,000 from Manufacturers Trust Company at 3% interest.

¹³ See Part Three, Ch. II, pp. 311-349, and *infra*.

¹⁴ See Part Three, Ch. IV, pp. 1098-9.

On their loans, especially to insiders, investment companies generally lost money, besides sterilizing for varying periods of time the investment funds supplied by investors. Insiders of Liberty Share Corporation on May 26, 1936, still owed \$3,397,113.68 secured by collateral of \$479,635. A liquidating corporation organized in 1934 to collect these debts was manned by the insiders themselves. For this reason collections were apparently very slow. Charge-offs on loans to officers and employees by M. & T. Securities Corporation of \$744,439.88 as of December 24, 1931, was \$454,452.89 when the company was dissolved on January 11, 1937. On the indebtedness of \$3,371,951.57 of Prince & Whitely to Prince & Whitely Trading Corporation, which included the \$1,500,000 note, \$670,043.31 was recovered from 1931 through 1936. Chatham Phenix Allied Corporation suffered a loss of \$5,410,930, a substantial part of its original capitalization, as a result of loans made in connection with the financing of Empire State, Inc., besides, of course, having a large part of its funds, always over \$7,000,000, sterilized for investment by the loans to insiders. On loans of \$4,500,000 acquired by Central-Illinois Securities Corporation from its sponsor, Central-Illinois Company and the affiliated bank, Central Trust Company of Illinois, the investment company sustained a net loss of \$1,112,369 as of December 31, 1935, and a balance of \$195,666 remained unpaid and was carried as an asset. General Investment Corporation, which took over a loan of its sponsors to a South American railway, sustained a loss of \$6,780,974. National Securities Investment Company sustained a loss of \$3,813,264.43 in its joint trading account with Sidney Z. Mitchell to whom it lent over \$6,000,000 at low interest rates. The loans which Donald P. Kenyon secured from his controlled companies are probably now total losses.

To carry the loans, most of which were made to insiders, some investment companies had to borrow large sums from banks and pledge collateral of companies which were foreclosed. Liberty Share Corporation, in order to provide for its loans to insiders, was required to borrow almost \$6,000,000 from banks. The Chase National Bank of the City of New York suffered a loss of over \$1,100,000 of its loans to the investment company. Interstate Equities Corporation, one of the investment companies, of which Wallace Groves secured control, borrowed \$1,000,000 from the National City Bank of New York and hypothecated \$1,400,000 of marketable securities therefor in order to cover its loans to Wallace Groves. The loans made by M. & T. Securities Corporation to insiders proved costly, not only because of the direct loss sustained on charge-offs but because the company was required to make bank loans from Manufacturers and Traders Trust Company from August 1, 1929, to December 31, 1935, during the period the company was carrying these loans to insiders. Interest payments on the bank loans were required even though interest on the loans to the insiders was not paid.

Loans were also made to persons of influence, such as the loans involving \$395,000 on which almost \$200,000 was lost, made by Ungeleider Financial Corporation to Martin T. Manton, a former member of the federal judiciary. General Investment Corporation, sponsored by The Harris Forbes Corporation and United Founders Corporation and its subsidiary, American Founders Corporation, sustained

a loss of \$6,780,974 in connection with its involvement in the loan of the sponsor to Buenos Aires Central Railroad and Terminal Company, which it was required to take over. Loans were also made by investment companies which the sponsors of such companies did not desire to make. Two loans of this character, one for \$2,000,000 and one for \$2,600,000, were made by M. & T. Securities Corporation.

Even in the case of loans to others than insiders, there was also generally a reason for lending other than reasons of investments. When questioned on the loans made by Central-Illinois Securities Corporation at its first business meeting, Philip R. Clarke, president of the corporation, testified:¹⁵

Q. I just wanted to point out something, Mr. Clarke. This was practically the first business meeting of the trust, November 13, 1929. The other meetings were just organization meetings.

A. That is it.

Q. Yet at the very first meeting there is a loan of \$1,000,000 secured by a lease to the sponsor, isn't that so? The trust loaned \$1,000,000 to its sponsor?

A. Yes, sir.

Q. At that very same meeting there was a loan of \$550,000 to Central-Illinois Company, its sponsor, on the Goudey Gum as security?

A. Yes.

Q. At that very same meeting there was a loan of \$550,000 to Central-Illinois Company 6,400 shares preferred capital stock of Hickok Oil Corporation for an aggregate of \$576,000?

A. As I say, I was not present, but I always had the impression that that was all purposely done in order to give this investment trust everything that the Central-Illinois Company had in its portfolio that might possibly not qualify for an investment house, in other words, not be subject to distribution in the normal course of its business, and at the same time give this company the largest amount of earning assets at the earliest possible time.

Q. Well, I don't want you to think that I am inferring this, but all those deals, because of their specialized situation at the particular time they were made, namely, the half interest in a chewing gum company, and a million dollar loan secured by a lease and the purchase of the Hickok Oil stock for over a half million dollars, and then, which I will develop in more detail, the purchase of over a million dollars of bank stock from Central-Illinois Company, then the additional loan of \$1,500,000 in order for the securities company to maintain a stable market in this stock, all those factors might create in somebody's mind the susceptibility of an inference of unloading; isn't that so?

A. Of a what?

Q. Of the sponsor unloading on its trust.

A. I wouldn't want to go so far as to say that. I think it certainly demonstrates that the Central-Illinois Securities was, of the three affiliated companies, the one to which long-term investments were to be turned over.

Loans were also made by an investment company because its original investment in an organization had become unsuccessful. An example of this is found in the underwriting of certain securities of Bonwit Teller & Company by Ungerleider Financial Corporation.¹⁶ In 1931 Bonwit Teller & Company encountered financial difficulties and required additional working capital. In order to protect a large invest-

¹⁵ Public Examination, Central-Illinois Securities Corporation, at 2004-6.

¹⁶ Public Examination, Ungerleider Financial Corporation, at 14977-95.

ment in the securities of Bonwit Teller & Company, Ungerleider Financial Corporation was required to lend this company additional working capital of \$358,000. However, the business of Bonwit Teller & Company did not improve. On December 31, 1932, Ungerleider Financial Corporation, then under the management of Atlas Corporation, wrote down its investment in Bonwit Teller & Company to \$1. In 1933, Bonwit Teller & Company entered into a composition with its creditors and reorganized its capital structure. The loan of \$358,000 due to Ungerleider Financial Corporation was compromised by the issuance of additional stock to Ungerleider Financial Corporation. Following the dissolution of Ungerleider Financial Corporation in 1933, Atlas Corporation, in order to protect the investment in Bonwit Teller & Company which it had inherited from Ungerleider Financial Corporation, itself advanced approximately \$600,000 to Bonwit Teller & Company.¹⁷

Another example is found in the loan of \$8,000,000 by Bankers Securities Corporation to City Stores Company. The result of this loan was to involve the investment company up to 50% of its assets and to require participation in the management of a department store business. In other words, as the result of a loan in a special situation, the investment company in 1935 had almost one-half of its assets frozen in a department store. In the case of this investment company, the investor had no assurance as to the use to which his funds would be put, and the management became involved in a type of business entirely different from that in which investors had placed their funds.¹⁸

B. Examples of Loans by Investment Companies to Insiders and Affiliates

In the following section are given a number of examples of loans by investment companies to insiders such as officers, directors, or employees of such companies or to affiliates of such companies. It will be seen that practically all of the loans which were made, even those made to apparent outsiders, to individuals or organizations which had no direct connection with the company, such as the loan made by Ungerleider Financial Corporation to Martin T. Manton, a former member of the federal judiciary, were made not for business reasons but for some particular purpose of the insiders for whether for financial reasons, for prestige, or for the purpose of building up goodwill.

These cases of loans by investment companies are not exhaustive or the only cases of the kind which the instant study has produced, but were merely selected to illustrate some of the purposes for which loans were made.

1. LOANS TO INSIDERS FOR SPECULATIVE PURPOSES

One of the purposes for which loans were made by investment companies was to permit insiders of such companies to speculate on margin

¹⁷ Derived from supplementary information supplied the Commission for Ungerleider Financial Corporation.

¹⁸ Derived from supplementary information supplied the Commission for Bankers Securities Corporation.

in stocks. This purpose is illustrated by two companies, Liberty Share Corporation sponsored by Liberty Bank of Buffalo, and M. & T. Securities Corporation sponsored by Manufacturers & Traders Trust Company of Buffalo.

a. Liberty Share Corporation

Liberty Share Corporation, a closed-end management type investment company,¹⁹ sponsored by the Liberty Bank of Buffalo,²⁰ was organized in New York on April 2, 1929,²¹ as a result of the consolidation of three investment companies, Liberty Bond & Share Corporation, North American Investors Corporation, and Frontier National Corporation.²² Thereafter, in February 1930, Great Lakes Share Cor-

¹⁹ Reply to Commission's questionnaire for Liberty Share Corporation, Part IV.

²⁰ Public Examination, Liberty Share Corporation, at 8939-40.

²¹ Id., at 8892.

²² Id., at 8892, and Commission's Exhibit No. 867.

Liberty Bond & Share Corporation, sponsored by the Liberty Bank of Buffalo, was organized in New York on March 19, 1926. North American Investors Corporation was organized in New York on August 31, 1926 (id., Commission's Exhibit No. 867), and sponsored by L. G. Ruth & Company, an investment securities firm (id., at 8894-5), of which Leon G. Ruth had been a senior partner until the creation of Liberty Share Corporation. Then he became the latter's vice president, and in 1935 its president (id., at 8896). Frontier National Corporation, sponsored by Frontier National Bank (id., at 8939-40), was organized October 5, 1928 (id., at 8892) and merged with the Liberty Share Corporation, when its sponsor was merged with the Liberty Bank of Buffalo (id., at 8939-40).

When the consolidation of the three investment companies was negotiated in 1929, the connection of the Liberty Bank of Buffalo weighed heavily in the exchange. Philip H. Gerner, secretary and treasurer of the bank, testified (id., at 9178-8):

The fourth factor that was used was the relative values of the various interests, and at that time it was conceded with the fine connections and the experience that the Liberty Bank had had that it would be of considerable value to this picture over and above any value that the other two corporations might have, in the way of securing financing, underwritings, participations, et cetera.

Therefore the basis was more or less arbitrary by agreement, * * *

That the connection with the bank and its personnel for which the stockholders paid a premium was not so great a bulwark against the operating conditions of the times, was conceded by Mr. Gerner (id., at 9190):

Q. And then the fourth factor was that they paid a lot of money for this connection with the Liberty Bank, and the personnel; and that turned out to be a gold brick, didn't it?

A. Well, of course, you must realize * * *

Q. In other words, they paid a premium for the thing which caused them so much trouble?

A. You must bear in mind the operating conditions of this company almost from the outset what it was encountered with.

When letters, setting forth proposed consolidation of the three companies were sent to the stockholders, no statements were included concerning the book values, the earnings, liabilities, or assets of the three companies. (Id., at 9192.)

Mr. Gerner testified that no comparative figures were sent or furnished the stockholders (id., at 9192):

Q. * * * In fact, there are no figures, are there?

A. Not to the stockholders; no, sir.

Q. Not to the stockholders, so that the stockholders actually knew nothing. They were asked to send in a proxy based upon no information, except that they were told what the board was going to do, and that they would get stock.

A. Well, the stockholders must have felt it was a very advantageous move for them, because there wasn't one dissenting vote.

These letters did not request the appearance of the stockholders at the meeting (id., at 9202), and only 20 or 25 of the 2,700 stockholders attended (id., at 9193-4).

poration and Erie Share Corporation, both sponsored by L. G. Ruth & Company²³ were merged with Liberty Share Corporation.²⁴

When the Liberty Share Corporation was organized on April 2, 1929, the Liberty Bank of Buffalo secured control of the investment company by means of an interlocking directorate. At that time, 13 of the 16 directors of the Liberty Share Corporation were officers and directors of the bank. Before consolidation, Mr. Ruth had not been a member of the bank, but later, because of the consolidation, he became a vice president of the bank. Thus the number of interlocking directors was increased to 14.²⁵ When the Federal Banking Act of

²³ Id., at 8896, 9203, and Commission's Exhibits Nos. 865, 894. At the time of the negotiations and subsequent merger, Mr. Ruth was an officer both of Liberty Bank of Buffalo and Liberty Share Corporation.

²⁴ Id., at 8896.

When the proposed merger was under discussion, the bank connection of the Liberty Share Corporation was offered as a reason for concealing the financial condition of the investment company (id., 9207). The minutes of an executive meeting of the investment company, held on January 15, 1930, state (id., at 9207, and Commission's Exhibit No. 892):

Mr. Gerner reported that in all likelihood any negotiations carried on with any corporation must be done without divulging any information of Liberty Share Corporation, such as book value, earnings, cash position, portfolio position, etc., on the basis that Liberty Share Corporation is so closely allied with the Liberty Bank of Buffalo that many of its policies pertain to banking matters of said bank which should not be divulged for such purpose. Therefore based on this assumption all discussions entered into with Great Lakes Shares Corporation and the Erie Share Corporation have been predicated on this thought. On the other hand, any negotiation of this nature would necessitate Liberty Share Corporation being advised completely of all information including financial condition of the company to be merged.

Three members of Liberty Share Corporation were appointed "to make an official investigation of the Great Lakes Share Corporation and Erie Share Corporation and report their findings and recommendations" (id., Commission's Exhibit No. 893):

It was the opinion of this committee, * * * that after considerable negotiations and consideration, the Liberty Share Corporation would have little if anything to gain by such merger, and it was suggested that the Great Lakes Share Corporation look after their own liquidation and that Liberty Share assist in this procedure to the fullest extent.

On February 4, 1930, 7 days after the report of disapproval the merger was approved (id., 9209-19, and Commission's Exhibit No. 893). On February 12, 1930, an agreement of merger was executed (id., at 9214), and in conformity with the adopted procedure of not divulging any information concerning the financial condition of Liberty Share Corporation, no balance sheet or income statement of that corporation was annexed, although the balance sheets of the other two companies were attached (id., at 9206, and Commission's Exhibit No. 894). Mr. Ruth, whose firm sponsored these two companies, could not explain the omission of the financial statement of the Liberty Share Corporation (id., at 9206).

²⁵ See following table:

Interlocking directorate

Name	Bank	Investment company
Leon G. Ruth.....	Vice president, Apr. 2, 1929.....	Vice president, April 1929 to 1935.*
Philip H. Gerner *.....	Director, vice president *.....	President, Nov. 1, 1935.* Director, 1932 to 1935.* President, November 1932 to Nov. 1, 1935.*

* Id., at 8895-6.

* Id., 8893, 8896.

* Id., at 9015.

* Id., at 8911.

* Id., at 8907.

/ Id., at 8893, 9019.

* Mr. Gerner became identified with the Liberty Bank of Buffalo on November 1, 1927. Then he became actively engaged in the affairs of the Liberty Bond & Share Corporation in January 1928. He was the secretary of that investment company (id., at 9015-6).

1933,²⁸ which required the divorcement of banks and their security affiliates, was enacted, 11 of the 16 directors connected with the Liberty Bank of Buffalo resigned from the board of the investment company.²⁷

Liberty Share Corporation began business with net assets of \$9,799,599.80 on April 3, 1929.²⁸ Thereafter its net assets declined so that at September 30, 1936, the net worth of the investment company amounted to \$712,963.06.²⁹

Leon G. Ruth, president of the investment company,³⁰ attributed the shrinkage of the net assets from the original amount of \$9,799,599.80 in 1929 to \$712,963.06 as of September 30, 1936, to four factors (1) the depression following the market crash in 1929; (2) large loans made by the investment company to individuals, which was "a very prominent cause"; (3) trading account activities, consisting of trading in its own shares, shares of the Liberty Bank of Buffalo and shares of the Western New York Securities Corporation, another investment company organized and sponsored by the Liberty Share Corporation; and (4) a few unsuccessful miscellaneous investments.³¹

Footnote 25 continued from p. 2653.

Name	Bank	Investment company
George G. Kleindinst ¹	President ¹	President, Apr. 2, 1928, to November 1932. ¹
Oliver J. Cabana, Jr.	Director ²	Director. ¹
Henry C. Zeller.....	Director.....	Director. ¹
John M. Kinney.....	Vice president.....	Director. ¹
Chas. G. Duffy.....	Director.....	Director. ¹
George J. Klofer.....	Vice president.....	Director. ¹
Jacob G. Lang.....	Director.....	Director. ¹
Clarence H. Littell.....	Director.....	Director. ¹
Edward L. Miller.....	Director.....	Director. ¹
Charles C. Theobald.....	Vice president.....	Director. ¹
William Lansil.....	Director.....	Director. ¹
J. W. Van Allen.....	Director.....	(Director. ¹ Counsel. ¹)

¹ Prior to the time Mr. Kleindinst became an officer of the Liberty Share Corporation, he was secretary and treasurer of the Liberty Bond & Share Corporation from its inception until 1927 when he became its president (id., at 8952-3.)

² Id., at 8911.

³ Id., at 8893-4, 8939-40.

⁴ Id., Commission's Exhibit No. 869.

⁵ Id., at 8906-7.

⁶ Id., Commission's Exhibit No. 869.

* * * * *

A management contract was entered into between the investment company and the bank on April 2, 1929, the day of consolidation (Reply to Commission's questionnaire for Liberty Share Corporation, Part I, Item 7). On the same day, however, this management contract, which was not made available to the Commission, was abrogated upon advice of counsel (ibid.). The investment company thereafter was controlled by the bank without the formality of a written agreement.

²⁸ 12 U. S. C., Sec. 378.

²⁷ Public Examination, Liberty Share Corporation, at 8909-10, 8936-7.

²⁸ Id., at 8896-7, 8941, and Commission's Exhibit No. 870. The total original capital contribution by the stockholders of the five companies was \$10,410,722. This sum consisted of \$3,900,722 invested in the five companies and \$6,510,000 raised at the time of consolidation by the sale of 217,000 shares of Liberty Share Corporation, at \$30 per share. (Id., Commission's Exhibit No. 865.)

On April 3, 1929, the gross assets of Liberty Share Corporation were \$12,463,712.24. On December 31, 1929, its gross assets amounted to \$15,247,387.66, the highest amount ever attained, but the net assets amounted only to \$7,853,178.23. (Id., Commission's Exhibit No. 870.)

²⁹ Id., at 8898, and Commission's Exhibit No. 866. Although the net worth in the financial statement was \$422,963.06, the portfolio appreciation as of September 30, 1936, was \$290,000, making the actual net worth \$712,963.06.

³⁰ Id., at 8893.

³¹ Id., at 8899-8901.

On April 2, 1929, loans of \$1,497,578.42 were owed to the Liberty Bond & Share Corporation²² and were accepted at full asset value by the Liberty Share Corporation.²³ Of this amount, \$745,567.78 or approximately 50% were loans made to officers and directors or persons affiliated with the Liberty Bank of Buffalo, many of whom subsequently became officials of the consolidated company.²⁴

²² Id., at 8902, 8908, 9197, and Commission's Exhibit No. 868.

²³ Id., at 9197, 8902, 8910-11.

The financial statement of Liberty Bond & Share Corporation was accepted without explanation in the plan of consolidation, because of the reputation of the Liberty Bank of Buffalo and its officers and directors. Mr. Ruth testified he did not know the details of these loans at the time of consolidation (id., at 9197):

Q. And at that time, or prior to the date of consolidation, did you know of this \$1,400,000 worth of margin accounts, which were included among the assets of the Liberty Bond & Share Corporation?

A. No; I didn't.

Q. You knew that their accounts payable were there?

A. Yes.

Q. But you didn't know that they were margin accounts?

A. I didn't know the details of it.

Q. Did you know that they were margin accounts?

A. No.

Q. And did you know that half of those accounts were involved margin accounts in which officers and directors of the bank or Liberty Bond & Share were involved?

A. No, sir.

Mr. Ruth asserted that it was a reasonable assumption that he relied upon the names of the men involved in the acceptance of the plan of consolidation without ordinary scrutiny and added that "99% of the people of the City of Buffalo would have done the same thing" (id., at 9198), but "I am not indicating, however, that I could not have found out. I did not know it, perhaps I am just as much to be criticized as anyone, as I view it now" (ibid.). "The big point, that was the motivating influence or force, surrounding this consolidation, was the dominant position of the Liberty Bank of Buffalo, in Buffalo" and "It is a fair statement to make that not only was the bank prominent but it had a long record of success" (id., at 9199).

After Mr. Ruth became an officer of the consolidated company, he learned that these loans were made to officers and directors of the bank and of the investment company and the nature of these accounts (id., at 8904-5, 8910-11).

²⁴ Id., at 8903, 8907-8, and Commission's Exhibit No. 868. Loans were made to over 28 persons and firms. As of April 2, 1929, loans to over 22 persons and firms were outstanding. Of this number 9 were connected with the bank, either directly or indirectly. These were as follows:

Borrower	Connection with Liberty Bank	Amount
Thomas H. Hanrahan.....	Director.....	\$52,000.00
Given Improvement Co.....	(Mr. Given) former director.....	40,000.00
J. M. Kinney.....	Vice president.....	41,800.00
George J. Kloefer.....	Vice president.....	70,000.00
Philip H. Gerner.....	Secretary and treasurer.....	113,297.95
Mildred Gerner.....	Wife of Philip Gerner.....	62,133.83
Henry C. Zeller.....	Director.....	155,736.00
Oliver J. Cabana, Jr.....	Director.....	150,000.00
Liberty Limited Corporation.....	Affiliate.....	60,000.00
Total.....		745,567.78

²⁵ Id., at 8903-4.

²⁶ Id., at 8905.

²⁷ Id., at 8906.

²⁸ Id., at 8904-5.

Mr. Ruth testified (id., at 8907-8908):

Q. So that practically all of these people who had margin accounts with the predecessor company, the Liberty Bond & Share Corporation, on the date of consolidation, were affiliated with the Liberty Bank and also became affiliated with the Liberty Share Corporation; is that right? Would that be a fair statement of those names that I read out?

A. Of those names you read?

Q. Of those names that I read.

A. Yes.

Thereafter the practice of lending money to insiders continued and these loans steadily increased.³⁵ Upon being questioned concerning the continuation of this practice, Mr. Kleindinst testified:³⁶

Q. So these loans were not just an isolated incident; it was sort of a habit or routine that had gone on for a long time; is that right?

A. Yes.

Q. It was a continuing practice; this practice had started with the Liberty Bond & Share Corporation, the predecessor company; is that right?

A. I rather think that corporation was borrowing from the bank also.

On December 31, 1929, 9 months after the creation of the new company, total loans amounted to \$3,664,716, of which \$1,888,473 was lent to officers, directors, and employees of the sponsor bank and \$418,012 to officers, directors, and employees of the investment company.³⁷ When the merger of the Great Lakes Share Corporation and Erie Share Corporation with Liberty Share Corporation was consummated in February 1930, no disclosure was made to the new stockholders of the existence of these loans. The testimony of Mr. Gerner in regard to the knowledge of the stockholders was as follows:³⁸

Q. As far as you know, the stockholders of the merging corporation had no idea that there were \$3,600,000 of margin accounts, or that out of that \$3,600,000 and that \$2,300,000, at least, were with officers and directors.

A. I can answer it this way, that so far as I know, I don't know that they didn't.

Q. But you don't know that they did.

³⁵ Id., at 8978.

³⁶ Ibid.

In connection with these practices, it is significant to note the following broad self-dealing clause contained in the charter of the Liberty Share Corporation (id., Commission's Exhibit No. 867):

7 (c). No contract or transaction between the corporation and any of its directors or any other individual, firm, association, or corporation shall be affected by the fact that the directors of the corporation are interested in, or are officers of other firm or association or corporation and any director individually may be a party to and may be interested in any contract or transaction of the corporation, and no contract or transaction of the corporation with any individual, firm, association or corporation shall be affected by the fact that any director of the corporation is a party to or interested in such contract or transaction or in any way connected with such individual, firm, association or corporation even though the vote of such director may have been necessary to effect such contract or transaction, and even though the interest of such director was not disclosed to the other directors or stockholders. No director having such adverse interest shall be liable to the Corporation * * * on account of such contract or transaction; neither shall such interested director be liable to account for any gain derived therefrom, and every director is hereby relieved from any [liability that] otherwise might prevent his contracting or dealing with the Corporation and from liability that might otherwise exist by reason of his having dealt with the Corporation for the benefit of himself or for any firm, association, or corporation with which he may be in any way interested.

³⁷ Id., Commission's Exhibit No. 870.

In the report to the stockholders for the year ending December 31, 1929, no mention was made of these loans to insiders. Instead, the investment company's connection with and reputation of the Liberty Bank of Buffalo were emphasized: (Reply to Commission's questionnaire for Liberty Share Corporation, Part I, Item 8; Public Examination, Liberty Share Corporation, at 8911):

Practically every deal for financing which has been figured on by your officers has been brought in through the Liberty Bank. Likewise, through its 21 branches, we have been enabled to give city-wide service, having the same effect as if we had 21 branches located throughout the city. From this source we received more than one-half the volume of our commission business to say nothing of their 160,000 depositors, many of whom are potential buyers, thus insuring your company large distribution of securities in the future, through this source alone.

To sum up—The Liberty Share Corporation is the Securities Department of the Liberty Bank * * *

³⁸ Id., at 9214-5.

A. I don't know that they did.

Q. You don't know?

A. Nor do I know that they did not.

Most of the loans to insiders were made after the market crash in 1929.³⁹ On December 31, 1930, the amount of these loans had reached a peak, when the total loans were \$5,443,625, of which sum \$3,617,662 was lent to officers, directors, and employees of the sponsor bank and \$573,635 to officers, directors, and employees of the investment company.⁴⁰ In the annual statement for the year ending December 31, 1930⁴¹ the item, which included these loans, was designated as ac-

³⁹ Id., at 9043.

⁴⁰ Id., Commission's Exhibit No. 870.

⁴¹ Id., Commission's Exhibit No. 876, and at 8997-8.

The December 31, 1930 statement showed the total assets of the investment company at \$18,550,178.64. In the general ledger of the investment company, investments were carried at \$7,784,000 but the annual statement reported those investments "at cost of \$11,907,593.72" with this notation "market or appraised value as of January 10, 1931, \$9,536,769.68" (Id., at 9036). In the computations for the annual statement 5,970 shares of the stock of The Liberty Bank of Buffalo were valued at \$215 per share and an appraised value of \$1,283,550 was represented as the market value, whereas the market value of that stock per share was \$158. Even on the books, the values were exaggerated. The Liberty Share Corporation stock was carried at \$72 per share, whereas its market value was \$17 and 50,000 shares of Western New York Securities at \$20 per share when its market value was \$13. (Id., Commission's Exhibit No. 878.)

Mr. Gerner, executive vice-president, who signed the report, was unable to give any reason for the discrepancy in the annual statement (id. at 9039):

Q. Why were you carrying this seven million dollars on your books and eleven million dollars in your public statement?

A. I don't know. I haven't any idea. That is something I can't answer.

These values were maintained on the books and published despite the fact that in a resolution on December 24, 1929, the executive provided that the basis of evaluation of securities was to be at cost or market whichever was lower. (Id., Commission's Exhibit No. 876, and 9036-7.)

In a report of a bank examiner of the State of New York, dated February 13, 1931 (Id., Commission's Exhibit No. 878), the examiner wrote that this statement which appeared in the January 1931 issue of the Liberty-Western New Yorker, a publication issued monthly by the corporation, was "misleading and to publish such a report is extremely reprehensible." Attention was directed to the Penal Law regarding misleading reports, Section 665, which reads as follows:

A director, officer, agent, or employee of any corporation who knowingly concurs in making or publishing any written report, exhibit, or statement of affairs or pecuniary condition containing any material statement which is false is guilty of a misdemeanor.

The statement of December 31, 1930, had been prepared by the auditors of the investment company (id., at 9013, 9036) and approved by all the officers (id., at 9036), nevertheless a day or two after it was mailed, counsel disapproved of its publication and Mr. Gerner testified that it was sent out "in error." (Id., at 9033.) To rectify the "error" a stockholders' meeting was called, at which only 25 stockholders attended. (Id., at 9033-4, and 9039-40.) Mr. Gerner testified as follows (id., at 9039-40):

Q. You signed the statement?

A. I have already stated it was sent out in error.

Q. And when you found the error, you called a stockholders' meeting to correct it, but you didn't tell all your stockholders you had made an error, did you?

A. We didn't send out a special letter concerning it.

Q. And only 20 or 25 stockholders attended?

A. That is right.

Q. So that the other 4,500 may or may not have found out about it?

A. That is right.

Q. As to the rest of them, did you send them any notice of the incorrect statement that was made in your annual report?

A. No; we did not. (Id., at 9034.)

At a special meeting of stockholders held on March 20, 1931, the \$10 par value stock of Liberty Share Corporation was changed to no par value and reserves of \$2,800,000 against

counts and notes receivable, but no indication was made from whom they were receivable nor that the officers and directors were speculating with the funds of the investment company nor using such money for their own purposes.⁴² Mr. Kleindinst testified:⁴³

Q. So that the shareholder, so far as you can see, would have no idea that the officers and directors were having large margin accounts with the corporation?

A. Not from there.

Q. Not from this report?

A. No.

By the end of 1931, although the total assets had shrunk over \$4,000,000, the loans continued to be almost 40% of the reduced assets. By the end of 1932, when the net assets were \$944,780.68, the loans outstanding were over \$4,000,000.⁴⁴ At that time the notes receivable

the Liberty Share stock that had been accumulated were set up. The stock was written down to \$2 per share. In the December 31, 1930 statement the value of each share was stated to be \$15.58 whereas the value per share was after allowance for estimated losses and other deductions \$2.80. (Id., Commission's Exhibit No. 878.) In connection with the book value of the assets of the Liberty Share Corporation, Mr. Gerner testified as follows (id., at 9058-9):

Q. So that what you did, at that time, went against the usual banking practice, isn't that right?

A. I would say that is correct, that it was against the usual banking practice.

Q. So that you applied one standard in the Liberty Bank and in the Liberty Share Corporation you had another standard as to the valuation of your assets?

A. Probably so.

Q. And the same principle was applied in the appraisal of the assets for the purpose of estimating your book value, isn't that right?

A. That is so.

Q. So that you had a dual standard there?

A. Yes.

⁴² Id., at 8998.

⁴³ Id., at 8999.

Although the December 31, 1930, statement was not very informative to the stockholders, nevertheless, Philip H. Gerner, executive vice-president did not fail to impress the importance of the bank connection of the investment company. As in the statement for 1929, he wrote (id., Commission's Exhibit No. 876):

I cannot stress too strongly the value of our relationship with the Liberty Bank, whose officers and executive committee provide the executive management of your corporation. More than half of our stock exchange business and a great deal of its distribution business has come from this institution with its 21 branch offices during the past year.

⁴⁴ Id., at 8922 and Commission's Exhibit No. 870. That the Liberty Share Corporation was also employed to accommodate the customers of the bank is disclosed in the minutes of December 19, 1932, wherein a personal loan of \$19,648 was carried to Rex T. Crandall, a former president of the Great Belt National Bank of Westfield, N. Y. The minutes show the Liberty Bank of Buffalo was "desirous of retaining the goodwill of Mr. Crandall with whose bank business was being done. The Liberty Bank, however, had on loan an excess amount of collateral of the Great Belt National Bank, and in order that accommodation might be given Mr. Crandall, this loan was sent to Liberty Share." (Id., at 9044.)

Mr. Kleindinst testified (id., at 8979-80):

Q. I say a lot of these accounts—some of these accounts that Liberty Share Corporation took over came from the bank. In other words, the Liberty Share Corporation was used to aid the bank in connection with its accounts, wasn't it?

A. Oh, yes; I understand. There were some loans sent up to Liberty Shares.

Q. Just as an example of this, do you remember in the minutes of June 30, 1933, Mr. Gerner advised that Mr. Kissig, executive vice president of the Liberty Bank, had called at his office in order to discuss the removal from the bank notes amounting to \$808,422, which originated with the Liberty Share Corporation that were given to Western New York Securities Corporation, in payment of interest on its loans, and in turn endorsed by Western New York Securities Corporation without recourse, and presented to Liberty Bank in payment of interest on the bank loan to Western New York Securities Corporation. Mr. Kissig suggested the Banking Department wanted these notes out of the bank and suggested a plan whereby this could be done.

Then there is further discussion about it, and Mr. Ruth explained in considerable detail the matter of how the loan to Western New York originated and it was his emphatic understanding at the time the loan was made that the Liberty Bank would

were carried at their full value, but if these loans had been reduced to their real value, the shrinkage in assets would have amounted to more than \$944,780.68, and Liberty Share Corporation would have been insolvent.⁴⁵

The following table contains a comparison of loans to total and net assets of the investment company from the time of the organization of Liberty Share Corporation to December 31, 1935.⁴⁶

Date	Loans to—					Total assets	Less notes and accounts payable	Net assets
	Officers, directors, and employees of Liberty Share Corporation	Officers, directors, and employees of Liberty Bank	Total loans to insiders	Customers	Total loans			
Apr. 3, 1929						\$12,463,712.24	\$2,664,112.44	\$9,799,599.80
Dec. 31, 1929	\$418,012	\$1,888,473	\$2,306,485	\$1,358,231	\$3,664,716	15,247,387.66	7,394,209.43	7,853,178.23
Dec. 31, 1930	573,635	3,617,662	4,191,297	1,252,328	5,443,625	14,626,284.27	8,543,508.38	6,082,775.89
Dec. 31, 1931	539,261	2,253,273	2,792,534	1,139,915	3,932,449	10,078,620.65	6,395,015.50	3,683,605.15
Dec. 31, 1932	539,686	2,335,914	2,875,600	1,140,490	4,016,090	6,528,437.08	5,583,656.40	944,780.68
Dec. 31, 1933	569,213	2,427,990	2,996,303	1,210,949	4,206,752	6,649,589.34	5,735,588.16	914,001.18
Dec. 31, 1934 ^a		20,394	20,394	307,272	327,666	2,288,736.61	1,529,229.70	759,506.91
Dec. 31, 1935 ^a		19,776	19,776	286,465	286,261	2,190,827.91	1,508,720.23	682,107.68

* Reduction of indebtedness in these years accounted for by transfer of accounts to Casterlan Corporation.

These loans were margin or brokerage accounts,⁴⁷ the purpose of which was to enable the borrower to buy and sell stocks of the bank, the investment company and its affiliate, Western New York Securities Corporation on margin. Mr. Kleindinst testified as follows:⁴⁸

Q. What were those margin accounts used for? That is, trading in what stock?

A. A general list of stocks, I assume that any Stock Exchange stock that would be purchased by any customer of the bank, or other stocks, and there was, of course, a preponderant amount of Liberty Bank stock and Liberty Share stock and Western New York stock, I assume.

Q. In other words, the majority of these accounts, as far as you know, were trading, trading accounts, margin accounts, in the Liberty Share stock, and Liberty Bank stock, and the Western New York Securities Corporation stock.

A. Preponderantly.

see that Western New York Securities Corporation suffered no penalty as a result of said loan.

So there was an intermingling back and forth, an intercourse back and forth between these various loans, between the bank and Liberty Share Corporation and Western New York Securities Corporation.

A. Between Liberty Share Corporation and the bank.

Philip H. Gerner also testified (Id., at 9043):

Q. * * * The bank was also during this time shooting loans it did not want to handle over to the Liberty Share Corporation, wasn't it?

A. They may have sent some loans in; yes.

⁴⁵ Id., at 8923-7.

⁴⁶ Id., Commission's Exhibit No. 870.

⁴⁷ Id., at 8913.

⁴⁸ Id., at 8947-8.

Q. Now four-fifths of these loans were to officers and directors of the—and insiders—and those were the ones primarily interested in the Liberty Share stock and the Liberty Bank stock and the Western New York Securities stock, isn't that right?

A. I think so.

In the management of the assets of the investment company, Mr. Kleindinst denied that the investment company had been employed as a personal loan company for the officers and directors, and that the amount of loans was excessive:⁴⁹

Q. Now you were president all this time, and what authority was there for you to permit this to be turned into a personal loan company, and that is practically what it was, isn't it, for the officers and directors?

A. No.

Q. You had one-third—at the end of 1930, if you will examine that statement, more than one-third of your total assets were the result of loans, isn't that right, out of your total assets of \$14,600,000 you had total loans of \$5,400,000?

A. That is right. That doesn't seem an excessive amount.

When these accounts were accepted by the investment company, they were secured by collateral and a number of them were carried on the basis of 20% margin and some on 40% margin.⁵⁰ In contrasting the practice of the bank in connection with the requirement of collateral, Mr. Kleindinst admitted that the bank demanded a greater percentage as a minimum:⁵¹

Q. As a member of the bank, you were president of the Liberty Bank, what collateral did you require for your loans? Did you permit loans after the crash in 1929, which only had a 20% margin?

A. We naturally tried to get additional collateral from everybody.

Q. Did you take loans on that basis?

A. We didn't take new ones.

Q. As a matter of fact, wasn't everybody demanding 50 and 60 and 70% collateral?

A. I don't think as much as that, after the crash. I think before the crash there were 50 and 55%.

* * * * *

Q. What was the practice of your bank, was that 20% collateral?

A. No.

Q. How much collateral was the practice of the bank?

A. We weren't making—after the crash we weren't making any collateral loans.

Q. I am asking you when you did make them, on what basis, or how much collateral did you require?

A. 35%.

Q. That was the minimum?

A. Yes.

Q. And you didn't make them on that basis, did you?

A. We didn't make many on any basis.

After the rise in the market in August 1930 the investment company lent \$1,806,555.37⁵² to nine directors and officers of the Liberty Bank

⁴⁹ Id., at 8948.

⁵⁰ Id., at 8950-1.

⁵¹ Id., at 8951-2.

⁵² Id., Commission's Exhibit No. 872.

of Buffalo⁵³ and of the Liberty Share Corporation for the purpose of conducting "an orderly market in Liberty Shares and Liberty Bank and Western New York Securities."⁵⁴ These nine men organized a syndicate, under the fictitious name of "Blakely & Company." Mr. Kleindinst denied that the employment of a fictitious name was to conceal the nature of the account.⁵⁵ Each member of the syndicate agreed to be liable to the extent of \$200,000, and upon the basis of these commitments the Liberty Share Corporation was ordered to purchase \$1,800,000 of those securities.⁵⁶ The investment company financed the syndicate up until May 19, 1931, when the nine members were called upon to meet their liabilities. Only six of the nine paid immediately.⁵⁷ Mr. Kleindinst, Mr. Zeller, and Mr. Lansill were the three who failed to meet their commitments.⁵⁸ Since that time, however, Mr. Zeller has supplied additional collateral to cover his obligation.⁵⁹

Shortly after the first month of operations securities prices in general were dropping constantly but the syndicate continued buying until it had purchased \$1,806,555.37 worth of stock of the bank, the investment company, and its affiliate.⁶⁰

Mr. Kleindinst testified:⁶¹

Q. Did you make any attempt at any time to terminate the syndicate when you saw it was getting sour?

A. No.

The stocks purchased by the syndicate had "a very limited" market. They were local stocks traded in on the Buffalo Stock Exchange.⁶² Mr. Kleindinst justified the employment of the funds of the investment company in the purchase of these securities as follows:⁶³

Q. Have you any justification as to why a trust of this sort should pay \$1,800,000—why a trust should permit money to the extent of \$1,800,000 to be used to buy unmarketable securities?

A. If the trust were doing it for its own account, no. If they were doing it for the account of individuals, who were at the time that the orders were given able to pay and were still able to pay at the termination of the obligation to the extent of six men out of nine—

The Blakely & Company account, therefore, in regard to collateral was "under water" immediately after its inception. Mr. Kleindinst

⁵³ Id., at 8920.

⁵⁴ Id., at 8955. Western New York Securities Corporation was organized in 1929 by Liberty Share Corporation. (Id., at 8900 and 8918.) Of the 250,000 issued shares of Western New York Securities Corporation, 50,000 were purchased as a permanent investment by Liberty Share Corporation. (Id., at 8900.) Western New York Securities Corporation raised \$2,500,000, which was employed in the purchase of various securities, mainly bank notes. After the market crash in the fall of 1929 it hesitated to continue to invest its funds but nevertheless desired to employ them. A sizable portion of its resources was lent on call. \$1,821,880.51 was lent to Liberty Share Corporation. (Id., at 8918-9, 9060, and Commission's Exhibit No. 880.)

⁵⁵ Id., at 8957-8.

⁵⁶ Id., at 8921.

⁵⁷ Id., at 8921, 8956.

⁵⁸ Id., at 8981.

⁵⁹ Id., at 8957, 8981-2.

⁶⁰ Id., at 8959.

⁶¹ Id., at 8984.

⁶² Id., at 8987.

⁶³ Id., at 8992-3.

conceded the point "if you disregard the credit standing of the individuals."⁶⁴

Mr. Kleindinst testified that he did not know of any banking or brokerage house, which would advance the funds upon the terms of the syndicate agreement.⁶⁵

Q. You wouldn't take an account like that at a bank, would you?

A. Against the contract, that is binding, as that—

Q. Against a contract of nine individuals, a contract which provided for the purchase of a stock which had practically no market involving the purchase of \$1,800,000?

A. It all depends upon the makers of the agreement.

Q. You would do that without security?

A. If the man's credit were good, absolutely, and we are loaning money like that all along.

Q. For speculation in the market?

A. Yes.

Q. And you are president of the bank today?

A. Yes, sir.

Q. Now you knew that the corporation, or the trust, in order to buy that \$1,800,000 worth of stock had to go out and borrow money, didn't you?

A. They were borrowing, I knew that.

Q. And you knew that a great many of the accounts, the margin accounts of the trust by that time, were under water, didn't you?

A. They were under water, some of them.

Q. A good many of them?

A. Yes.

Q. And the trust had to borrow money to finance your gambling in this \$1,800,000 amount of stock, didn't it?

A. Our investing in that stock.

Q. You call that an investment, do you?

A. Yes.

Q. Where you buy \$1,800,000 of stock without a cent of money being put up, and you are not able to pay for it when it comes due?

A. That is common practice, isn't it?

Q. I don't know what is common practice—with you.

A. You give your order to buy, and when the security is presented for payment, and your payment is made, that doesn't constitute gambling.

Q. Do you know of any brokerage house or any other house, where you can give an order to accumulate over a period of 9 months \$1,800,000 of stock, without putting up a cent of money?

A. I can't answer that.

Q. Do you know of any banking house or brokerage house that would do it?

A. I couldn't answer that.

Q. Well, as a matter of fact, you don't know of any, do you?

A. No.

At the time the Blakely & Company account was in existence the nine members of the syndicate constituted a majority of the board of directors of the Liberty Share Corporation. Mr. Kleindinst testified:⁶⁶

⁶⁴Id., at 8958.

⁶⁵Id., at 8960-1. The syndicate agreement was not made available to the Commission.

⁶⁶Id., at 8965-6.

Q. Can you answer my question as to whether or not the 9 members of the syndicate constituted a majority of the board of directors of the Liberty Share Corporation?

A. I think they would, yes; if there were 12.

Q. If there were 12 and they were all directors, obviously so.

A. If there were 16—

Q. There were 16 directors and there were nine in this syndicate, so there was a majority of the board of directors. There is some explanation as to one of the members of the syndicate, as to whether he was or was not a member of the board.

So there was either a majority or 50 percent of the board?

A. Yes.

As to knowledge on part of the stockholders, Mr. Kleindinst was silent but stated that the directors knew of the syndicate account, and that they were furnished with a weekly statement.⁶⁷

Q. Was there any directors' approval of this account?

A. I couldn't say.

Q. And the stockholders didn't know of it, did they?

A. The directors must have known, because they were furnished with a statement every week.

That this syndicate account was the largest account permitted to be carried without collateral or down payment was acknowledged by Mr. Kleindinst.⁶⁸

Q. Do you have any other accounts in the Liberty Share Corporation of that magnitude or any magnitude which had no collateral, which were just purchased and carried without collateral?

A. No; this was the largest account we had.

Q. Well, this was the only account, wasn't it, where you permitted the account to start up without any collateral and to be carried without any security or down payment?

A. That is right.

Q. This is the only one?

A. Yes.

Q. It may be, then, an easy explanation why Liberty Share Corporation would allow such an unsecured loan to take place, if the majority of the board of directors were personally interested on the other side of the bargain.

That might be an easy explanation, might it not?

A. And they knowing their ability to pay; yes.

Mr. Kleindinst asserted that this was the only instance where the directors of the investment company borrowed from it without collateral.⁶⁹

As to justification for the speculative use of the funds of the Liberty Share Corporation, Mr. Gerner testified:⁷⁰

Q. And what justification have you, Mr. Gerner, as operating vice president, for permitting the officers and directors of the Liberty Bank and the Liberty

⁶⁷ Id., at 8958.

⁶⁸ Id., at 8982, 8986.

⁶⁹ Id., at 8994-5.

⁷⁰ Id., at 9022.

Share Corporation to speculate at the expense of the shareholders with the shareholders' money?

A. More or less a matter of precedent, and it was done when I came into the situation, and it was continued. It was continued because * * * we were buying and selling securities, not only for our own account, but for our customers.

During the operation of the Blakely & Company account, the Liberty Share Corporation borrowed from The Chase National Bank and from the Liberty Bank of Buffalo, to finance the purchases of the syndicate. Frank X. Ulrich, treasurer of the Liberty Share Corporation,⁷¹ who had been auditor at that time, testified:⁷²

Q. Suppose you tell us what were the loans made by the Liberty Share Corporation, what borrowings from other banks and trust companies, from August 1930 to May 1931?

A. My recollection is that we had additional collateral in our portfolio, together with additional collateral of the various accounts, which was not pledged at the time, and as I needed additional money, I would put up this additional collateral in the bank.

Q. Which bank?

A. The Liberty Bank or the Chase; both the Liberty and the Chase.

In February 1931, while the syndicate account had been in operation, a bank examiner rendered a report, in which he called attention⁷³ to the apparent violations of the Stock Corporation Law of New York, Section 59, pertaining to liability of directors for loans to stockholders and the Banking Law, Section 103 (7) and (8) formerly Section 108 (7) and (8) pertaining to restrictions on loans, etc.,⁷⁴ but the

⁷¹ Id., at 8964.

⁷² Id., at 8965.

⁷³ Id., Commission's Exhibit No. 878.

From the foregoing it appears that the Liberty Share Corporation is financing short loans of officers, directors, and employees by using their collateral to borrow directly and indirectly from the Liberty Bank. In the opinion of your examiner, such arrangements are in violation of Section 108, subdivisions 7 and 8, of the New York State Banking Law. Attention is also directed to Section 59 of the Stock Corporation Law which prohibits a corporation from loans to its stockholders. It will be noted that most of the borrowers are stockholders.

⁷⁴ See Bank Examiner's Report, 2/13/31. (Id., Commission's Exhibit No. 878.)

Liability of directors for loans to stockholders.—No loan of moneys shall be made by any stock corporation, except a moneyed corporation, or by any officer thereof out of its funds to any stockholder therein, nor shall any such corporation or officer discount any note or other evidence of debt, or receive the same in payment of any installment or any part thereof due or to become due on any stock in such corporation, or receive or discount any note, or other evidence of debt, to enable any stockholder to withdraw any part of the money paid in by him on his stock. In case of the violation of any provision of this section, the officers or directors making such loan, or assenting thereto, or receiving or discounting such notes or other evidences of debt, shall, jointly and severally, be personally liable to the extent of such loan and interest, for all the debts of the corporation contracted before the repayment of the sum loaned, and to the full amount of the notes or other evidences of debt so received or discounted with interest from the time such liability accrued. (Stock Corporation Law, Section 59, Cahill's Consolidated Laws of New York, 1930.)

Restrictions on loans, purchases of securities, and total liabilities to bank of any one person. A bank subject to the provisions of this article—

7. Shall not knowingly lend, directly or indirectly, any money or property for the purpose of enabling any person to pay for or hold shares of its stock, unless the loan is made upon security having an ascertained or market value of at least fifteen per centum more than the amount of the loan. Any bank violating the provisions of this subdivision shall forfeit to the people of the state twice the amount of the loan.

8. Shall not, nor shall any officer thereof, lend directly or indirectly any sum of money to any officer, director, clerk, or employee of the bank without the written

Blakely & Company account was not terminated until May 1931.⁷⁵ Mr. Kleindinst testified:⁷⁶

Q. So if you read the report, you saw they thought it was in violation of the statute. You kept on nevertheless. I am not trying to say whether it was or was not—you kept on nevertheless.

A. That is right.

Q. And you kept on nevertheless even though the market was no good, and you permitted the trust to keep on buying until May, and then when the time came for payment in May you couldn't sell the securities—the trust didn't sell the securities, did it?

A. No.

Q. They just hung on to it, and that obligation to pay them is still outstanding today.

A. That is right.

Q. Unreduced.

A. That is right.

approval of a majority of the board of directors thereof, filed in the office of the bank or embodied in a resolution adopted by a majority vote of such board, exclusive of the director to whom the loan is made, or in any event to any officer thereof, if such bank is located in a city of the first class; and if any such officer, director, clerk, or employee shall own or control a majority of the stock of any other corporation a loan to that corporation shall be considered for the purpose of this subdivision as a loan to him. Every bank or officer thereof violating this provision shall, for each offense, forfeit to the people of the state twice the amount lent. (Banking Law, Section 108, Cahill's Consolidated Laws of New York, 1930. Section 108 of the Banking Law was revised and renumbered Section 103 in 1937.)

In the report of February 13, 1931, the bank examiner also called attention to the payment of dividends by the Liberty Share Corporation at a time when its capital was apparently impaired (Id., Commission's Exhibit No. 878, and id. at 9053-4).

The report in regard to dividend payments stated:

Attention is directed to Schedule 4 showing earnings * * * for the year ending December 31, 1930. Quarterly dividends are being paid at the rate of 25¢ per share. In the opinion of your examiner, such dividends are being paid out of capital funds in violation of Section 58 of the Stock Corporation Law. It is somewhat difficult to determine just how long the capital of this corporation has been impaired, but, in the opinion of the examiner, the dividends paid in September and December of 1930 are in violation of said law.

See also Penal Law, Section 664, Cahill's Consolidated Laws of New York, *Misconduct of officers and directors of stock corporations*:

A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:

1. To make a dividend, except from surplus, and in the cases and manner allowed by law; * * * Is guilty of a misdemeanor.

Mr. Gerner disagreed with the report and justified the payment of dividends at that time on the ground that the loans of the directors and officers were sound assets, the collateral loans being made in good faith and on the good moral and credit standing of the individuals. However, on the basis of the actual collateral value, he could not dispute the fact that the dividends were paid out of capital (Id., at 9055-6) which practice, with his present knowledge, Mr. Gerner testified would not be continued. (Id., at 9057.)

⁷⁵ In his report of February 13, 1931, the bank examiner, referring to certain reserves to be required, stated (Id., Commission's Exhibit No. 878):

* * * In setting up these reserves, your examiner has been rather drastic, due to the fact that most of these borrowers are heavily involved, and, if forced, the unsecured portion would probably be a loss. In some cases, this was not conceded, but in the absence of proper credit information to support same your examiner has set up reserves. In a number of cases, collateral mortgages held, were not allowed due to the fact that no supporting papers were on file and other necessary information was not available. In this connection, the question of validity may also arise as most of the borrowers who gave such collateral mortgages, which are now less than four months old, were unquestionably insolvent.

⁷⁶ Id., at 8989-90.

In giving his interpretation of the New York Banking Law, Mr. Kleindinst stated:⁷⁷

Any loan that the Liberty Share Corporation had at the bank was secured by stock exchange collateral, properly margined, and we did not construe it as being an indirect loan to an employee or officer of the bank.

In discussing Section 59 of the New York Stock Corporation Law, Mr. Kleindinst, in conceding that he was a stockholder of the corporation, did not consider that the statute affected his situation because "in the first place we were not making loans to stockholders. We were taking brokerage accounts, or margin accounts, and our account did in no way permit them to withdraw against their stockholdings in the corporation, * * * and that they were putting up additional collateral into the corporation as against withdrawing, as defined in the statute."⁷⁸

At the time these loans were made the officers and directors knew of the existence of these provisions of the statutes. Mr. Kleindinst testified that logically the aim of the law was violated.⁷⁹

Q. Did you know about them [the existence of these provisions of the statutes] at the time these loans were made?

A. I rather think so.

* * *
Q. Regardless of whether this was technically a violation of the law or not, it was in violation of what the law was directed at, wasn't it?

A. If I follow your line of reasoning—

Q. It was?

A. It was, yes.

⁷⁷ Id. at 8968.

Mr. Kleindinst's testimony covering these loans from the bank in connection with the operation of the New York Banking Law was as follows (id. at 8968-70):

Q. When this \$1,800,000 loan was made, Liberty Share Corporation had to go to the Liberty Bank, as you just heard, and borrow more money, didn't it, so that the effect of that was the same money that was borrowed from the bank went directly into your account; isn't that right?

A. It would seem so.

Q. It would seem so?

A. Yes.

* * *
Q. In other words, the loans from the Liberty Bank to the Liberty Share Corporation were approved, is that right, by the directors of the Liberty Bank?

A. Yes.

Q. But no approval was given of the loans to officers and directors?

A. It wasn't construed as necessary. We didn't understand that we were making a loan to an employee; that is, to an employee of the Liberty Bank.

Q. What do you think the purpose of this statute was, to prevent loans by the bank to its officers and employees, wasn't it?

A. That is right.

Q. And by putting the Liberty Share Corporation in between, you avoided the operation of this statute, didn't you?

A. No.

Q. And the money came from the bank, didn't it?

A. The money was loaned by the bank on collateral.

Q. And it was borrowed just at the same time, as Mr. Ulrich testified, in order to meet your obligations, and as he needed more money, he went to the bank and borrowed more money, and that additional money went into your account; have you any doubt about that?

A. I can see that you could reason the thing out the way you do, Mr. Smith.

Q. I see, but you didn't construe it that way?

A. We did not construe it that way.

⁷⁸ Id., at 8971-2.

⁷⁹ Id., at 8974-6.

In retrospect, Mr. Kleindinst admitted that there was no justification for those activities, where the interests were so conflicting.⁸⁰

Q. Do you think, as you look back on it, that this is any justification for permitting yourself to be on three sides of the picture, to permit this syndicate account?

A. As I look back, no; but when I did the thing, I was looking forward.

In order to make these loans, Liberty Share Corporation borrowed large sums from the Liberty Bank of Buffalo, the Western New York Securities Corporation, and The Chase National Bank.⁸¹ On October 31, 1934, the Liberty Share Corporation owed these three institutions \$5,935,189.87, of which \$2,706,172.14 was the indebtedness to the Liberty Bank of Buffalo, \$1,821,880.51 to Western New York Securities Corporation, \$1,377,136.92 to The Chase National Bank, and \$30,000 to others.⁸² On that date Western New York Securities Corporation owed the Liberty Bank of Buffalo \$1,682,174.18.⁸³

On October 31, 1934, the indebtedness of the Liberty Share Corporation to The Chase National Bank was settled by a cash payment of \$200,000.⁸⁴ The Chase National Bank suffered a loss of over \$1,100,000.⁸⁵

On October 31, 1934, Liberty Share Corporation was in fact insolvent and in order to save the investment company the margin accounts and underlying collateral were transferred to the Casterlan Corporation, organized for the purpose of liquidating these accounts.⁸⁶ The officers and directors of the Casterlan Corporation actively engaged in liquidating these "assets" were Messrs. Gerner, Ruth, Notman, Winkler, and Van Allen. Mr. Van Allen, counsel and director of both the bank and the investment company, was the only one of these directors who had not borrowed and had not been involved in any of these margin accounts.⁸⁷

At the inception of the Casterlan Corporation, that company issued to the Western New York Securities Corporation \$200,000 in trust

⁸⁰ Id., at 8990.

⁸¹ Id., at 8916, 8918-9, 8923-4, and 9069, and Commission's Exhibit No. 880. Mr. Ruth submitted a formal resignation, dated June 30, 1933, as vice president of Liberty Share Corporation because of his dual positions. He was also president of Western New York Securities Corporation and "stated that in view of the existing loan of \$1,692,821 granted Liberty Share Corporation by Western New York Securities Corporation and an offsetting loan approximately the same amount granted to Western New York Securities Corporation by the Liberty Bank, that he could not do justice to the two corporations by serving as an officer of both." His resignation, however, was not accepted and he did not resign. (Id., Commission's Exhibit No. 885.)

⁸² Id., at 9060 and Commission's Exhibit No. 880.

⁸³ Ibid. The loan of the Western New York Securities Corporation from the Liberty Bank of Buffalo was reduced to \$1,000,000, then increased to \$2,000,000 in 1929. In March 1930, it was reduced to \$1,000,000, then increased, when Western New York Securities Corporation lent more money to the Liberty Share Corporation (id., at 9062).

Mr. Gerner testified concerning the effect of this circuitous borrowing, as follows (ibid.):

Q. So that in that transaction, you do see the direct effect of the borrowing of the Liberty Share Corporation would be reflected directly on Western New York Securities Corporation, and in turn on the Liberty Bank?

A. In that interpretation, yes.

⁸⁴ Id., at 9071.

⁸⁵ Id., at 8923-4.

⁸⁶ Id., at 9071-2.

⁸⁷ Id., at 9092, 9096.

notes for that amount of cash, which was paid to The Chase National Bank in settlement of the indebtedness owed it by the Liberty Share Corporation. At the time of this settlement, the collateral held by The Chase National Bank was released and transferred to the Casterlan Corporation.⁸⁸

The balance of the obligation assumed by the Casterlan Corporation was settled by the delivery of trust notes issued in series beginning with Series A and ending in Series G.⁸⁹ As soon as money would be obtained, the Series A notes would be paid first, and, if there were any surplus, such surplus would be applied to the payment of the next series.⁹⁰ These notes mature October 31, 1941, and as at May 22, 1936, were outstanding as follows:⁹¹

At the time these trust notes were distributed to the various creditors, the directorate of the bank and the investment company was not interlocking but had been separated because of the passage of the Federal Banking Act of 1933, previously referred to, but the people who participated in the distribution of these trust notes, were interested either as debtors or stockholders of the Liberty Share Corporation. Mr. Gerner testified:⁹²

⁸⁸ Id., at 8923-4, 9072-3.

At the time the loan by The Chase National Bank was made, 13,500 shares of Liberty Bank of Buffalo Stock and 50,000 shares of Western New York Securities were supplied as collateral. (Id., at 9068.)

⁸⁹ Id., at 9073-4.

⁹⁰ Id., at 9074.

⁹¹ Id., Commission's Exhibit No. 881, and at 9075-6.

On May 22, 1936, a bank examiner of the State of New York estimated the assets of Casterlan Corporation to be \$643,337.04, which amount did not allow any value to the unsecured portion of any of the margin accounts. The stocks of the Liberty Bank of Buffalo, Liberty Share Corporation, and Western New York Securities Corporation were considered by him at current over-the-counter quotations. (Id., Commission's Exhibit No. 881.) On this estimated value of the assets, he found the margin accounts to be worth about 15¢ on the dollar. (Id., at 8930.) According to his appraisal, the Series F notes in the sum of \$621,380 held by Western New York Securities Corporation and the Series G notes in the sum of \$1,737,900, held by Liberty Bank of Buffalo, were worthless. The Series E notes in the sum of \$1,465,000 owned by the Liberty Bank of Buffalo were valued by him at \$25,337. (Id., Commission's Exhibit No. 881.)

Series	Outstanding	Owned by
A.....	\$300,000	Liberty Bank of Buffalo.*
B.....	20,000	Liberty Share Corporation.
C.....	225,000	Liberty Share Corporation, Western New York Securities Corporation, et al.
D.....	73,000	Liberty Share Corporation.
E.....	1,465,000	Liberty Bank of Buffalo.
F.....	621,880	Western New York Securities Corporation.
G.....	1,737,900	Liberty Bank of Buffalo.
	4,442,780	

* Series A were originally issued for \$335,000 and delivered to the Liberty Bank of Buffalo, because the bank released that amount of collateral. Id., at 9077. \$35,000 of these notes was retired. Id., Commission's Exhibit No. 881.

¹ Series C have priority as to interest only and such interest had been paid. A nominal amount of interest was paid on Series A.

⁹² Id., at 9089.

Q. Isn't it a fact that the people who negotiated this settlement were all interested, either as debtors or else as stockholders of the Liberty Share Corporation?

A. That is quite correct.

One year and a half after the organization of the Casterlan Corporation, on May 22, 1936, 86 "insiders" still owed \$3,397,113.38, supported by collateral of \$479,635.⁸² Of those 86, 73 were connected with the Liberty Bank of Buffalo, and of this latter group 19 officers and directors were indebted in the sum of \$1,989,789.04 (collateral, \$310,985), 30 employees, \$321,842.60 (collateral \$29,086),—17 of these employees owed sums ranging from \$5,000 to \$84,000—and 24 former officers and employees, \$478,523.79 (collateral \$72,887).⁸⁴ The remainder of 13 of the 86 insiders were connected with the Liberty Share Corporation. This group of 13 consisted of 4 officers and directors, who owed \$345,764.91 (collateral \$54,916) and 9 former officers and employees, who were indebted in the sum of \$261,193.04 (collateral \$11,761).⁸⁵

No independent agency was ever employed to collect these loans⁸⁶ and the people involved are still in a dual and conflicting position. Mr. Gerner conceded this situation existed:⁸⁷

Q. Even today, you do not have an independent collection agency.

A. That is correct, sir.

Q. That your persons in this situation are still on both sides of the table, as they were right from the beginning.

A. That is right.

No suits were ever brought against the officers and directors of the bank for the loans made to them, many of which remain uncollected since 1930.⁸⁸ Mr. Gerner testified that the people who owed these obligations were the same ones endeavoring to liquidate them.⁸⁹

Q. And the people who were pressing these loans were the same people who had loans outstanding, weren't they? The people who are trying to collect these loans for the Liberty Share?

A. That is correct. * * *

* * * * *

⁸² Id., at 9044-5, Commission's Exhibit No. 875.

⁸³ Id., Commission's Exhibit No. 875, 8933-8.

⁸⁴ Id., at 8933-4 and Commission's Exhibit No. 875. Leon G. Ruth owed a small indebtedness in 1929, which he paid off. (Letter dated November 16, 1937, annexed to the transcript of testimony.)

⁸⁵ Id., at 9095-6. The only attempt to obtain an independent person to head the Casterlan Corporation was made by Mr. Gerner, who asked a certain individual to undertake the liquidation of the assets of that company but he refused the position because the undertaking did not appeal to him. (Id., at 9098.)

⁸⁶ Id., at 9094-5. Mr. Gerner testified that generally, despite the honesty of the individual, self-interest will be served in a situation where conflicting interests are involved (Id., at 9100):

Q. But the fact remains that irrespective of an individual's honesty, when he has a self-interest on one side of the bargain, he isn't going to be the most effective agent on the other side of bargain, isn't that true?

A. I would say, generally speaking, that is true; yes.

Q. You get a diffusion of loyalty in situations like this. Unless the diffusion of loyalties is not present, self-interests tend to be served, isn't that true?

A. I think that is generally true; yes, sir.

⁸⁷ Id., at 9044.

⁸⁸ Id., at 9045-6.

Q. * * * The people in Casterlan Corporation, the liquidating corporation, are the same people who got into all this mess and still have obligations, aren't they?

A. That is correct.

A New York bank examiner's report of May 22, 1936, criticized the management of these accounts by the Casterlan Corporation:¹⁰⁰

At the present time the officers and directors of Liberty Share Corporation keep the records and make collections for the Liberty Bank as trustee for the Casterlan Corporation notes, but very little, if any, effort was made to obtain payments. * * * These accounts are not being managed for the best interest of the bank as evidenced by the following: One, some debtors pay interest to other creditors, but not to this corporation. Two, other debtors have substantial income, but they are making no payments. Three, one director has a substantial amount of excess collateral but pays only part interest on his liability here. Four, collateral mortgages held are not properly handled. Rents should be collected by this corporation in cases where the creditor makes no payments of interest or taxes. Five, hypothecation certificates in connection with large securities are missing in some instances.

Mr. Gerner disputed the allegations of the report, concerning the efforts to collect the amounts outstanding¹⁰¹ and stated, "We did have the various officers in periodically and interviewed them about their loans to see if we couldn't secure additional collateral and in many cases we did."¹⁰² He concluded, "I would rather put it that the results were not great."¹⁰³

b. M. & T. Securities Corporation

M. & T. Securities Corporation, sponsored by Manufacturers & Traders Trust Company of Buffalo, N. Y., was organized on August 5, 1929, and took over the assets of Western New York Investors, Inc. which had been organized on December 14, 1925.¹⁰⁴ As of May 11, 1931, gross assets were \$31,355,312.65¹⁰⁵ and as of December 31, 1935, these had fallen to \$3,916,425.¹⁰⁶ On January 11, 1937, the company was dissolved.¹⁰⁷

Perry Wurst was president of Western New York Investors, Inc. and became president of M. & T. Securities Corporation on its organization. He was also executive vice president of the Manufacturers &

¹⁰⁰ Id., at 9046-7.

¹⁰¹ Id., at 9048.

¹⁰² Id., at 9044-5, 9048-9.

¹⁰³ Id., at 9049.

To illustrate the possibility of recovery on these loans is the settlement offer of Philip Gerner of his indebtedness of \$211,992.37 (collateral \$21,700). (Id., Commission's Exhibit No. 875, and at 9017-22.) Interest on this loan had not been paid since 1932. (Id., at 9020.) Since 1930 until 1935, when he resigned, he was receiving a salary of \$10,000 (ibid.), but during that time failed to make any payments in reduction of his indebtedness. In 1936, he offered the collateral and \$34,000 additional, to be paid over a period of 5 years. (Id., at 9021-2.)

¹⁰⁴ Public Examination, M. & T. Securities Corporation, at 9913.

¹⁰⁵ Reply to Commission's questionnaire for M. & T. Securities Corporation, Pt. IV.

¹⁰⁶ Id., at Pt. II.

¹⁰⁷ Derived from supplementary information supplied the Commission for M. & T. Securities Corporation.

Traders Trust Company.¹⁰⁸ The officers and directors of the investment company were also officers and directors of the bank.¹⁰⁹

Mr. Wurst testified one of the reasons for organizing the investment company was to buy and sell stock of the bank which the bank itself was not legally permitted to do.¹¹⁰ Making loans to officers and employees of the bank was also an activity in which the company intended to engage. Neither of these projected activities was disclosed to investors.¹¹¹

On August 5, 1929, when the M. & T. Securities Corporation succeeded Western New York Investors, Inc., the latter had notes receivable of \$977,475.55, consisting of 56 individual loan items.¹¹² Eleven of these loans,¹¹³ including one loan of \$155,000¹¹⁴ had been made to directors and officers of Western New York Investors, Inc.¹¹⁵

The average of loans to officers and directors was more than twice the average of loans to outsiders. Mr. Wurst testified:¹¹⁶

Q. If you will look at that list, Mr. Wurst, you will find that the eleven loans to officers and directors total \$331,349.96. While there are loans to 45 other people, which total \$616,125.02, which, as I said, works out as an average of loan to the eleven officers and directors, of \$32,949. While the average loan to the other people is \$13,691.66?

A. One director's loan is \$155,000 and this corporation would have been glad to have a deal more of that.

Q. * * * you said that these weren't above the average?

A. I just referred to one loan.

Q. Well, if you take that loan out, I shall suggest that the average—

A. It may be. I haven't figured it out. The exhibit will show.

After the formation of M. & T. Securities Corporation, the aggregate amount of notes and accounts receivable of that company increased, reaching a peak of \$4,935,586 at the end of 1929. By December 31, 1932, this amount had declined to \$1,721,406 and by December 31, 1935, it was \$143,037.¹¹⁷

A large proportion of the loans made by M. & T. Securities Corporation were to the officers, directors, or employees of Manufacturers & Traders Trust Company, which had sponsored both the Western New York Investors, Inc., and its successor, M. & T. Securities Corporation. During the period from 1929 to December 31, 1935, 72 loans were made

¹⁰⁸ Public Examination, M. & T. Securities Corporation, at 9906.

¹⁰⁹ Ibid. and id., at 9916-7.

¹¹⁰ Id., at 9908-9.

¹¹¹ Id., at 9914.

¹¹² Id., at 9923-4, and Commission's Exhibit No. 938.

¹¹³ Id., at 9926.

¹¹⁴ Id., at 9928.

¹¹⁵ Ibid. The accounts receivable of this latter corporation had increased rapidly. There were outstanding as at December 31, 1926, the sum of \$53,014.12; as at December 31, 1927, \$428,649.73; as at December 31, 1928, \$1,048,427.78; and as at August 5, 1929, \$977,475.55.

¹¹⁶ Id., at 9928-32.

¹¹⁷ The aggregate loans made by M. & T. Securities Corporation outstanding at the year-ends were: 1929, \$4,935,586.24; 1930, \$1,709,024.99; 1931, \$1,910,346.97; 1932, \$1,721,406.62; 1933, \$338,340.52; 1934, \$142,483.20; and 1935, \$143,037.52. (Id., Commission's Exhibit No. 939.) In 1933, the sum of \$821,074.45 was charged off on these loans by the M. & T. Securities Corporation. (Ibid. and id., at 9937.)

to 46 such officers, directors, and employees. As at December 24, 1931, the loans to these officers and employees aggregated \$744,439.88 out of a total aggregate of \$1,911,235.20 of loans outstanding on that date.¹¹⁸

The investment company was also used to make loans that the bank did not desire to or could not make. Lewis G. Harriman, president of M. & T. Securities Corporation, testified with reference to a loan of \$200,000:¹¹⁹

Q. I understood that that loan was one of the very few loans taken because the bank didn't want it.

A. There were a few loans made to afford additional working capital to people. Mortgages were taken to secure that. And, as a matter of fact, in those few instances the bank took over the loans, principal and interest, in full.

Q. Was there an understanding that the Bank would take it over?

A. Undoubtedly there was.

Q. Why didn't the Bank take the loan?

A. Because it could not take the mortgage.

Q. So this was an accommodation to the Bank?

A. That is true.

Mr. Harriman testified as follows with respect to another loan of \$2,600,000 made by the investment company to accommodate the bank:¹²⁰

Q. This was one of the loans by the Bank. There was an accommodation to the Bank, because it permitted the man to borrow \$2,600,000 at the time from the Securities Company because he didn't want to go to the Bank.

A. I think that is absolutely true, but there were three interested parties to that who were satisfied with the deal, and it worked out satisfactorily for all three of them.

The collateral pledged for the loans made by M. & T. Securities Corporation to its officers and directors, as well as to others was usually its own common stock or the capital stock of Manufacturers & Traders Trust Company, the sponsoring bank.¹²¹ Although most of the accounts and notes receivable were secured by sufficient collateral at the time loans were made, and later became undermargined due to the drastic decline in the value of the stock of both of these institutions, 21 out of 58 loans to officers and employees were undermargined at their inception.¹²² Perry E. Wurst, president of the M. & T. Securities Corporation from August 5, 1929, to December 1933, and executive vice president of Manufacturers & Traders Trust Company, justified these insufficiently collateralized loans by reliance on the personal credit of the borrowers, admitting, however, that in some instances these individuals were financially involved.¹²³

Q. Now, when these officers and directors borrowed at this time did they submit financial statements or did they just come along?

A. They had collateral, or we had information as to their financial standing.

Q. Did you have information as to their financial standing in all cases?

A. Absolutely.

¹¹⁸ Id., at 9938, and Commission's Exhibit No. 941.

¹¹⁹ Id., at 10085.

¹²⁰ Id., at 10086.

¹²¹ Id., at 9942.

¹²² Id., at 9943.

¹²³ Id., at 9932-3.

Q. Did you know about their borrowings from other banks?

A. Not always.

Q. Or other brokerage houses?

A. We had financial statements of their condition, unless the collateral was adequate when they borrowed from us.

Q. If the collateral was adequate, you didn't have a financial statement?

A. No.

Q. And you later discovered that a lot of these men had a lot of loans in other banks and brokerage houses?

A. I won't say that. We discovered some of them were involved.

The charge-off on the amount due from officers and employees as of January 11, 1937, when the company was dissolved, was \$454,452.89, while the charge-off on the accounts of persons other than these officers and employees was only \$228,413.65.¹²⁴ Although the amount borrowed by the officers and employees was approximately only one-half the amount borrowed by others, yet the amount of charge-off on the loans to these officers and employees was more than twice the "charge-off" on loans to others.¹²⁵ Mr. Wurst admitted this as follows:¹²⁶

Q. * * * Now, the outside loans were charged off only half as much as the inside loans, and yet the outside loans were double, at least—and I can give you the exact figures on it—that they were very much more than double the inside loans. Is that correct?

A. They were at various times.

Q. They were?

A. Yes.

Q. So that on that basis there would be a four to one greater charge-off, at least, to officers and employees on these loans, than to customers.

A. That is correct.

Q. And that is a "conservative" estimate?

A. I think [it] is correct.

Q. That is right?

A. Yes.

In December 1933, the company agreed to sell to the Manufacturers & Traders Trust Company a block of capital stock of the bank at \$15 per share to make up the 100,000 shares that the bank intended to retire. This block of 63,228 shares consisted not only of the bank stock in its portfolio but also the stock pledged as collateral for certain of the loans then overdue, with the result that the collateral was sold at the low point of the market.

¹²⁴ Id., at 9941.

¹²⁵ The largest individual loan was a loan of \$2,590,336 in 1929 to an individual who subsequently became a director of the company. On April 16, 1931, the market value of collateral securing this loan was \$2,630,303, while the loan as shown on the balance sheet as of December 31, 1931, was \$361,082. The balance of the loan was ultimately paid.

A loan of \$103,262 was made by M. & T. Securities Corporation to another director, with an additional loan of \$80,000 in February 1930. On December 31, 1934, a payment of \$35,171.84 was made on this obligation, leaving an unpaid balance of \$28,407, the value of the collateral pledged. This remaining balance of \$94,279 was settled for only \$2,500, with a resultant loss of approximately \$90,000. (Id., at 9960-1.) Similarly an unpaid balance of \$24,502, due from an officer of Manufacturers & Traders Trust Company upon an original loan of \$40,100, was settled for \$1,000, with a consequent loss of approximately \$23,000. The major portion of the collateral for the loans made by the M. & T. Securities Corporation consisted of capital stock of Manufacturers & Traders Trust Company, which could not, of course, be repledged with this bank. (Id., at 9957-60.)

¹²⁶ Id., at 9942.

The collateral loans which M. & T. Securities Corporation made to "insiders" proved costly to M. & T. Securities Corporation not only because of the direct loss sustained on charge-offs, but because M. & T. Securities Corporation had to carry bank loans with the Manufacturers & Traders Trust Company from August 5, 1929, to December 31, 1935, during the period the securities corporation was carrying these loans to "insiders". Interest payment on the bank loan had to be met by the company even though interest on the loans made by the company were not paid. The following table indicates the difficulty experienced by M. & T. Securities Corporation in keeping sufficient collateral pledged with the bank:¹²⁷

Bank borrowings^a

[In thousands of dollars]

December 31	Amount of loans	Book value of collateral pledged ^b	Unrealized appreciation or (depreciation) not reflected in the book valuation	Computed market value of collateral pledged	Market value of collateral pledged as a percentage of loan
1929.....	\$4,800	\$7,281	(\$872)	\$6,409	133.5
1930.....	6,100	11,909	(5,317)	6,592	108.0
1931.....	6,205	15,704	(9,310)	6,394	103.1
1932.....	5,600	5,915	(1,003)	4,912	87.7
1933.....	5,000	4,393	(1)	4,392	87.6
1934.....	2,900	3,060	(31)	3,029	104.4
1935.....	2,500	2,965	405	3,370	162.0

^a All funds borrowed from Manufacturers & Traders Trust Company.

^b Book value figures on average cost basis.

Excepting during the years 1929 and 1935, the bank loans of the company were always seriously under-secured. Had the bank in 1932 and 1933 not exercised leniency in demanding additional collateral or on calling the loan and foreclosing the collateral, the company would have been precipitated into bankruptcy because almost all of the eligible assets of the company were already pledged with the bank. The bank examiners' reports indicate that during this period the only free assets of the company were either the stock of Manufacturers & Traders Trust Company which could not be accepted by this bank as additional collateral or other securities which were relatively worthless. The loans to "insiders" substantially contributed to the predicament in which the company found itself when it had to pledge virtually every available asset for its bank loans.

Mr. Wurst, while denying that these bank loans were made with the specific intent of reloaning the funds thus obtained to "insiders," testified:¹²⁸

Q. So this is your distinction--You say, "Yes, we borrowed money from the bank, but since we had plenty of capital, you can't say that that money was borrowed for the specific purpose of going into these loans."

A. That is what I say exactly.

¹²⁷ Id., Commission's Exhibit No. 943.

¹²⁸ Id., at 9955-6.

Q. Although it goes into a common pot and loans come out of the common pot?

A. Out of our assets, naturally.

Q. So that they do go into the common pot, and it is just a question—your point is that you can't segregate or allocate them?

A. That is what I say, exactly.

Mr. Wurst denied that these loans to officers and directors of the bank violated the New York Banking Act,¹²⁹ which prohibits a bank either "directly or indirectly" from lending money to an officer or director of such bank or trust company. He testified:¹³⁰

Q. I just want to discuss with you generally, though, the fact that the banking laws prohibit, as I understand it, loans to officers and directors of any kind, without the approval of the board of directors. Is that right?

A. That is right.

Q. Or does it prohibit them entirely?

A. It prohibits loans to officers entirely.

Q. It prohibits loans to officers entirely?

A. And it prohibits loans to directors, unless a majority of the other directors approve it, either [by] resolution or in writing.

Q. Now, as far as the officers who borrowed in this case were concerned, they were enabled to do something indirectly which they couldn't do directly. Isn't that right?

A. No, that is not right.

Q. Why not?

A. Because the Securities Company had ample capital of their own and had a right to loan it to whom they saw fit. That has got nothing to do with the situation of what the Bank could do or could not do.

Mr. Wurst, president of the company, justified making loans on the basis that they were the same as investments. He testified:¹³¹

A. You made a statement a little while ago that there was nothing in the letter when this company was organized that they were making loans. I think that making loans was part of the term "making investments," or whatever was used in that letter.

Q. Making investments?

A. Yes; I think making a loan is the same thing as buying a bond.

Q. You think that the loan business, the business of making loans, which involves the credit standing of the individual, is the same type of business as buying bonds?

A. I do, exactly.

Q. And don't you have them segregated in the Bank?

A. What?

Q. Isn't it an entirely different business as far as the bank is concerned?

A. They are not required to segregate them; in the published statement it is "loans [and] investment."

Q. But I am talking about the Bank. Do you have the same man buying bonds as you have making loans?

A. To some extent, yes, sir.

¹²⁹ Banking Law, Section 108, Cahill's Consolidated Laws of New York (1930), revised and renumbered Section 103 (1939).

¹³⁰ Id., at 9950-1.

¹³¹ Id., at 9935-6.

Q. Doesn't it in fact take a great deal of experience in understanding credit and dealing with men on a loan basis, which is quite a different type of business from buying bonds and stocks on the Stock Exchanges? And don't you recognize that in your Bank?

A. To some extent the elements differ.

Q. Sure you do. How about the small loans business? You will agree that that is different, won't you?

A. I think it all involves the determination of what constitutes the proper basis for credit.

Q. So that you would say that the two are practically the same, would you? Is that your statement?

A. There are some elements of difference.

Although a substantial portion of the stockholders' funds was loaned to the "insiders," the officers of the company and of the bank, the reports to the stockholders admittedly contained no disclosure of this fact. Mr. Wurst testified:¹³²

Q. * * * was [there] any indication in your reports, in your annual reports, that you were making loans to officers and directors?

A. There was nothing on the subject.

Q. Nothing was said about it, was there?

A. No.

2. LOANS TO BROKERS THREATENED WITH EXPULSION FROM EXCHANGES

Broker-sponsors of investment companies were often in a position to use the funds of the companies when personally pressed for funds. In two cases, reputable and nationally known members of the New York Stock Exchange utilized the funds of investment companies to avoid expulsion from the New York Stock Exchange. In both cases, as a more or less direct result, the investment companies were placed in receivership.

a. Prince & Whitely Trading Corporation (Phoenix Securities Corporation)

Prince & Whitely, a New York brokerage firm,¹³³ organized Prince & Whitely Trading Corporation under the laws of Delaware on August

¹³² Id., at 9965.

¹³³ Reply to Commission's questionnaire for Phoenix Securities Corporation, Part I, Item 5. The sale of portfolio securities by the sponsor to the investment company is discussed in a previous section, pp. 2595-99, *supra*.

Prince & Whitely was a member of the New York Stock Exchange (Public Examination, Prince & Whitely Trading Corporation, at 9429) and was engaged in the brokerage and underwriting business (id., at 9445). It had eight or ten branch offices in the East (id., at 9446). The firm failed on October 9, 1930 (id., at 9503, 9521).

James Mitchell Hoyt was the senior partner and owned an 80% share in the partnership. The other 20% was spread among the other partners (id., at 9431). G. Lisle Foreman owned the next largest participation. Prior to the Commission's public hearing, both Mr. Hoyt and Mr. Foreman had died (ibid.).

In addition to a general partnership agreement Mr. Hoyt had a separate agreement with each partner. Upon the admission or retirement of a partner a supplemental agreement was made between Mr. Hoyt and the individual partner (id., at 9436).

The idea of creating an investment company was conceived by Mr. Hoyt, who because of his dominant position in the partnership met little or no opposition to this venture (id.,

31; 1929.¹³⁴ On September 17, 1929, the investment company received \$25,000,000 in cash with which it began business.¹³⁵ This fund was managed by the sponsor until October 9, 1930, when Prince & Whitely was declared bankrupt.¹³⁶ Up to the date of failure the sponsor had borrowed from the investment company approximately \$3,600,000.¹³⁷

Within one year after the organization of Prince & Whitely Trading Corporation the sponsor, because of impaired financial condition, utilized the funds of the investment company in an unsuccessful attempt to avoid bankruptcy. In the beginning of August 1930 the auditors of the New York Stock Exchange advised Prince & Whitely that its free capital did not amount to at least five percent of its assets, which was the requirement of all members of the Stock Exchange.¹³⁸ This lack of free capital had resulted from the impairment of the assets of H. & J. Securities Corporation, a company wholly owned by the partnership,¹³⁹ through which Mr. Hoyt had guaranteed the accounts of a number of customers and assumed their liabilities. These accounts were undermargined and as a result the partnership was drained of

at 9435-6). Oscar B. Van Sant, one of the partners, who joined Prince & Whitely as officer manager in 1924 and owned $\frac{1}{2}$ of 1% interest in the partnership since January 1, 1928, testified as follows (id., at 9429-30, 9435-36) :

Q. Who did you say was the dominating factor in organizing the company?

A. Unquestionably Mr. Hoyt.

Q. Would you say he experienced any large opposition from his partners to the venture?

A. I don't think you would call it large opposition because I don't think any of them was in a position to put up any strenuous opposition. He was the dominating factor.

Q. You were all partners, more or less at his sufferance, would you say?

A. Yes; I would say so.

The control Mr. Hoyt exercised is illustrated in the instructions issued to an employee contained in a letter dated April 11, 1930 (id., at 9625) :

I do not wish you to give any statements of position of the Trading Corporation or its portfolio or its cash position to any member or employee of Prince & Whitely except to members of the executive committee of the Prince & Whitely Trading Corporation, namely, myself, Mr. Van Sant, and Mr. Critchell.

Lawrence S. Critchell, a partner since 1926, owned a 2% participation in the firm (id., at 9594-5). When the investment company was formed he became its vice president and one of its directors (id., at 9600, 9616). On October 16, 1930, he severed his connections with Prince & Whitely and the investment company (id., at 9616).

At the Commission's hearing Mr. Critchell corroborated Mr. Van Sant in regard to the domination of Mr. Hoyt who, he disclosed, maintained a private trading room which was kept locked and from which the partners were excluded (id., at 9614, 9620).

Q. Who was in that private trading room?

A. Just clerks, and it was even kept locked.

Mr. Critchell concluded that:

There wasn't a partner in the firm of Prince & Whitely who did not disapprove of this private trading room (id., at 9614). I think every partner resented the fact that there was a place there that they couldn't go into (id., at 9621).

In any question of policy, Mr. Hoyt always prevailed (id., at 9461) and no one resigned as an officer or director of the investment company because of any disagreement with his policies. One week after the bankruptcy of the partnership, in October 1930, however, all resigned (id., at 9473, 9478).

¹³⁴ Public Examination, Prince & Whitely Trading Corporation, at 9440, and Commission's Exhibit No. 909.

¹³⁵ Public Examination, Prince & Whitely Trading Corporation, at 9457, 9438, 9441.

¹³⁶ Id., at 9503.

¹³⁷ Id., at 9524.

¹³⁸ Id., at 9573-4 and Commission's Exhibit No. 913, No. 2.

¹³⁹ Id., at 9481, 9575.

its cash.¹⁴⁰ That this condition was desperate was admitted by Mr. Van Sant:¹⁴¹

Q. At any rate, you had to abide by the Stock Exchange order and it was necessary if you were to survive to get additional capital?

A. Exactly.

To remedy this situation, Mr. Hoyt represented to his partner he was negotiating for additional capital from outside sources and was about to obtain a loan of approximately \$2,000,000.¹⁴²

Eventually the requirement of the Stock Exchange had to be met. Mr. Hoyt suggested that the investment company lend \$1,500,000 to J. M. Hoyt & Company, a personally owned corporation of Mr. Hoyt.¹⁴³ He represented that his company was financially responsible, but the other partners were unable to investigate this claim because of the dominant position of Mr. Hoyt.¹⁴⁴ Mr. Van Sant testified "Mr. Hoyt at that time was supposed to be worth millions."¹⁴⁵

The \$1,500,000 loan was to be evidenced by a promissory note signed by J. M. Hoyt & Company and endorsed by all the partners of Prince & Whitely.¹⁴⁶ No security was given for the note except that each partner was liable because of his endorsement on the note.¹⁴⁷ To obtain the necessary funds to comply with the requirement and rectify the situation, Prince & Whitely borrowed the necessary amount from the investment company, Mr. Van Sant conceded that "it might have been the easiest place to go for a loan of that kind."¹⁴⁸

The loan was made by issuing a check of \$1,500,000 against the bank account of the investment company. This amount was then deposited to the credit of the account of J. M. Hoyt & Company,¹⁴⁹ which paid the obligations of J. M. Hoyt to H & J Securities Corporation. Then the H & J Securities Corporation settled its accounts with Prince & Whitely. The Stock Exchange auditors thereupon recognized this compliance with the 5% rule.¹⁵⁰

Although, apparently, Prince & Whitely complied with this rule of the Stock Exchange, nevertheless, this transaction failed to save the partnership from failure. Mr. Van Sant testified:¹⁵¹

Q. In any case, the firm did fail, so that in so far as the providing of the additional \$1,500,000 that was put up by the Trading Corporation, it was designed to prevent that failure, it was unsuccessful, isn't that so?

A. That is true. I think rumor was partly responsible for that condition.

After the loan was made the problem of inserting it in the annual statement arose because at that time, August 31, the end of the fiscal

¹⁴⁰ Id., at 9577.

¹⁴¹ Id., at 9576.

¹⁴² Id., at 9576-7.

¹⁴³ Id., at 9491, 9577-9.

¹⁴⁴ Id., at 9577-8.

¹⁴⁵ Id., at 9580.

¹⁴⁶ Id., at 9491, 9526-7.

¹⁴⁷ Id., at 9578-9.

¹⁴⁸ Id., at 9581.

¹⁴⁹ Id., at 9586-7.

¹⁵⁰ Id., at 9587.

¹⁵¹ Id., at 9587-8.

year was approaching.¹⁵² Mr. Van Sant stated "if that item was on the stockholder's statement, unquestionably there would have to be some explanation of it."¹⁵³ "It was Mr. Hoyt's idea, or perhaps after discussion by him with the auditors that the question came up as to how they would treat that note. If they put it in there, just cold, like that, it might have raised some question about whether it should be there or shouldn't be in there."¹⁵⁴ To meet this problem the note was sold to H & J Securities Corporation, the wholly owned company of the partners, and the corporation which had guaranteed the undermargined accounts.¹⁵⁵ As a result of a bookkeeping entry, whereby a margin account of the investment company with Prince & Whitely was reduced by the sum of \$1,503,500, the \$3,500 representing interest, the loan appeared to be repaid.¹⁵⁶ For 11 days the H & J Securities Corporation was the repository of the note.¹⁵⁷ Then, on September 8, 1930, it was reacquired by the investment company¹⁵⁸ and credit of \$1,506,000 was given to Prince & Whitely, the \$6,000 covering the accrued interest.¹⁵⁹

On August 31, 1930, the books of the investment company indicated the sale of the note to H & J Securities Corporation. Thus the annual statement of that fiscal year end did not reflect the loan of \$1,500,000 to the sponsor.¹⁶⁰

On August 31, 1931, 1 year later, the indebtedness of Prince & Whitely was adjusted and determined to be in the sum of \$3,371,951.57,¹⁶¹ which included the \$1,500,000 note. From 1931 through 1936, \$670,043.31 was recovered on the total claim.¹⁶²

Following the failure of its sponsor, Prince & Whitely, Philip DeRonde was elected chairman of the board of directors on October 16, 1930. The name of the company was changed to Phoenix Securities Corporation on February 20, 1931.¹⁶³ Early in 1934 Wallace Groves obtained control of the company.¹⁶⁴

b. Continental Shares, Inc.

Continental Shares, Inc., was organized by Cyrus S. Eaton and interests associated with him in March 1926.¹⁶⁵ Mr. Eaton was a part-

¹⁵² Reply to Commission's questionnaire for Phoenix Securities Corporation, Part I, Item 1 (h).

¹⁵³ Public Examination, Prince & Whitely Trading Corporation, at 9589.

¹⁵⁴ *Id.*, at 9588.

¹⁵⁵ *Id.*, at 9590.

¹⁵⁶ *Id.*, at 9588-90.

¹⁵⁷ *Id.*, at 9590, 9617.

¹⁵⁸ *Ibid.*

¹⁵⁹ *Id.*, at 9590.

¹⁶⁰ *Id.*, at 9590, 9617. This fiscal year-end report was never issued to the stockholders because of the failure of Prince & Whitely on October 6, 1930. (*Id.*, at 9500.)

¹⁶¹ Reply to Commission's questionnaire for Phoenix Securities Corporation, Part II, Exhibit A, Schedule 5-A, Sheet 2.

¹⁶² *Ibid.*

¹⁶³ Reply to Commission's questionnaire for Phoenix Securities Corporation, Pt. I, Item 1.

¹⁶⁴ For detailed discussion of the activities of Philip DeRonde in connection with other investment companies, see Part Three, Chapter II, page 584 et seq., dealing with General Investment Corporation. For detailed recital of Wallace Groves in connection with other investment companies, see Part Three, Chapter II, page 181 et seq., relating to Yosemite Holding Corporation, Chain and General Equities, Inc., and Interstate Equities Corporation.

¹⁶⁵ Public Examination, Continental Shares, Inc., at 21073. See also pp. 2625-27, *supra*.

ner in Otis & Company, which had seats on the New York Stock Exchange and other exchanges.

From the time of the organization of Continental Shares, Inc., to the latter part of April 1931, when he resigned as chairman of the board of directors,¹⁶⁶ Cyrus S. Eaton held directly or indirectly between 15% and 20% of the common stock of Continental Shares, Inc.¹⁶⁷ Through powers conferred on the chairman of the board of directors by the bylaws of the company, Cyrus S. Eaton, as chairman, exercised direction over the company.¹⁶⁸ In December 1930, Continental Shares, Inc., made a loan to Mr. Eaton amounting to \$2,087,480.¹⁶⁹ The loan was evidenced by Mr. Eaton's personal note, guaranteed by all the proprietary partners of Otis & Company and by the subsidiary of Continental Shares, Inc., Industrial Shares, Inc. Pledged as collateral were 31,213 shares of common stock of Republic Steel Corporation, having a then market value of approximately \$577,440. This loan has never been repaid. The obligation was finally settled through court action, which resulted in various cancellations and mutual releases by the interested parties. Continental Shares, Inc., retained the 31,213 shares of Republic Steel originally pledged to secure the loan. As of June 22, 1933, the receiver for Continental Shares, Inc., reported that accrued interest on this loan was \$306,861.32 and that the realizable value was \$518,916.12.¹⁷⁰

In October 1930, Otis & Company was threatened with suspension by the New York Stock Exchange unless it raised additional funds of approximately \$12,000,000. To meet this requirement, Otis & Company devised the following plan. On October 8, 1930, the board of directors of Continental Shares, Inc., approved the purchase from Foreign Utilities, Ltd., a Canadian corporation personally controlled by Cyrus S. Eaton¹⁷¹ of a list of securities for \$56,958,409.62, of which \$35,000,000 was to be in cash, and the balance was to be paid in 1,040,000 shares of common stock of Continental Shares, Inc., at \$21.114 per share.¹⁷² Subsequently the purchase price of the securities was reduced to \$45,400,000 by a reduction in the shares of Continental Shares, Inc., to be delivered to Foreign Utilities, Ltd., from 1,040,000 to 280,000, but the amount of cash to be paid by Continental Shares, Inc., was increased by \$5,100,000 to \$40,100,000, and a loan of \$2,500,000 to Foreign Utilities, Ltd., was cancelled.¹⁷³ The securities which were purchased from Foreign Utilities, Ltd., were practically all its substantial holdings with the exception of some Citizens Gas Company's stock.¹⁷⁴

Foreign Utilities, Ltd., with the proceeds of the sale of its securities, paid off an indebtedness of \$11,610,618.55 to Otis & Company and created a credit through Mr. Eaton with the firm of approximately

¹⁶⁶ *Id.*, at 21138.

¹⁶⁷ *Id.*, at 21105.

¹⁶⁸ *Id.*, Commission's Exhibit No. 3705, Article 4, Sec. 3, Article 8, Sec. 3.

¹⁶⁹ *Id.*, Commission's Exhibit No. 3262.

¹⁷⁰ *Id.*, Commission's Exhibit No. 3266.

¹⁷¹ Cyrus S. Eaton and his wife held 26% of the stock of Foreign Utilities, Ltd. (*Id.*, at 21761.)

¹⁷² *Id.*, Commission's Exhibits Nos. 3289, 3290; *id.*, at 21246, 21283.

¹⁷³ *Id.*, at 21254, 21300, and Commission's Exhibit No. 3296.

¹⁷⁴ *Id.*, at 21277-8.

\$21,856,048.11.¹⁷⁵ Otis & Company used the funds to pay its indebtedness to banks.¹⁷⁶

Mr. Eaton denied that there was any connection between the sale of the securities of Foreign Utilities, Ltd., to Continental Shares, Inc., the loan of cash to Otis & Company and the difficulties of Otis & Company with the New York Stock Exchange.¹⁷⁷

At the time of the original transaction, Continental Shares, Inc., did not have the \$35,000,000 in cash which the agreement required it to pay to Foreign Utilities, Ltd. To obtain the necessary funds it borrowed \$30,000,000 from The Chase National Bank and \$5,000,000 from the Union Trust Company, Cleveland, Ohio.¹⁷⁸ This \$35,000,000 was used to pay off the loans incurred by Otis & Company, Foreign Utilities, Ltd., and Cyrus S. Eaton and thereby release the securities hypothecated for these loans. The securities thus released were then given as security for the \$35,000,000 borrowed by Continental Shares, Inc., from The Chase National Bank and the Union Trust Company, Cleveland, Ohio. These banks demanded in addition other collateral and Continental Shares, Inc., was compelled to pledge an additional \$28,000,000 of its own stock as further collateral.

The bank loans incurred by Continental Shares, Inc., ultimately led to its receivership. Mr. Burwell, former president of the company, testified:¹⁷⁹

Q. And it was the failure of Continental Shares to pay off the \$30,000,000 loan from the Chase Bank and the loan of \$5,000,000 from Union Trust Company that resulted in the foreclosure on Continental's collateral in June 1933; isn't that right?

A. Yes.

Q. So that if Continental Shares had not borrowed that \$35,000,000 from the banks on October 1930 it would have had no difficulty in retaining its portfolio throughout the depression; isn't that right?

A. That is quite true; yes.

Q. That is, it was the borrowing of this \$35,000,000 that put Continental Shares into trouble; isn't that right?

A. Exactly so, with the decline in the market, of course; that is understood.

Q. And even with the declining market, if Continental Shares had not had these large bank loans, it would have been able to survive the depression; isn't that right?

A. If it had no loans, obviously there would have been no question about it.

On December 31, 1930, before the revaluation of the securities purchased from Foreign Utilities, Ltd., the total assets of the investment company were reported at \$156,499,787.¹⁸⁰ By the next year-end they were reported at \$46,753,116,¹⁸¹ and stood at \$16,670,855 as of June 22, 1933, the date the investment company was placed in receivership.¹⁸²

¹⁷⁵ Id., Commission's Exhibit No. 3312; id., at 21279, 21332, 21795.

¹⁷⁶ Id., at 21279-80, 21333-4, 21795.

¹⁷⁷ Id., at 21787, 21789.

¹⁷⁸ Id., Commission's Exhibit No. 3292.

¹⁷⁹ Id., at 21326.

¹⁸⁰ Id., Commission's Exhibit No. 3263.

¹⁸¹ Id., Commission's Exhibit No. 3264.

¹⁸² Id., Commission's Exhibit No. 3266.

3. LOANS TO SPONSORS TO FLOAT SECURITY ISSUES

Another use to which funds of investment companies were put was floating securities for sponsors who were also underwriters. In some cases the power to borrow these funds was important for the sponsor, because banks might not have extended such accommodations to the sponsors.

Companies which illustrate the practice of lending funds to insiders in connection with underwritings were Shenandoah Corporation, Blue Ridge Corporation and Old Colony Investment Trust.

a. Shenandoah Corporation

Loans to insiders by investment companies in the Central States Electric Corporation group are illustrated by the loans which were made to the investment banking firm, Goldman, Sachs & Co., in connection with the initial offerings of the securities of Shenandoah Corporation and Blue Ridge Corporation.

The Goldman Sachs Trading Corporation and Central States Electric Corporation had jointly sponsored the formation of Shenandoah Corporation in July 1929.¹⁸³ By an agreement dated July 23, 1929, made between these two sponsors and Shenandoah Corporation and Goldman, Sachs & Co., sponsor of The Goldman Sachs Trading Corporation,¹⁸⁴ for the organization and financing of Shenandoah Corporation, it was provided that Central States and the Trading Corporation would each lend to the bankers the sum of \$6,250,000 or a total of \$12,500,000, for the purpose of financing Goldman, Sachs & Co. during the period between the original issuance of 1,000,000 shares of Shenandoah Corporation common stock to the bankers at \$12.50 per share and the sale of such shares to the public.¹⁸⁵ Both loans were made by the sponsor investment companies to Goldman, Sachs & Co. without interest and without collateral, repayable on August 7, 1929.¹⁸⁶

In order to make the loan under this agreement, The Goldman Sachs Trading Corporation and Central States Electric Corporation were each required to borrow from Manufacturers Trust Company the sum of \$6,250,000 for which they each paid an interest rate of 3%.¹⁸⁷ While these loans were satisfied in full on their due date,¹⁸⁸ they show how available to insiders upon favorable terms are the funds of their sponsored investment companies.

b. Blue Ridge Corporation

A similar procedure was followed at the organization of Blue Ridge Corporation. By an agreement dated August 19, 1929, to which Blue Ridge Corporation became a party, a loan of \$15,000,000 was made

¹⁸³ Public Examination, Central States Electric Corporation, at 12405.

¹⁸⁴ Public Examination, The Goldman Sachs Trading Corporation, Commission's Exhibits Nos. 1652 and 1654.

¹⁸⁵ Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1262.

¹⁸⁶ *Ibid.*

¹⁸⁷ *Id.*, Commission's Exhibit No. 1323.

¹⁸⁸ *Id.*, at 13228, and Commission's Exhibit No. 1323.

available to the same investment banker, Goldman, Sachs & Co., by Shenandoah Corporation to enable the bankers to underwrite the original issuance of 1,000,000 shares of Blue Ridge common stock at \$15 per share.¹⁸⁹ Likewise this loan, repayable September 5, 1929, was made without interest and without collateral. While the investment bankers were prompt in making repayment, yet in order to make the loan this investment company also was required to borrow the sum of \$15,000,000 from the Manufacturers Trust Company at a 3% interest rate.¹⁹⁰

c. Old Colony Investment Trust

The use by a sponsor of the funds paid as consideration for the issued securities of an investment trust prior to their investment in portfolio securities is illustrated in the management of the Old Colony Investment Trust.

Old Colony Investment Trust, a common-law trust,¹⁹¹ was organized in Massachusetts by a declaration of trust dated January 14, 1927,¹⁹² under the sponsorship of Old Colony Corporation, an investment affiliate of the Old Colony Trust Company.¹⁹³

At the inception of the trust, the trustees¹⁹⁴ issued \$1,000,000 par value 6% preferred stock callable at \$1,200,000,¹⁹⁵ \$5,000,000 of 4½% Series A debentures and 100,000 shares of common, "which would represent the future of the enterprise."¹⁹⁶ Of these shares of common stock, 50,000 were distributed to the public as a bonus for its investment of \$5,000,000 in Series A debentures and the remainder was retained by the sponsor as a bonus for its purchase of the preferred stock at its call price.¹⁹⁷ In the fall of 1927, in the same year as the creation of the investment trust,¹⁹⁸ because of the appreciation of the portfolio, the trustees decided to issue rights to subscribe to 2 shares of common at \$20 per share to the holder of one share of common.¹⁹⁹ The public and the sponsor had equal rights to subscribe to 200,000 additional shares of common stock.²⁰⁰ The public paid \$2,000,000 for its additional 100,000 shares of common. To pay for the additional 100,000 shares of common to which it was entitled as a holder of one-half of the outstanding shares of common, the sponsor redeemed the

¹⁸⁹ Id., Commission's Exhibit No. 1285.

¹⁹⁰ Ibid.

¹⁹¹ Public Examination, Old Colony Investment Trust, at 6111.

¹⁹² Id., at 6109-11, and Commission's Exhibit No. 551.

¹⁹³ Id., at 6109.

¹⁹⁴ Id., at 6114. The original trustees were Francis R. Hart, vice chairman of the board of directors of the bank; Philip Stockton, president of the bank; T. Jefferson Coolidge, vice president of the bank; Edwin R. Marshall, vice president of the bank and its investment affiliate; and F. Winchester Demo, vice president of the bank and its investment affiliate.

¹⁹⁵ Id., at 6125.

¹⁹⁶ Id., at 6115 and 6125. F. Winchester Demo was the witness at the examination.

¹⁹⁷ Id., at 6124-5.

¹⁹⁸ Id., Commission's Exhibit No. 551.

¹⁹⁹ Id., at 6126.

²⁰⁰ Id., at 6127. The rights were assignable and negotiable. The price of \$20 was fixed at that sum in order to equalize the cost per share of all outstanding common stock to the actual asset value. By exercising the rights at \$20, the original shareholder having received his common stock as a bonus, obtained his shares of common at a cost of \$13.33 per share, which was the asset value at that time (id., at 6126). The nearest price of the common stock was around \$40 per share.

preferred at the call price of \$1,200,000, the amount originally paid therefor and added \$800,000 to that sum.²⁰¹

At this time, the investment trust issued and sold to the public \$2,500,000 Series B debentures.²⁰²

The total contributed capital of the investment amounted approximately to \$11,500,000, of which the public paid \$5,000,000 for Series A debentures, \$2,500,000 for Series B debentures, and \$2,000,000 for 150,000 shares of common stock and the sponsor contributed \$2,000,000²⁰³ for 150,000 shares of common stock.²⁰⁴

In paying for the preferred stock the sponsor drew its check for \$1,200,000 to the order of the investment trust, which deposited it in the bank, Old Colony Trust Company, to the credit of the investment trust.²⁰⁵ Three or four days later, however, the investment trust returned the \$1,200,000 to the sponsor because only 2 percent could be obtained on that deposit from the bank.²⁰⁶ The sponsor did not execute or deliver a note to the investment trust but merely agreed to pay 5% on the daily balance,²⁰⁷ while the trust was required to pay 6 percent on the preferred stock.²⁰⁸ At the time of this transaction, besides the use of this money, the sponsor also obtained not only the preferred stock but 50,000 shares of common stock, which carried with it 50% of the future profits of the investment trust.

Subsequently, the total capital contribution of \$11,500,000 of the investment trust was lent to the sponsor, which paid 5% interest until these funds were invested in portfolio securities.²⁰⁹

This transaction thus limited the income on this fund to 5%, insofar as the investment company was concerned. It may be assumed that since the sponsor was willing to pay 5%, it was capable of earning a greater percentage, which it retained for itself.

²⁰¹ Id., at 6127-8. Mr. Demo testified (id., at 6127) :

* * * the reason we took the preferred stock out of the situation was that for the first time we were selling shares as shares, just as we had sold, or were about to sell, debentures as debentures, and not with a bonus attached to them, and we did not want the corporation to be in a preferred position, ahead of the shares which we were about to offer to the public, and we much preferred to be on a parity ourselves with the shares which the public was paying money for and to put our \$2,000,000 in the lowest position, alongside their dollars.

Although the preferred stock was not a participating preferred, Mr. Demo testified " * * * we had a right to subscribe to 100,000 shares of common, as a holder of the then half of the outstanding shares, and left our preferred in" (id., at 6128), but upon being reminded that in this situation the sponsor's investment would have been \$3,200,000 instead of \$2,000,000, he answered (id., at 6128-9) :

That is the result, but it was not the purpose. The purpose was to make the common stock—or to take away from ourselves any preference that we might have on the assets of the trust, ahead of the public's.

²⁰² Id., at 6130 and Commission's Exhibit No. 553-c. The sponsor received a 2½-point spread on these debentures. The price to the public was \$96½.

²⁰³ This figure does not consider the gross commission amounting to approximately \$200,000 obtained by the sponsor in the sale of \$7,500,000 debentures to the public.

²⁰⁴ Id., at 6133.

²⁰⁵ Id., at 6152.

²⁰⁶ Id., at 6134.

²⁰⁷ Ibid.

²⁰⁸ The sponsor subsequently redeemed these preferred stocks at the call price of \$1,200,000 and added \$800,000 to that amount, to purchase 100,000 additional shares of common. (Id., at 6127.) The public paid \$2,000,000 for a similar number of additional shares of common (id., at 6126).

²⁰⁹ Id., at 6135.

In its dealings with its sponsor, the investment company in effect, said: "We are giving you 50,000 shares of the common stock as a bonus for the purchase of the preferred stock at the call price; we are returning to you the \$1,200,000 which you have paid for the preferred stock and you may keep it as a loan at 5%, but we will pay you 6% interest; we will give you the right to subscribe to 100,000 shares of common stock at \$20 per share by reason of your ownership of 50,000 shares of common stock which we have given you; and we are calling at \$1,200,000 the preferred stock which you purchased from us for \$1,200,000 so that you may apply this sum toward the purchase of 100,000 shares of the common stock at \$20 a share."

By these readjustments, the sponsor secured for \$2,000,000, 150,000 shares of common stock at a time when the common stock was selling for \$40 per share.

4. LOANS TO SPONSORS OR THEIR AFFILIATES TO OPERATE TRADING ACCOUNTS

Loans of very considerable amounts were made by investment companies to permit their sponsors to operate trading accounts. In the cases of two important companies, United States & International Securities Corporation, sponsored by Dillon Read & Co., and National Securities Investment Company, sponsored by A. G. Becker & Co., Inc. and George Pick & Co., Inc., loans up to \$7,000,000, and \$6,000,000, respectively, were made to sponsors or their associates to operate trading accounts in the market. In both cases, loans were made at low interest rates to the borrowers and the risk taken by the investment company.

a. United States & International Securities Corporation

United States & International Securities Corporation, a subsidiary of United States & Foreign Securities Corporation, was organized and sponsored by Dillon, Read & Co. on October 26, 1928.²¹⁰ Clarence Dillon and certain of his associates were members of Dillon, Read & Co. and directors of United States & International Securities Corporation. The majority of the voting stock of the latter corporation was owned by Dillon, Read & Co.

On July 13, 1929, United States & International Securities Corporation formed jointly²¹¹ with Dillon, Read & Co. a "Joint Railroad Securities Account" of \$30,000,000 to acquire the securities of various railroads. The magnitude of this account was significant because the \$30,000,000 commitment was equivalent in size to approximately 83% of the investment company's paid-in capital and surplus²¹² and to about 50% of the full payments on the investment company's entire subscribed capital.²¹³

²¹⁰ Reply to Commission's questionnaire for United States & International Securities Corporation, Part I.

²¹¹ Hearings before the Committee on Banking and Currency, United States Senate, 73d Congress, Part 4, Exhibit No. 15.

²¹² Reply to Commission's questionnaire for United States & International Securities Corporation, Part II.

²¹³ *Id.*, Parts II and V.

According to the agreement, Dillon, Read & Co. was pledged to 50% of the joint account's total commitment. Nevertheless, United States & International Securities Corporation agreed to finance the entire account and in so doing render credit accommodation to Dillon, Read & Co. at an interest rate of $5\frac{1}{2}\%$.²¹⁴ Aside from the general risks implicit in this venture, the matter of the interest rate was distinctly disadvantageous to the investment company, being approximately 27% less than the New York Stock Exchange rate of $7\frac{1}{2}\%$ for 90-day time money on the day of the agreement.²¹⁵ Despite provision for joint management, the Railroad Joint Account was, in effect, an arrangement by which Dillon, Read & Co. obtained the use of a substantial part of the investment company's assets and, by reason of its control of the investment company, the banking firm commanded the operations and purposes of the account. In fact, despite the obvious importance of the agreement, the president of the investment company admitted that no formal minute was recorded in the investment company's books until about two months after the account's inception:²¹⁶

Q. Will you kindly look through the minute book for that period of time and see if you find any entries therein relating to the investment trust's going into this joint account with Dillon, Read & Co.?

A. No; I do not find any reference to it, but I know it was gone into at great length during the months of May and June and up to the middle of July. I went away about the middle of July.

Q. Do you find any entries in the minutes of any meeting of the board of directors of your investment trust for the months of May or June that relate to this joint-account venture?

Incidentally, while you are looking at it you need not confine yourself to any period of time. Look through the minute book and see if you can point out any entries therein relating to this joint account.

A. No; I do not see any until you get over to September 9.

Q. But this joint account, you say, was formed on July 13?

A. That is correct.

Furthermore, of the investment company's ten directors²¹⁷ in 1929 only five²¹⁸ were in attendance at the meeting held September 9 of that year which confirmed the transactions of the joint account. Of those five directors, two, namely, Messrs. Dillon and Mathey, were members of Dillon, Read & Co.;²¹⁹ one, E. B. Tracy, was president of the investment company;²²⁰ and another, Charles Hayden, senior partner of Hayden, Stone & Co., investment banker, was chairman of the board of directors of Chicago, Rock Island & Pacific Railway

²¹⁴ According to the investment company's minute book, page 174, "reimbursement of $5\frac{1}{2}\%$ interest on daily balances." (Op. cit. supra, note 211, p. 1745.)

²¹⁵ New York Times, July 14, 1929.

²¹⁶ Op. cit. supra, note 211, p. 1742.

²¹⁷ The directors were: Walter P. Chrysler, Clarence Dillon, Charles Hayden, J. H. Hillman, Jr., Dean Mathey, J. W. McConnell, S. Z. Mitchell, Geo. M. Moffet, Matthew S. Sloan, and Ernest B. Tracy. (Op. cit. supra, note 212, Part I.)

²¹⁸ Op. cit. supra, note 211, p. 1745.

²¹⁹ Op. cit. supra, note 212, Part VII.

²²⁰ Id., Part I.

Co.,²²¹ the common stock of which constituted one of the largest single holdings in the account.²²²

While the agreement was not confined to a specific objective, it included the following provision:

If at some future time all or part of any of the securities long in the account be turned over to a new company, it is our understanding that you [Dillon, Read & Co.] will be given an opportunity to make an offering of the securities of such company and for doing so will be entitled to reasonable compensation.

Thus, one actuating motive for the joint account was the possible formation of a new investment company,²²³ presumably a railroad holding company.²²⁴ To such a new company Dillon, Read & Co. could turn over its participation in the joint account. Clearly, the general policy of the investment banking business is inimical to "tying up" its resources in long term investment, as pointed out by Clarence Dillon.²²⁵

Notwithstanding the purpose of United States & International Securities Corporation, the stock market collapse within a few months after the inception of the Joint Account prevented fulfillment of the program. As a consequence, the account was closed on November 9, 1929, at which time less than one-half of the potential commitment was exhausted:²²⁶

Q. Then the account was terminated on November 9, 1929, and you had not exhausted your \$30,000,000. You had purchased \$14,261,000. I will show you the statement.

A. Yes.

The \$14,261,000 in round figures was expended (there were no sales) by the Joint Account to acquire the following issues: common stocks of Chicago, Rock Island & Pacific Railway Co., St. Louis & San Francisco Railway Co., Southern Pacific Company, Pennsylvania

²²¹ Id., Part VII.

²²² The report submitted by the treasurer referred to at p. 174 of the minute book "19,900 shares of Chicago, Rock Island & Pacific Railway Co. common at \$138.39—\$2,753,962.50." (Op. cit. supra, note 211, at p. 1745.)

²²³ Assuming the same sequence and pattern of corporate pyramiding employed by Dillon, Read & Co. and their associates in the organization of the United States & Foreign Securities Corporation and its subsidiary, United States & International Securities Corporation itself, a third company, presumably a subsidiary of the second, was planned. Thus, commencing with an aggregate investment of \$5,100,000 (Reply to Commission's questionnaire for United States & Foreign Securities Corporation, Part I, Dillon, Read & Co. and associates obtained control over United States & Foreign Securities Corporation whose total net paid-in capital amounted to \$29,100,000 (id., Part II). Subsequently by causing U. S. & Foreign Securities Corporation to invest \$10,000,000 in United States & International Securities Corporation (op. cit. supra, note 212, Part I), Dillon, Read & Co. extended their influence over additional capital amounting to \$60,000,000 (id., Part II), representing the public subscription to the securities of the second company.

²²⁴ During the early part of 1929 two large railway holding companies, the Alleghany Corporation and the Pennroad Corporation had already appeared. Dillon, Read & Co., with other investment bankers, were connected with the offerings of Alleghany Corporation.

²²⁵ Q. But you as a banking firm don't buy large blocks of stocks for investments, and don't tie up your money in it?

A. We don't tie the money up in it when we need the money for other purposes.

Q. You don't tie it up at any time, do you?

A. By tying it up, you mean get it where you can't get it out?

Q. Yes.

A. We don't do it enough to interfere with our banking business.

(Public Examination, United States & Foreign Securities Corporation, at 11905.)

²²⁶ Public Examination, United States & Foreign Securities Corporation, at 11850.

Railroad Company, Southern Railway Company, and certain bonds of the Seaboard Air Line Railroad Company.²²⁷ Of these holdings Rock Island and Frisco represented almost 56% of the account's aggregate purchases, being 27,400 shares at a cost of \$3,791,594 and 32,100 shares at \$4,185,379, respectively.²²⁸

Upon the termination of the account, Dillon, Read & Co. went through the following procedure to pay off the funds it had borrowed from United States & International Securities Corporation in the joint account. (1) United States & Foreign Securities Corporation, the parent corporation, purchased for cash from Dillon, Read & Co. its holdings in the joint account other than the part sold in the open market; (2) with the proceeds, Dillon, Read & Co. discharged its indebtedness to United States & International Securities Corporation, the subsidiary; (3) United States & International Securities Corporation, the subsidiary, then bought from United States & Foreign Securities Corporation the stocks previously sold by Dillon, Read & Co. and retained them.

The depreciation on Chicago, Rock Island & Pacific Railway Company and St. Louis & San Francisco Railway Company, the largest individual holdings as at December 31, 1935, was \$5,493,000 and \$5,753,000, respectively, or a total of \$11,246,000, representing 99% of their aggregate cost. This depreciation alone accounted for approximately 60% of the entire shrinkage in the assets of United States & International Securities Corporation for the period 1928-1935.

In effect, therefore, the investment company became the receptacle for taking Dillon, Read & Co.'s interest in "Rock Island" and "Frisco," in addition to which it retained its own holdings and acquired those of United States & Foreign Securities Corporation.²²⁹ Clarence Dillon admitted that the investment company complemented the activity of his banking firm when it came to the matter of maintaining a long-term position in these two railways:²³⁰

Q. That being the case, what persuaded Dillon, Read & Co., on November 11, 1929, to sell at the then market to the United States & Foreign Securities Corporation the shares of these two railroad companies that I have already mentioned, and which had been acquired through the medium of this joint account?

A. Dillon, Read & Co. went into this joint account to accumulate this stock in the expectation and in the belief that the stocks being so cheap and so attractive, would rise in price, and could later be sold at a profit. Dillon, Read & Co. are interested only in short-term investments. They do not make long-term investments. When it came to the termination of this account, it looked as though to hold them profitably would mean a long-term investment, which is not of interest to Dillon, Read & Co. Security companies, on the other hand, are interested in long-term investments.

²²⁷ Op. cit. supra, note 212, supplementary file.

²²⁸ Ibid.

²²⁹ Op. cit. supra, note 212. Part 7. Item 70.

²³⁰ Op. cit. supra, note 211, p. 1867.

The following two tables summarize transactions in the common stocks of Rock Island and Frisco relating to Dillon, Read & Co., and the two affiliated investment companies and their effect at December 31, 1935, on International:²⁸¹

Transactions in St. Louis-San Francisco Ry. Co. common stock

	Shares	Amount	Shares	Amount
Purchases by joint account:				
U. S. & I. participation (50%) cost.....			16,050	\$2,092,689
D. R. & Co. participation (50%) cost.....	16,050	\$2,092,689		
Sold to U. S. & F. proceeds.....	16,050	1,783,588		
Realized loss to D. R. & Co.....		299,101		
Sold to U. S. & I. by U. S. & F.....	16,050	1,688,781		
Realized loss to U. S. & F.....		104,807		
Resulting cost of D. R. & Co. participation acquired by U. S. & I.....			16,050	1,688,781
Aggregate cost to U. S. & I. (joint account).....			32,100	3,781,470
Transactions exclusive of joint account:				
Purchases from U. S. & F. (cost to U. S. & I.).....			4,000	469,100
Portfolio purchases by U. S. & I. cost.....			15,000	1,807,513
Total holdings by U. S. & I. at Dec. 31, 1929, cost.....			51,100	6,058,083
Sold 2,000 shares, reducing total held by U. S. & I. at Dec. 31, 1935 at cost to.....			49,100	5,820,983
Market value at Dec. 31, 1935.....			49,100	67,512
Unrealized loss by U. S. & I., at Dec. 31, 1935.....				5,753,471

Summary of losses and depreciation sustained, at Dec. 31, 1935, in connection with transactions (exclusive of moderate trading in bond issues) in St. Louis-San Francisco Ry. Co., common stock

U. S. & I.	
Unrealized loss on portfolio holdings.....	\$5,753,471
Estimated realized loss (amount not disclosed) from sale of 2,000 shares.....	220,000
Total.....	5,973,471
Percent of realized and unrealized loss to net paid-in capital, \$57,166,125.....	10.4

²⁸¹ Op. cit. supra, note 212, Parts VI and VII.

Transactions in Chicago, Rock Island & Pacific Ry. Co. common stock

	Shares	Amount	Shares	Amount
Purchases by joint account:				
U. S. & I. participation (50%) cost.....			13,700	\$1,895,797
D. R. & Co., participation (50%) cost.....	13,700	\$1,895,797		
Sold to U. S. & F., proceeds.....	13,700	1,565,225		
Realized loss to D. R. & Co.....		330,572		
Sold to U. S. & I. by U. S. & F.....	13,700	1,532,208		
Realized loss to U. S. & F.....		33,017		
Resulting cost of D. R. & Co. participation acquired by U. S. & I.....			13,700	1,532,208
Aggregate cost to U. S. & I. (joint account).....			27,400	3,428,005
Transaction exclusive of joint account:				
Purchased from U. S. & F. (cost to U. S. & I.).....			4,000	447,979
Portfolio purchases by U. S. & I., cost.....			10,000	1,310,962
Total holdings by U. S. & I. at Dec. 31, 1929, cost.....			41,400	5,186,946
Additional purchases by U. S. & I. 1930, cost.....			3,600	379,420
Total held by U. S. & I. at Dec. 31, 1935, cost.....			45,000	5,566,366
Market value at Dec. 31, 1935.....			45,000	73,125
				5,493,241

Summary of losses and depreciation sustained, at Dec. 31, 1935, in connection with transactions (exclusive of moderate trading in bond issue) in Chicago, Rock Island & Pacific Ry. Co. common stock

U. S. & I.:

Unrealized loss on portfolio holdings..... \$5,493,241
 Percent of depreciation to net paid-in capital, \$57,166,125..... 9.6

At the year-end 1938, the portfolio of United States & International Securities Corporation showed the following securities: \$197,000 face amount 4½% Convertible Bonds of 1960, and the above 45,000 shares of common stock of the Rock Island; also \$599,000 face amount Series B 6's of 1936 and 37,000 of the 49,100 shares of common stock of the Frisco shown in the above table. These holdings at that time represented only a nominal market value, indicating that as of that date, United States & International Securities Corporation still showed a loss on its investment in the two railways aggregating over \$11,000,000 and over 20% of its net paid-in capital.

b. National Securities Investment Company

National Securities Investment Company, sponsored jointly by A. G. Becker & Co., Inc., and George Pick & Co., Inc., Chicago investment houses, was incorporated on June 18, 1926, in Delaware.²³² The company received a total capital distribution of \$23,225,000 which, when added to its assets after the redemption of its preferred stock but prior to its recapitalization, gave it a total of \$30,986,721.33.

²³² Public Examination, National Securities Investment Company, Commission's Exhibit No. 1445. A discussion of National Securities Investment Company will be found in Pt. Three, Ch. IV (pp. 1094-1120).

From June 30, 1929 to September 25, 1931 at the time the company was taken over by Atlas Corporation, the assets of the company shrank approximately from \$40,000,000 to \$11,500,000²³³ with allowance for retirement of preferred stock. This was a shrinkage of 36% from the net public contribution to the company.²³⁴

The company engaged in joint trading accounts with individuals who were supposed to possess "inside dope"²³⁵ on the market movements of certain securities. The company lent these individuals funds at rates of interest substantially less than the prevailing rates on call loans obtainable from brokers. One of the largest of these joint trading accounts was with Sidney Z. Mitchell, chairman of the board of directors of Electric Bond & Share Corporation.²³⁶

In the latter part of 1928 a three-way joint trading account between George Pick & Co., Inc., and A. G. Becker & Co., Inc., the two sponsors of National Securities Investment Company and Sidney Z. Mitchell was in operation.²³⁷ The funds for this joint account were advanced by A. G. Becker & Co., Inc., and George Pick & Co., Inc.²³⁸ On February 18, 1929, the sponsors transferred their respective interests in this joint account to National Securities Investment Company, thus forming a new trading account composed of Sidney Z. Mitchell, personally, with a one-third interest, and National Securities Investment Company with a two-thirds interest.²³⁹ The amount of securities transferred to this new account was approximately \$5,794,405.21, representing the Becker and Pick companies' share in the three-way joint account.²⁴⁰ The investment company also reimbursed its sponsors for their advances to the trading account on behalf of Mr. Mitchell.²⁴¹ By this transfer to the investment company, the sponsors derived a profit of over \$2,221,072,²⁴² which was the difference between the cost of their interest in the account and the price at which they sold their interest to the investment company. Mr. Mitchell failed to put up any cash in the account but put up some securities as collateral and was carried by the investment company.²⁴³

Of the approximately \$6,000,000 of securities that were in the account when it was started, \$3,554,000, or 59% of the total were securities of companies of which Mr. Mitchell was either chairman of the board or a director.²⁴⁴ Later Mr. Mitchell's participation was increased from 33% to 50%.²⁴⁵

Balances due from Mr. Mitchell during the period of the operation of this account were: September 30, 1930, \$6,413,961; November 30, 1930, \$6,394,017. The peak amount due from Mr. Mitchell was reached on October 30, 1930, when there was a balance due of \$6,428,581.²⁴⁶

²³³ Id., at 14303-4.

²³⁴ Id., at 14305.

²³⁵ Id., at 14308.

²³⁶ Id., at 14306.

²³⁷ Id., at 14313.

²³⁸ Id., at 14319.

²³⁹ Id., at 14313.

²⁴⁰ Id., at 14313-4.

²⁴¹ Id., at 14320, 14320.

²⁴² Id., at 14314-5.

²⁴³ Id., at 14318-9.

²⁴⁴ Id., at 14325.

²⁴⁵ Id., at 14325-6.

²⁴⁶ Id., at 14326.

One of the principal benefits accruing to Mr. Mitchell was the ability to borrow over \$6,000,000 at this time at four percent interest from the company when call money rates rose as high as 20%. Mr. Schaffner testified:²⁴⁷

Q. You remember he was being carried from June 1929 or February 1929 right through 1930. Do you remember what the call money rates were in 1929?

A. I think they were higher.

Q. They were higher by how many percent?

A. I have to depend on my memory. I would say they were around 6 percent.

Q. I beg pardon?

A. Around 6 percent.

Q. Our records, and we have a transcript of the call money rates from January to March, show that the high was 20 percent; from April to June it was 16 percent; from July to September it was 15 percent; from October to December it was 10 percent. The average during 1929 was 10.44 on a quarterly basis.

Now, what was virtually happening as far as Mr. Mitchell was concerned was that he was conducting transactions in securities of his own company at a rate of interest with the investment trust which he could not duplicate in the call money market, is that right?

A. That is right.

Q. And when he increased his participation to 50 percent, the fact might have been that he was trying to avail himself of that cheap money rate, isn't that so?

A. We did not regard it that way. He insisted on a 50-percent participation instead of 33⅓. The result of that was to give us even greater confidence in the account.

Q. Well, the result of that transaction was that the total commitment in the account between the trust and Sidney Z. Mitchell ultimately was \$6,199,684.09 each, which gave a total commitment of approximately \$13,000,000, the greater portion of which was in securities of companies of the Electric Bond & Share group or companies of which he was the chairman of the board or a director, isn't that so?

A. That is right.

In order to finance Mr. Mitchell's portion of the account, National Securities Investment Company borrowed \$6,000,000 from banks during 1929 at 6% interest.²⁴⁸ Mr. Schaffner testified concerning this:²⁴⁹

Q. * * * You were borrowing money at the bank and virtually lending it to Sidney Z. Mitchell at 4 percent. Do you know what the interest rates were at the bank?

A. I think around 6 percent.

Q. So that in order to carry this account for Mr. Mitchell there was a 2-percent difference in interest.

A. That was a premium we were paying—

Q. For the inside knowledge?

A. For the inside knowledge we were getting.

Q. And on the \$6,000,000 you were carrying, 2 percent is quite a substantial bit of money? What is it, \$120,000 a year?

A. Yes.

²⁴⁷ Id., at 14326-8.

²⁴⁸ Id., at 14334.

²⁴⁹ Id., at 14334.

On the termination of the account, Mr. Mitchel paid the balance due for his proportion of the account.²⁵⁰ National Securities Investment Company took down, as its share, securities having a market value of \$2,386,419.66²⁵¹ which had cost the company \$6,199,684.09. As a result of this trading with Mr. Mitchell, National Securities Investment Company lost \$3,813,264.43 on this one account.²⁵² Mr. Schaffner testified:²⁵³

Q. Of course, that inside connection, as far as the National Securities Investment Company was concerned, was not a blessing, was it? It was actually a catastrophe.

A. Yes, in the light of subsequent events it was not very smart.

Q. The fact is that the loss in that one single transaction of approximately \$4,000,000, \$3,800,000, was more than one-half of the total deficit that the company sustained, isn't that so, of \$7,500,000?

A. Yes.

On January 11, 1930, or approximately 1 year after National Securities Investment Company took over the two-thirds interest of George Pick & Co., Inc., and A. G. Becker & Co., Inc., in the account with Sidney Z. Mitchell, a resolution was passed by the board of directors approving the acts of the officers of the company in reimbursing the sponsors for their advances to Sidney Z. Mitchell and for carrying the account.²⁵⁴

In summing up his attitude on this transaction, Mr. Schaffner testified:²⁵⁵

Q. I just want to get your experience on this, Mr. Schaffner. There was a time when this investment trust had a position in that stock of \$6,500,000 in that one transaction?

A. Yes.

Q. And it was also carrying Mr. Mitchell, and I am not unmindful of the fact that a substantial part of his collateral was in the same companies as the trade account, isn't that right?

A. Yes.

Q. You had a potential commitment in that one situation here of almost \$13,000,000, isn't that so?

A. Yes.

Q. And that, as compared with your total assets, which in February of 1929 were about \$30,000,000, was almost half of the money in that trust which was being staked in that one transaction, isn't that so?

A. Yes.

Q. Do you think that is a desirable situation?

A. It was a mistake, there is no question about it.

²⁵⁰ Id., at 14328.

²⁵¹ Ibid.

²⁵² Id., at 14328.

²⁵³ Id., at 14331.

²⁵⁴ Id., at 14329-30.

²⁵⁵ Id., at 14332.

5. TRANSFER TO INVESTMENT COMPANIES OF LOANS MADE TO SPONSOR

In certain cases, sponsors of investment companies transferred slow loans to the companies and thereby increased their own liquidity or even bailed themselves out of difficult situations in which they had become involved.

a. Central-Illinois Securities Corporation

Central-Illinois Securities Corporation,²⁵⁶ an investment company of the management type, was organized under the laws of Delaware on October 1, 1929, by Central Trust Company of Illinois, a commercial bank in Chicago, Ill., and by Central-Illinois Company, a security affiliate of the bank.

The directors and all the executive officers of the investment company were either officers or directors of the bank or its security affiliate. The initial board of directors and administrative personnel of the investment company remained in office continuously from October 1929 until November 1932 without substantial change.

Not only was the investment company entirely controlled by a board of directors completely interlocked with its sponsors, but, in addition, self-dealing transactions between the investment company and its directors and sponsors were explicitly authorized by the certificate of incorporation of the investment company. The charter provided:²⁵⁷

In case the Corporation enters into contracts or transacts business with one or more of its directors, or with any firm of which one or more of its directors are members, or with any other corporation or association of which one or more of its directors are stockholders, directors or officers, such contract or transaction shall not be invalidated or in any way affected by the fact that such director or directors have or may have interests therein which are or might be adverse to the interests of this Corporation; provided that such contract or transaction is entered into in good faith and authorized or ratified in the usual course of business as may be provided for in the bylaws of the Corporation.

The investment company commenced operations about October 21, 1929.²⁵⁸ One week later, while its funds were still almost intact, the stock market broke precipitously.²⁵⁹ On November 13, 1929, the board of directors of the investment company, at its first business meeting,²⁶⁰ and in the face of the collapsing securities market authorized acceptance of loan applications and offers of sale of various securities and notes receivable which were submitted by the bank, the security affiliate,

²⁵⁶ For a history of this company, see Part Three, Ch. II, pp. 142-181.

²⁵⁷ Reply to Commission's questionnaire for Central-Illinois Securities Corporation. Pt. I (Exhibit A, Article Twelve.)

²⁵⁸ Public Examination, Central-Illinois Securities Corporation, Commission's Exhibit No. 240.

²⁵⁹ *Id.* at 2045.

²⁶⁰ *Ibid.*

and the bank's subsidiaries on their own behalf.²⁸¹ The sum of \$5,459,966, or about 36% of the investment company's resources, was advanced or pledged in these transactions.²⁸² In exchange for \$5,459,966 of cash, the investment company agreed to acquire from the bank and the security affiliate, securities and obligations mainly of an unmarketable character. Consequently the funds of the investment company were utilized to increase the liquidity of the bank and the security affiliate at this time.²⁸³

At subsequent meetings, additional transactions of like nature were authorized by the board of directors of the investment company. In effect, up to the time of the severance of the investment company from the successor of the bank in 1932, the investment company functioned as an auxiliary of the bank and its security affiliate,²⁸⁴ taking over such existing investments as the sponsors did not think proper for themselves to retain, or such financing proposals as they did not see fit to undertake but which they desired to have undertaken.

The investment company purchased from the bank, over a period of time, loans to the amount of \$13,500,000.²⁸⁵ Of this sum, \$9,000,000 went into the purchase of Chicago brokers' loans from the bank, which were apparently repaid. The balance of \$4,500,000 was used to acquire from the bank and its security affiliate loans made to affiliated interests or to enterprises in which affiliated interests were involved. On these purchases the investment company had sustained a net loss of \$1,112,369 as of December 31, 1935, and a balance of \$195,666 remained unpaid²⁸⁶ and was carried as an asset on the books of the investment company.

In addition to the loans and securities which the investment company took over from the security affiliate, the bank, and its subsidiary, the Federal Securities Corporation, the investment company made loans directly to the security affiliate to finance ventures in which the security affiliate was interested.

The investment company also made loans to the security affiliate to finance the security affiliate's market operations in the stock of the in-

²⁸¹ *Id.*, Commission's Exhibit No. 248. The following transactions were authorized at this meeting:

With security affiliate:	
Purchase of Federal Securities Corporation note (secured by Goudey Gum Company stock)-----	\$500,000
6,400 shares of Hickok Oil Pfd-----	578,000
Loan secured by West Monroe Street Building-----	1,000,000
Loan for purchase of the investment company stock-----	1,500,000
With Federal Securities Corporation:	
Purchased the following:	
1,203 shares Congress Trust & Savings Bank stock-----	180,450
250 shares National Builders Bank stock-----	62,500
200 shares Drovers National Bank stock-----	75,000
4,107 shares Personal Loan & Savings Bank stock, with unpaid assessments-----	1,116,016
Illinois Syndicate note-----	450,000
Total-----	5,459,966

²⁸² *Ibid.*

²⁸³ Public Examination, Central-Illinois Securities Corporation, at 2004.

²⁸⁴ *Id.*, at 2018.

²⁸⁵ *Id.*, at 2022.

²⁸⁶ *Id.*, Commission's Exhibit No. 251.

vestment company. The units of the preferred and common stock of the investment company were offered to the public in October 1929. Approximately 2 weeks later the stock market broke and the market price of the investment units declined rapidly.

Approximately 1 month after the organization of the investment company, the security affiliate had repurchased on the market \$1,400,000 of the investment company's securities (or approximately 10% of the total contributed capital of the investment company) at substantial discounts below asset value²⁶⁷ and in addition the sum of \$1,500,000 was made available by the investment company for further purchases. Of this latter sum, \$560,811 was borrowed by the security affiliate and was later repaid.²⁶⁸ Although Mr. Clarke, president of both the investment company and the security affiliate, stated that the stock purchased on the market by the security affiliate was not resold to the investment company,²⁶⁹ the records of the investment company disclosed that, during the year 1931, the investment company purchased for about \$1,000,000²⁷⁰ approximately 40,000 units of its own stock from the security affiliate.²⁷¹

Viewing the loans in retrospect, Philip R. Clarke, former president of the investment company, testified:²⁷²

Q. * * * looking back * * * do you consider them proper investments?

A. Most emphatically not, looking back * * * I think we have all learned a lot of lessons and I think very decidedly it is a mistake for an officer of a commercial bank to have any connection with an investment trust. * * *

Q. Put frankly and candidly, Mr. Clarke, that relationship necessarily creates a dual function, particularly in these instances where a trust is dealing either with a bank or with a security affiliate of the bank.

A. That is true.

Q. Every time the investment trust purchases one of the loans from the securities affiliates or purchases a loan from the bank, you are necessarily put in that position where you are acting on both sides of the transaction, isn't that so?

A. A very difficult position, and it, of course, became more accentuated as soon as trouble began to ensue.

Q. Then it was necessary for individuals who are dominating both of them to make decisions which might sacrifice the interests of one or the other, both ways, isn't that so?

A. Exactly.

Q. You feel there is no useful purpose served by having a commercial bank acting as sponsor to an investment trust?

A. I feel that it is very illogical, based on the experience we have had.

²⁶⁷ Id., at 2046, 2057-8.

²⁶⁸ Id., at 2049-50.

²⁶⁹ Id., at 2052.

²⁷⁰ Id., at 2052 et seq. and Commission's Exhibits Nos. 256-259.

²⁷¹ During the 6-month period in which these 40,000 units were repurchased by the investment company from the security affiliate, there were traded on the Chicago Stock Exchange a total of approximately 50,000 units of the investment company's stock, which would make the investment company's purchases 80% of the total amount of stock traded. (Id., at 2058-9.) However, allowance must be made for the fact that some of this stock was doubtless accumulated by the security affiliate prior to January 1931, and consequently should not be included within the 6-month period. Mr. Clarke stated that 50% of the total trading in these units on the exchange during this period was for the account of the investment company which had issued the stock. (Id., at 2059.)

²⁷² Id., at 1980-82.

b. General Investment Corporation

General Investment Corporation²⁷² was incorporated in Delaware on September 5, 1929, as The Public Utility Holding Corporation of America, under the sponsorship of The Harris Forbes Corporation, and United Founders Corporation and its subsidiary, American Founders Corporation.²⁷⁴ The purposes and powers of the corporation were both those of an investment company and a holding company, but Harris, Forbes & Company on which the United Founders Corporation group relied for the management of General Investment Corporation, and which controlled The Harris Forbes Corporation intended to have General Investment Corporation invest in the equity securities of public utility companies, particularly those which Harris, Forbes & Company had theretofore been financing.

General Investment Corporation sustained a loss of \$6,780,974 in connection with its investment in South American Railways Company and Buenos Aires Central Railroad and Terminal Company. In 1929 the Terminal Company, a banking client of Harris, Forbes & Company, had borrowed \$5,250,000 from a New York bank to finance, temporarily, construction of a subway in Buenos Aires. When the loan was made and later extended, Harris, Forbes & Company had represented to the bank that it, Harris, Forbes & Company, intended to distribute publicly a bond issue for the terminal company, which would thus be provided with funds to repay the bank loan. However, after the market break in 1929, Harris, Forbes & Company did not offer the bonds of the terminal company publicly but had General Investment Corporation organize South American Railways Company and had General Investment Corporation guarantee a \$12,000,000 note issue of South American Railways Company, which Harris Forbes & Company distributed to the public. The proceeds of this issue were lent by South American Railways Company to the terminal company which used the funds to repay the bank loan and complete the construction of the subway. Eventually the terminal company defaulted on its obligation to pay the loan from South American Railways Company, and General Investment Corporation was compelled to purchase for approximately \$9,882,000 the \$12,000,000 of South American Railways Company notes which had been sold, with the guarantee of General Investment Corporation, to the public. On the resale of its entire investment in this venture, which aggregated approximately \$14,300,000, General Investment Corporation sustained a loss of about \$6,780,974.

6. LOANS TO SPONSORS AS A DEVICE FOR DRAINING FUNDS FROM AN INVESTMENT COMPANY

In a number of cases, namely in companies controlled respectively by Donald P. Kenyon, C. D. Parker & Co., Inc., Wallace Groves, and American Founders Corporation, extensive use of the funds of the

²⁷² For a history of this company, see Part Three, Ch. II, pp. 497-623.

²⁷⁴ Public Examination, American General Corporation, Commission's Exhibit No. X3423 (p. 1). On July 21, 1933, the name of the company was changed to General Investment Corporation.

investment companies was made for the private pecuniary purposes of the sponsors.

a. Companies Controlled by Donald P. Kenyon and Associates

Donald P. Kenyon, a former real estate promoter went to New York and Boston in the Fall of 1935 and began a series of acquisitions which ultimately resulted in Kenyon's securing control of about 30 investment companies and associated organizations with total assets of about \$14,000,000.²⁷⁵ There was little effort made, apparently, to pursue rational investment policies. Instead, Kenyon used the assets of one series of companies to acquire the securities representing control of other investment companies and used the assets of the controlled companies for his own personal purposes.

Among the abuses perpetrated was Kenyon's practice of causing a large number of loans to be made to himself either directly or indirectly through individuals and corporations dominated and controlled by him. For example, in March 1936 when Kenyon was trying to raise the money to purchase control of the North Bergen Trust Company, a bank in North Bergen, N. J., he caused \$50,000 to be lent to one George R. Grantham, an associate, by Monthly Income Shares, Inc. (of New York) and \$36,000 to be lent to Kenyon & Company, Inc. by Monthly Income Shares, Inc. (of New Jersey).²⁷⁶ This was sufficient to cover \$86,000 of the \$89,000 payment for the issuance to Kenyon and his associates of 1,133 shares of stock of the bank.²⁷⁷ Thereafter, Kenyon caused each of these Monthly Income Shares companies to lend large sums of money to himself, his associates and controlled corporations so that by the end of July 1936, the indebtedness of Kenyon and his associates to the two Monthly Income Shares companies amounted to \$326,514, in spite of the fact that such loans were violations of the charters of both companies.²⁷⁸ These loans represented 81% of the assets of Monthly Income Shares, Inc. (of New Jersey) which at that time had total assets of \$171,553 and 83% of the assets of the New York corporation which at that time had total assets of \$225,836. Kenyon and his associates also borrowed about \$154,000 from the North Bergen Trust Company, and since he and other directors had an interest in those loans, such borrowings were in violation of the New Jersey banking laws.²⁷⁹

Kenyon also borrowed about \$100,000 from Investors Fund of America, another of his controlled investment companies. Of this sum, \$50,000 was ostensibly for the purpose of maintaining a market in the stock of the investment company and \$50,000 was set up on the books of the lending company as loans or accounts receivable, in order to cover various transactions, including Kenyon's failure to deliver portfolio stock of the investment company for the purpose of which he had been advanced funds.²⁸⁰

²⁷⁵ See Part Three, Ch. II, pp. 309-349.

²⁷⁶ Public Examination, Alpha Shares, Inc., et al., at 19587-8, 19591.

²⁷⁷ *Ibid.*

²⁷⁸ *Id.*, Commission's Exhibits, Nos. 3083 and 3162.

²⁷⁹ New Jersey P. L. 1936, Ch. 131, Sec. 15, as amended June 5, 1936.

²⁸⁰ *Id.*, at 19803-8, 19828.

Mr. Kenyon also depleted the assets of United Standard Oilfund of America, Inc., another investment company in this group, a substantial part of the depletion being effected by causing loans to be made to himself and controlled corporations which were never repaid. This investment company had net assets of about \$260,000 on June 30, 1936, which was about the time that Kenyon secured control of it. A year later the corporation had no assets. Among the items of loss was an unsecured loan of \$100,500 to Kenyon & Company, Inc., one of Kenyon's controlled corporations without assets at the time or since and which is now defunct.

b. Companies Sponsored by C. D. Parker & Co., Inc.

C. D. Parker & Co., Inc., an investment banking firm of Boston, Mass., organized three investment companies during the year 1929: Seaboard Utilities Shares Corporation in March; Railroad Shares Corporation in July; and Utilities Hydro & Rails Shares Corporation in November.²⁸¹

The board of directors of Seaboard Utilities Shares Corporation (the largest) consisted of 45 members of whom 17 were employees or officers of the sponsor and 28 were dealers and distributors of securities located throughout the country. Approximately this same proportion of employees and officers of the sponsor and the security dealers on the board of directors was maintained from 1929 to 1934. Four of the principal officers and stockholders of the sponsor were principal officers of the investment company, namely, Chauncey D. Parker, president; Bowen Tufts, vice president; Merton E. Grush, treasurer, and Edward L. Bennett, secretary.²⁸²

In the latter part of 1929, after the entire contributed capital of Seaboard Utilities Shares Corporation had been invested in securities, Seaboard Utilities Shares Corporation borrowed substantial sums from banks to purchase additional securities and gave as collateral for these loans portfolio securities. The market value of the portfolio of the investment company by December 31, 1931 (including the securities pledged with the banks), had depreciated in value to \$3,112,535.89. The securities held by the banks were valued at market at \$2,180,853.25, representing over two-thirds of the total market value of the portfolio.

In April 1932, the banks called the loans and, upon the failure of the investment company to pay, sold the collateral. During the month of April 1932, when the forced liquidation of the loans occurred, the books of the investment company indicate that losses of over \$6,000,000 on the basis of cost were suffered from the sale of portfolio securities. These losses comprised approximately half of the total of all losses on the sale of securities by the investment company during its existence. At the time when this sale took place, the investment company had on deposit over \$1,270,000 with C. D. Parker & Co., Inc.,

²⁸¹ See Part Three, Ch. II, pp. 76-93.

²⁸² The officers and principal stockholders of C. D. Parker & Co., Inc., were Chauncey D. Parker, president; Bowen Tufts, vice-president and general manager; Merton E. Grush, vice-president; Harold B. Lamont, vice-president; Charles E. Adams, vice-president; and Edward L. Bennett, treasurer. Public Examination, C. D. Parker & Co., Inc., at 20555-J.

which had acted as depository of the cash funds of the investment company shortly after its inception. If this money had been paid to the banks it would have been sufficient to satisfy approximately the investment company's entire indebtedness and thus might have conserved a substantial part of its assets. The sponsor, nevertheless, did not take any action to avert the foreclosure of the collateral.

By June 16, 1934, Seaboard Utilities Shares Corporation had deposited with C. D. Parker & Co., Inc., \$1,957,417.61, consisting of cash deposits in a checking account aggregating \$622,491.64; certificates of deposit issued by the sponsor, including accrued interest amounting to \$888,335.42; and funds reserved for the payment of securities under order, amounting to \$446,590.55. The other two investment companies by that time had likewise deposited with C. D. Parker & Co., Inc., an aggregate amount of approximately \$1,182,191.17, of which \$478,700.18 comprised cash deposits in checking accounts and certificates of deposit, including interest.

Thus when the Banking Act of 1933, compelling the divorcement of private and commercial banking from investment banking, went into effect on June 17, 1934,²⁸³ the three investment companies had \$3,139,608.78 with their sponsor, of which \$1,989,527.24 was in cash deposits in checking accounts and certificates of deposit. Since C. D. Parker & Co., Inc., was engaged in the investment banking business, it was required to return to the investment companies the \$1,989,527.24 on deposit with itself. However, at this time the sponsor was insolvent, and these cash deposits were not turned over to the investment companies. Instead, the sponsor changed the designation of all deposit accounts, then aggregating \$3,139,608.78, describing them as "Funds reserved for the purchase and sale of portfolio securities under order" and as "Funds reserved for the purchase and sale of treasury shares under order."

In this manner, in circumvention of the Banking Act of 1933, the sponsor retained and even slightly increased the cash funds of the three investment companies that it held. By December 31, 1935, the sponsor was indebted to the three investment companies in the aggregate sum of \$3,304,776.62. Actually C. D. Parker & Co., Inc., was insolvent, and with its ensuing bankruptcy virtually the entire amount of these "deposits" was lost to the stockholders of the investment companies.

c. Companies Acquired and Controlled by Wallace Groves

Wallace Groves,²⁸⁴ a promoter of small-loan companies in Baltimore, Md., came to New York in 1931 and began acquiring various independent investment companies to form a holding company system of investment companies to be controlled by him.

With funds borrowed from Franklin Plan Corporation, a holding company of small-loan companies, which was under his domination, Mr. Groves in October 1931 purchased control of Interstate Equities Corporation, an investment company, from its sponsor, Bancamerica-Blair Corporation, and its officers, directors, and other insiders, for \$963,775.50.

²⁸³ 12 U. S. C., Sec. 378.

²⁸⁴ See Part Three, Ch. II, pp. 181-227.

Previously, on September 23, 1931, Wallace Groves had contracted to purchase from Chain & General Equities, Inc., another investment company, 467,938 shares of its newly authorized common stock for approximately \$940,000. In order to meet this commitment to purchase the block of Chain & General Equities Inc., stock, Mr. Groves, who had assumed control of Interstate Equities Corporation, caused that corporation to agree to purchase this block of Chain & General Equities Inc., stock upon condition that Mr. Groves would repurchase the identical block within ten days at approximately the same price.²⁸⁵ This transaction, although in form a contract of sale and repurchase, was in effect a loan of approximately \$940,000, collateralized by the block of Chain & General Equities Inc., stock, which Groves was obligated to buy from Chain & General Equities, Inc.²⁸⁶ Interstate Equities Corporation, in order to effect this "purchase" of the Chain & General Equities, Inc., stock from Wallace Groves, had to borrow approximately \$1,000,000 from the National City Bank of New York and to hypothecate \$1,412,125²⁸⁷ of marketable securities as security therefor. Had Wallace Groves defaulted on his contract of repurchase, Interstate Equities Corporation would have had, in lieu of this \$1,412,125 of marketable securities, a claim against Mr. Groves for approximately \$940,000 and the large block of Chain & General Equities, Inc., stock as collateral.²⁸⁸ On November 4, 1931, Wallace Groves used the funds "borrowed" from Interstate Equities Corporation to meet his obligation to purchase the block of Chain & General Equities, Inc., stock. He immediately took control of the board of Chain & General Equities, Inc. Simultaneously with the payment to that company of approximately \$940,000 for the block of Chain & General Equities, Inc., stock, he sold his block of Interstate Equities, Inc., stock, which had cost him \$963,775, to Chain & General Equities, Inc., for \$1,325,034, with a net profit to him of \$271,069.72 (after expenses totaling \$90,188).²⁸⁹

d. American Founders Corporation

Another investment company that was used as a reservoir of funds for loans to insiders was American Founders Corporation, one of the United Founders Corporation group of companies. This company was organized in 1922 as a Massachusetts trust under the name of Weeks, Lewis and Bull Company to serve as sponsor of International Securities Corporation of America.²⁹⁰ By October 31, 1924 American Founders Corporation had raised a capital of about \$824,000.

The funds of American Founders Corporation from its organization in 1922 until October 31, 1924 were devoted largely to enterprises of particular interest to Christopher F. Coombs and William R. Bull and to personal loans to them. Loans and investments in the stock of Bridgeport Rolling Mills, W. R. Bull & Company, Inc., aggregated

²⁸⁵ Public Examination, The Equity Corporation, Commission's Exhibit No. 11.

²⁸⁶ *Id.*, at 118.

²⁸⁷ *Id.*, at 95 and Commission's Exhibit No. 13.

²⁸⁸ *Id.*, at 114-6.

²⁸⁹ Derived from supplementary information supplied the Commission for The Equity Corporation.

Subsequent activities of Wallace Groves in connection with these companies are set forth in Ch. II of this part of the report, p. 181 et seq.

²⁹⁰ See Ch. VI of this part of the report, Sec. II, B. 1.

at cost approximately \$300,000 or 40% of the paid-in capital of American Founders Corporation. Bridgeport Rolling Mills had been running steadily at a loss.

At this time, when loans to insiders were being made, the stock of American Founders Corporation was being publicly distributed as the stock of a conservative management company. Neither the stockholders nor the board of directors of American Founders Corporation were aware of the loans to Bridgeport Rolling Mills or W. R. Bull & Co., Inc.

In March 1925 the loans to Mr. Bull and companies in which he was interested, amounting to \$300,000, were found to be uncollectible. Mr. Bull thereupon gave his own notes for \$300,000 secured by such stock of American Founders Corporation as he had received and such stock as he might thereafter receive for his services as manager of the investment company at \$29.40 per share. The settlement absolved Bull for any personal liability for any deficiency that might result from the sale of the collateral.

In November 1925 the loans were finally settled by their retransfer to Bull in return for 12,000 shares of stock of American Founders Corporation previously issued to Bull for his services.

These shares were taken back by American Founders Corporation at \$25 per share, which was fifteen times the price per share at which they were issued to Bull for services and about 35% higher than the current book value of \$18.50 per share.

In addition to the above loans were others made to Coombs and Bull. During June 1924 they settled obligations for \$166,735 by the sale to American Founders Corporation of stock previously issued to them on credit. As of October 29, 1924, American Founders Corporation held balances due on notes and accounts receivable from Coombs and Bull of \$102,258 (besides the \$300,000 above).

7. LOANS TO SUPPORT MARKET OF STOCK OF COMPANIES AFFILIATED WITH INVESTMENT COMPANIES

It was not uncommon for investment companies to trade in the stock of sponsors or their affiliated companies to protect the market for shares of stock of companies in which the sponsor was interested. Loans, for example, aggregating \$1,500,000 were authorized, of which \$560,811 were lent to its sponsor by Central-Illinois Securities Corporation during the market break of 1929 to support the price of the investment company's stock.²⁹¹ Chatham Phenix Allied Corporation purchased 63,224 shares of Chatham Phenix National Bank & Trust Company at a cost of \$6,885,862 to support the stock of the bank and sold the shares at a loss of \$88,073.93.²⁹²

Another case in which such support was forthcoming from an investment company to support stock of a company in which the sponsor was interested was Central States Electric Corporation.

²⁹¹ See Part Three, Ch. II, p. 158 et seq. and see *supra*, this chapter.

²⁹² See Part Three, Ch. II, p. 131.

a. Central States Electric Corporation

During the years 1927-1929 which marked the major period of its growth and financing,²⁹³ Central States Electric Corporation, an investment company engaged in substantial borrowings from, and lendings to, the personally-owned holding companies of its sponsor, Harrison Williams, particularly North American Securities Company (NASCO). For example, in 1927-1928, when Central States Electric Corporation was broadening its interests in the securities of utility companies, its cash needs for this purpose were frequently met by borrowing substantial sums from these inside sources. In the year 1927, it borrowed a total of \$5,800,000 and made payments in the same year in the amount of \$2,000,000, leaving a balance due from it at the year-end of \$3,800,000. In the following year, 1928, it borrowed an additional \$5,950,000 from the same sources. By the close of 1928 cash obligations of Central States Electric Corporation to Harrison Williams and his privately owned companies were completely satisfied.²⁹⁴

Central States Electric Corporation itself was frequently tapped as a source of cash and securities by the personal companies of Mr. Williams. NASCO, as early as May 1924, began heavy tradings in the common stock of The North American Company, a utility holding company, and in 1928 and 1929 in the common stock of Central States Electric Corporation itself and its other portfolio securities. In the course of these trading and distributing activities comprising substantial purchases on, and resales off, the exchange, there were occasions when NASCO needed stock to cover an over-allotment or an oversale, and other occasions when NASCO actually needed cash wherewith to buy blocks of stock.

One such occasion arose in May 1927 in connection with tradings of NASCO in The North American Company common stock when it found its position in this stock short by approximately 98,000 shares. Among the advances which had been made by Central States Electric Corporation to NASCO at about this time were some 40,000 shares of the stock. By a resolution adopted June 7, 1927, Central States Electric Corporation adopted these sales by NASCO to the extent of these 40,000 shares at an average price of \$46.13, despite the fact that the current market was somewhat higher.²⁹⁵

In 1929, Central States Electric Corporation, continuing its policy of assisting NASCO in its activities, made substantial loans of cash rather than securities. By September 1929, the investment company had senior securities outstanding totaling approximately \$73,000,000.²⁹⁶ Its cash loans to NASCO for the year amounted to \$14,-

²⁹³ For detailed account of Central States Electric Corporation, see Part Three, Ch. V, pp. 1683-1708.

²⁹⁴ Public Examination, Central States Electric Corporation, at 12401-3 and Commission's Exhibit No. 1323.

²⁹⁵ *Id.* at 12615-9 and Commission's Exhibits Nos. 1219 and 1220.

²⁹⁶ *I. e.*, comprising more than \$44,000,000 in debentures and nearly \$29,000,000 in preferred stock. (*Id.*, Commission's Exhibit No. 1237.)

223,000,²⁹⁷ a sum equal to nearly 20% of the entire face amount of senior securities outstanding. These loans which had increased from a balance due at the end of March 1929 of \$355,000 to \$2,837,000 at the end of July and \$10,477,000 by the end of October had been made principally to enable NASCO to carry on its activities in the issues of Class A and Class B stock of American Cities Power and Light Corporation. In this connection, Christian Johnson, an employee of Harrison Williams, testified:²⁹⁸

Q. Will you explain to me what those loans were for?

A. I can only tell from what I have seen. Our record here shows that up until August 30, 1929, those loans were approximately three and a half million dollars, and that the big increase in those loans came during the month of October of 1929 when they increased from five million to ten million dollars. In other words, approximately five million dollars of loans in the month of October 1929.

Q. Yes.

A. It was during the period of the market break, as I recall it, at that time.

Q. Yes.

A. North American Securities Company had at that time a substantial long position in American Cities Power and Light Corporation, which ran up to several million dollars, and they also owned North American and owned a very substantial amount of Central States Electric common. Most of those funds in October 1929, as such, were used to buy Central States common in the declining market of that period. Those loans, incidentally, were repaid in the following month, one month from the date of the loan.

Q. That was due to the sale in connection with the donation.

A. In connection with the donation, partly, and partly through the turning over to Central States Electric Corporation of the long position in American Cities which it had acquired for the account of Central States Electric Corporation.

By the end of November 1929 the balance of \$10,477,000 due Central States Electric Corporation from NASCO at the end of the preceding month had been reduced to \$7,322,100, principally by repayment with the proceeds from the sale of the securities of American Cities Power and Light Corporation. Of this balance \$6,830,000 was paid in December 1929²⁹⁹ following Harrison Williams' donation to Central States Electric Corporation of a portion of his holdings in its common stock. By this donation, Harrison Williams gave to Central States Electric Corporation 1,800,000 shares of its own common stock, in turn to be given by Central States to Shenandoah Corporation and Blue Ridge Corporation to build up their asset values.³⁰⁰ As a direct and pre-arranged result of the donation, Harrison Williams was placed in a position to sell 278,771 additional shares of his Central States common stock from which he received \$6,237,000.³⁰¹ The proceeds of this

²⁹⁷ Id., Commission's Exhibit No. 1323. All but \$492,000 of these loans was repaid by NASCO by the end of 1929. The balance was settled in full in March 1930. (Ibid.)

²⁹⁸ Id., at 13238-9.

²⁹⁹ Id., Commission's Exhibit No. 1323.

³⁰⁰ Id., at 13243.

³⁰¹ Id., at 13249.

sale by Mr. Williams were used by NASCO to repay its obligations to Central States Electric Corporation. In this connection, Mr. Johnson testified:³⁰²

Q. So that as a result of this transaction Mr. Williams gave up 1,718,000 shares, is that true?

A. That is the stock, excluding the shares sold.

Q. He gave up 1,718,000 shares of common stock and in addition to that he sold 278,000 shares for cash?

A. That is correct.

Q. At a market value of \$22 per share, is that right?

A. That is right.

Q. This cash was used for what purpose, do you remember?

A. The cash was transferred primarily to North American Securities Company, and they used the funds to repay Central States for these loans you mentioned previously.

Q. So that the money goes out and comes back again.

A. Yes.

Cash loans such as were made by Central States to NASCO tended to impose heavy risks upon investors in the lending investment company. In the case of Central States Electric Corporation, the public had contributed practically all of its senior money and working capital,³⁰³ while Mr. Williams for a comparatively small investment owned practically all of the Central States Electric Corporation common stock and was therefore in complete control of its affairs.³⁰⁴ As has been shown, substantial amounts of these publicly contributed funds were made available during 1929 to Mr. Williams' privately owned North American Securities Company upon rather favorable terms. Although the initial advances by Central States Electric Corporation to NASCO were secured by the shares of the stock of American Cities Power & Light Corporation and The North American Company, nevertheless, when the largest extensions of credit were granted increasing NASCO's indebtedness to Central States Electric Corporation from \$2,837,000 at the end of July 1929, to \$10,477,000 at the end of the following October, there was no additional collateral security advanced by the borrower against these increases.³⁰⁵

Mr. Williams recognized the danger involved in the making of upstream loans to personal holding companies arising from the dual position which characterizes the practice. His testimony on this question was as follows:³⁰⁶

Q. Mr. Williams, what do you think now as you look back on the idea of investing companies loaning to personal holding companies or their sponsors?

A. Are you referring to these loans we were just talking about?

³⁰² Id., at 13251.

³⁰³ Id., at 12277-9, 12387-9 and Commission's Exhibit No. 1233.

³⁰⁴ Harrison Williams' total investment in Central States common stock amounted to \$2,070,000, while there was returned to him nearly \$2,000,000 in cash dividends. (Id., at 12321-2, 12328-34, and 13477-80.) Mr. Williams held 97% of the common stock of Central States at the end of 1928 and as much as 90% in July 1929. (Id., at 12315 and Commission's Exhibit No. 1205.) See also Part Three, Ch. III, pp. 961-6.

³⁰⁵ Public Examination, Central States Electric Corporation, Commission's Exhibit No. 1323.

³⁰⁶ Id., at 13239-42.

Q. Referring to these loans, these transactions, wholly inter-company transactions, where the credit of the Central States Electric Corporation is used by your personal holding company to the extent of \$10,000,000. So far as I can see, for this \$5,000,000 increase in October there was no collateral.

Mr. JOHNSON. Not during the month of October. It was partly collateralized.

Mr. SMITH. Only partly covered?

Mr. JOHNSON. That is right, although up until that time it had been secured—that is, up to the increase, although I may say that many loans were made during these times without any collateral at all. It was unnecessary to put up collateral on loans in those days, generally speaking.

By Mr. SMITH:

Q. What do you think, Mr. Williams?

A. You mean what do I think of it as a practice? Was that what you are trying to get?

Q. I am trying to get the philosophical aspect of it, in looking back.

A. I think there is always some question in connection with inter-company loans. It is a thing that has been up very much lately in connection with utility companies, which is the same picture exactly, which comes into this situation, what we call downstream and upstream loans.

* * * * *

Q. The reason for it is—

A. It is all right so long as both parties are strong and everything goes all right.

Q. These loans were repaid, weren't they?

A. Yes.

Q. And they were upstream loans, weren't they?

A. Yes; to that extent. That was a comparatively short period, while the other loans were made downstream by these of the company, some of them which lasted until some later period were over a longer period, and I think most of them without any collateral. Weren't they?

Mr. JOHNSON. Sometimes there was collateral.

By Mr. SMITH:

Q. In other words, it is a dual position there.

A. A dual position. I don't think if I was doing it over again I would allow it to be done. I may not have known it at the time.

The following is a table of the loans to North American Securities Company and repayments.

INVESTMENT TRUSTS AND INVESTMENT COMPANIES 2707

Particulars of loans of Central States Electric Corporation to North American Securities Co. and repayments during period from January 1, 1927 to December 31, 1935

Date of loan	Collateral •	Advances during month	Repayments		Balance due at end of month or period	Interest rate
			Date	Amount		
1929						
Mar. 1-27...	14,000 shares American Cities Power & Light Corporation, class B.	\$365,000.00	Mar. 5....	\$10,000.00	\$355,000.00	Percent 6
Apr. 2-30...	39,100 shares American Cities Power & Light Corporation, class B.	1,110,000.00	-----	-----	1,465,000.00	6
May 1-31...	2,086 shares American Cities Power & Light Corporation, class B.	483,000.00	May 1-31	436,000.00	1,512,000.00	6
June 10-27...	(11,700 shares American Cities Power & Light Corporation, class B.	2,375,000.00	June 3-27...	1,665,000.00	2,222,000.00	6
	4,800 shares North American Co., common.					
	3,000 shares American Cities Power & Light Corporation, class A.					
	4,506 shares American Cities Power & Light Corporation, class B.					
July 2-31....	2,000 shares North American Co., common.	1,160,000.00	July 15-29	545,000.00	2,837,000.00	6
Aug. 8-30.....		1,650,000.00	Aug. 8-30	1,000,000.00	3,487,000.00	6
Sept. 13-30.....		2,095,000.00	Sept. 19-28	90,000.00	5,492,000.00	6
Oct. 2-31.....		4,985,000.00			10,477,000.00	6
Nov. —			Nov. 4-22	1,400,000.00		
			Nov. 1.....	^b 1,446,999.48	7,322,100.52	6
			do.....	^c 307,900.00		
Dec. —			Dec. 6-31	6,830,000.00	492,100.52	-----
1930						
Mar. —			Mar. 8.....	492,100.52	-----	-----

* Represents stock received (net) or returned (net) during month.

^b Purchase price of 57,880 shares American Cities Power & Light Corporation class B bought from North American Securities Co., applied in reduction of loan.

^c Purchase price of 12,316 shares American Cities Power & Light Corporation class B bought from North American Securities Co., applied in reduction of loan.

8. LOANS FOR INDIRECT PURPOSES OF SPONSOR

Loans were in a number of cases made to investment companies apparently to secure good will for the sponsor or to enhance his prestige.

a. Ungerleider Financial Corporation

Ungerleider Financial Corporation was organized on May 7, 1929, by the firm of Samuel Ungerleider & Co., members of the New York

Stock Exchange. The charter of the corporation indicated that the general purpose of the corporation was to operate as an investment trust.³⁰⁷

There was no indication in these articles that a substantial portion of the business was to be lending of funds of the corporation. Nor did the prospectus describing the corporation indicate that one of the main purposes would be lending of money.³⁰⁸

However, Ungerleider Financial Corporation, during the period of its management by Samuel Ungerleider & Co., loaned a large proportion of its total assets to various individuals. In most cases the loans were made with the hope that contact with the borrower might result in future underwriting or securities distribution business for the corporation. Loans were also made to officers and directors of the corporation.³⁰⁹ The following table shows the loans made by the corporation other than call loans and loans to officers and employees.

Schedule of Loans of Ungerleider Financial Corporation ^a

Name of debtor	Dec. 31, 1929	Dec. 31, 1930	Dec. 31, 1931	Dec. 31, 1932	As at liq- uidation Nov. 4, 1933
Alamac Esplanade Corp.		\$346,610	\$365,059		
Blumberg, Elinor		5,015			
Bonwil, Teller & Co.			358,000	\$358,000	\$310,067
Eisemann, Emil	\$65,000	65,335			
Kelley, Converse & Co.			75,000	70,180	70,180
Manton, Martin T. #1	50,000				
Manton, Martin T. #2	345,000				
Manton, Martin T.			74,853	62,500	62,500
McGowen, Cassady & White	900,000				
McGowen, Cassady & White		275,000			
McGowen, Cassady & White		7,901			
Renz, Adrian M. #1	128,000				
Renz, Adrian M. #2	160,000				
Renz, Adrian M.		178,913	104,600	97,299	94,691
Rieser, Norvin H.		126,664			
Sisto Financial Corp.	1,892,209				
Syndicate advances:					
Federal Screw Works syndicate	238,900				
National Screen Service Corp. syndicate		425,416	216,000		
Various (2 syndicate participants)	1,247				
Total	3,780,356	1,430,854	1,193,512	587,979	537,438

^a Reply to Commission's questionnaire for Ungerleider Financial Corporation, Part II, Exhibit A, Schedule 5.

³⁰⁷ Public Examination, Ungerleider Financial Corporation, Commission's Exhibit No 1528.

³⁰⁸ Id., at 14917.

³⁰⁹ Id., at 14944. The corporation made a loan of \$12,000 in 1929 to Maurice K. Baker, vice president of the corporation, and in 1930, \$5,101.65 to H. Hansell Hillyer, director and vice president of the corporation, and \$1,026.82 to W. J. Lee, an employee. No security was given for these loans. In 1931, the Baker and Hillyer loans were written down to a nominal amount of fifty cents each. The loan to W. J. Lee was completely charged off the books in 1931. (Reply to Commission's questionnaire, Part II, Exhibit A, Schedule 4.)

Some of these loans will be examined in some detail.¹¹⁰

b. Loan to Renz

On October 2, and on October 21, 1929, two loans aggregating \$288,000 were made to Adrian Renz, the president and director of the Midtown Bank of New York. Renz' notes were endorsed by Carl Sherman, a former attorney general of the State of New York, Frank Cohen, Max Gibian, and Leo Lowy, all of whom were directors of the Midtown Bank, and secured by the deposit with Ungerleider Financial Corporation of 3,600 shares each of the Midtown Bank and its security affiliate, MidPrud Corporation. Ungerleider Financial Corporation had the option to purchase the collateral at a price equivalent to the amount of the loan.¹¹¹

Apparently a merger between the Midtown Bank and the Prudential Bank, another New York bank was anticipated. It was contemplated that upon the conclusion of the merger, Ungerleider Financial Corporation might make a profit by distributing to the public the stock it held as collateral for the loan. The merger, however, did not materialize and Renz and his associates defaulted upon their notes. Eventually, a loss of \$95,248.51 was sustained by the corporation upon this loan.¹¹²

c. Loan to McGowen, Cassady & White

Another loan which was apparently inspired by the hope of future banking business from the borrower was made in September of 1929 to McGowen, Cassady & White, Chicago investment bankers. This firm, in conjunction with DeWolf & Company, another Chicago investment banking firm, were bankers for Commonwealth Public Utilities Company, a company which held all of the stock of several telephone companies, doing business in Wisconsin. DeWolf & Company became insolvent in the summer of 1929 and their banking relations with Commonwealth Public Utilities Company terminated.¹¹³

Notes of Commonwealth Public Utilities Company, aggregating \$1,400,000, were maturing on September 1, 1929. The company was unable to pay these notes. McGowen, Cassady & White arranged a bank loan for the company, totalling \$500,000. Ungerleider Financial Corporation advanced to McGowen, Cassady & White on its note, the additional \$900,000 required by the company. This sum McGowen, Cassady & White in turn loaned to the company on the collateral of all of the securities of the various telephone companies owned by the company. This collateral was in turn pledged by McGowen, Cassady & White with Ungerleider Financial Corporation. The stocks of the operating companies were appraised by en-

¹¹⁰ On October 30, 1929, a loan of \$687,000 was made to William C. Durant. The loan was secured by listed securities and was repaid on November 30, 1929. (Public Examination, Ungerleider Financial Corporation, at 14944.)

¹¹¹ Id., Commission's Exhibit No. 1544, and 14946-7.

¹¹² Id., at 14948-50.

¹¹³ Id., at 14954-6.

gineers as being worth \$1,000,000 on a distress liquidation and \$1,700,000 "if ample time were available for liquidation."³¹⁴

In return for making the loan, Ungerleider Financial Corporation was to replace DeWolf & Company as one of the bankers for Commonwealth Public Utilities Company and its subsidiaries and was to share with McGowen, Cassady & White, both of whom were to be exclusive bankers for the company, all of the banking business of the company and its subsidiaries for a period of 10 years.³¹⁵

It was contemplated that Ungerleider Financial Corporation and McGowen, Cassady & White would underwrite and distribute a new issue of the securities of Commonwealth Public Utilities Company, the proceeds of which would enable it to repay the \$500,000 bank loan and the \$900,000 advanced by Ungerleider Financial Corporation.³¹⁶ However, the investigation of Commonwealth Public Utilities Company made by Ungerleider Financial Corporation had not disclosed that that company and its subsidiaries were in "ill repute" with the Wisconsin Railroad Commission "due to questionable accounting practices and unsatisfactory services being rendered by the company."³¹⁷ The Wisconsin Commission demanded a dismissal of the company's management and a reorganization of the company and its subsidiaries.³¹⁸ This situation prohibited the contemplated public sale of the securities of Commonwealth Public Utilities Company from the proceeds of which the loan of \$900,000 made by Ungerleider Financial Corporation was to be repaid. McGowen, Cassady & White, to whom the loan had actually been made, were unable to repay it.³¹⁹ The only means of salvaging the loan was by realizing upon the collateral securing it; that is, upon the securities of the operating telephone companies. To do so, it was necessary for Ungerleider Financial Corporation to participate in a reorganization of these companies. Eventually the securities received by Ungerleider Financial Corporation as a result of the reorganization of the operating companies were disposed of for a total consideration of \$533,024.44. A loss of \$366,975.56³²⁰ was, therefore, sustained on this loan.

d. Loan to Martin T. Manton

A loss was also suffered by Ungerleider Financial Corporation on loans made to Martin T. Manton, then an associate judge of the United States Circuit Court of Appeals for the Second Circuit. Judge Manton and general business associates owned a substantial interest in the Alamac and Esplanade Hotels in New York City.³²¹ Samuel Ungerleider & Company, the sponsor of Ungerleider Financial Corporation, had a client who desired to purchase these hotels and the

³¹⁴ Ibid. and Commission's Exhibit No. 1545.

³¹⁵ Id., at 14956.

³¹⁶ Ibid.

³¹⁷ Id., Commission's Exhibit No. 1545.

³¹⁸ Ibid.

³¹⁹ Id., at 14956-7.

³²⁰ Id., at 14964.

³²¹ Id., Commission's Exhibit No. 1540.

loans were made to Judge Manton, apparently in the hope that they might serve to induce Judge Manton to sell these hotels.³²²

On August 22, 1929, a loan of \$50,000 was made to Judge Manton by Ungerleider Financial Corporation on his demand note secured by all of the outstanding capital stock of the Island Home Laundry Company and the Modern Carpet Cleaning Company.³²³ These securities were not listed upon any securities exchange, nor were they traded over the counter.³²⁴ This loan was repaid by and the collateral returned to Judge Manton on November 30, 1930.

Meanwhile, on September 16, 1929, Ungerleider Financial Corporation advanced an additional \$345,000 to Judge Manton, evidenced by his demand note and secured by 3,000 shares of the capital stock of Camala Corporation, which was not listed upon any exchange or traded over the counter³²⁵—in fact, had no market. The principal assets of Camala Corporation were its ownership of 23,360 shares of the preferred stock and 110,120 shares of the common stock of Alamac-Esplanade Corporation which owned the equity in the Alamac Hotel, the Esplanade Hotel, and eight apartment houses in New York City.³²⁶

A default upon the loan would, in effect, have placed the Ungerleider Financial Corporation in the real estate business. Mr. Ungerleider testified, however, that the possibility, in the event of a default upon the loan, of selling the hotel properties to one of his clients at a profit to Ungerleider Financial Corporation motivated the making of the loan.³²⁷ Following the crash in the securities market, however, Mr. Ungerleider's client lost all interest in the hotel properties owned by Judge Manton's companies.

Some attention was given to the possibility of refunding this loan by a public offering of the securities of Alamac-Esplanade Corporation to be made by the Ungerleider Financial Corporation.³²⁸ However, this was not done.

Apparently Ungerleider Financial Corporation became dissatisfied with the collateral securing the \$345,000 loan. The corporation desired a lien interest on the real estate in which the Camala Corporation stock represented the equity ownership. Accordingly, on December 2, 1930, in substitution for the note to Judge Manton, a note

³²² Id., at 14923. Mr. Ungerleider testified:

Q. Will you give us the reason for making that loan, on the part of the Ungerleider Financial Corporation?

A. I had a party who was interested in buying some hotels, * * * and Mr. Sullivan indicated to me that he would be interested in working out a deal with his holdings and Judge Manton's holdings, and that they might sell the junior securities they owned in those two hotels.

³²³ Id., at 14019 et seq.

³²⁴ Id., at 14920.

³²⁵ Id., at 14925.

³²⁶ Id., at 14922-4.

³²⁷ Id., at 14923 et seq. Mr. Ungerleider testified:

Q. You say you were contemplating the possibility of buying these properties for the investment company, is that it?

A. No. I had a party who was interested in forming a chain of hotels, and I wanted the opportunity of buying a chain of hotels, and I wanted the opportunity of buying these securities, the junior securities in these two properties, to sell to this party.

Q. So that you made that loan in order to do what?

A. To make a profit in the purchasing of these junior securities in these two hotels.

³²⁸ Id., Commission's Exhibit No. 1540.

in the sum of \$345,000 was taken from the Alamac-Esplenade Corporation. This note was secured by a second mortgage upon the Alamac Hotel. A first mortgage in the sum \$1,820,000 was held by the Emigrant Industrial Savings Bank of New York City which had, prior to the crash in security and real estate values after 1929, appraised the hotel as being worth \$3,500,000.³²⁹ Payment of both the note of Alamac-Esplenade Corporation and the second mortgage in the Alamac Hotel was guaranteed by Judge Manton.³³⁰

In August of 1931, Atlas Corporation acquired control of Ungerleider Financial Corporation. Under Atlas Corporation management, on August 13, 1931, Ungerleider Financial Corporation lent to Judge Manton an additional \$75,000 on the security of 14,319 shares of the common stock of National Cellulose Corporation, a corporation engaged in the manufacture of paper products and which was substantially owned by Judge Manton and his associates. This stock was not traded in on any securities exchange or quoted on any over-the-counter market. This loan was finally paid in full by Judge Manton in October of 1935.³³¹

Because of the steady decline in real estate values, by October of 1931, the second mortgage securing the still outstanding \$345,000 loan (which, with accrued interest, then amounted to \$361,283) guaranteed by Judge Manton had, in the opinion of the management of Ungerleider Financial Corporation become of doubtful value. Accordingly, on October 16, 1931, an agreement³³² was entered into with Judge Manton whereby the second mortgage on the Alamac Hotel was to be cancelled. In lieu thereof Judge Manton transferred to Ungerleider Financial Corporation 3,612.83 shares of the preferred stock of National Cellulose Corporation and agreed that on the request of Ungerleider Financial Corporation he would, on October 26, 1935, repurchase the preferred stock at \$100 a share, or a total price of \$361,283, the amount of the loan. In effect, the National Cellulose Corporation preferred stock was substituted as collateral for the second mortgage on the Alamac Hotel.

In the summer of 1935, Judge Manton informed the trustees in dissolution of Ungerleider Financial Corporation (which had been dissolved in 1933) that he was financially unable to repurchase the National Cellulose Corporation preferred stock on October 26, 1935, at the agreed price of \$361,283.³³³ He offered, instead, to find a buyer for the stock for \$125,000. Atlas Corporation was convinced that \$125,000 was an attractive price for the stock in the then financial condition of National Cellulose Corporation. Accordingly, it acceded to Judge Manton's compromise. The \$361,283 owed by Judge Manton was therefore released for a total consideration of \$125,000. The loss suffered by the Ungerleider Financial Corporation on the loan was, therefore, \$236,283.³³⁴ However, during the period of Ungerleider Financial

³²⁹ Ibid.

³³⁰ Id., Commission's Exhibit No. 1541.

³³¹ Id., at 14922.

³³² Id., at 14935-6 and Commission's Exhibit No. 1543.

³³³ Id., at 14940-1.

³³⁴ Id., at 14941-2. Mr. Rathvon testified:

Q. So that ultimately the block of stock was sold to this buyer for \$125,000 instead of \$361,000 some?

A. That is correct.

Q. So that ultimately there was a difference there of approximately \$236,000.

A. Yes.

Corporation's possession of the National Cellulose Corporation preferred stock, dividends of \$40,000 were paid to it on the stock. Crediting these dividends in reduction of the loan the net loss to Ungerleider Financial Corporation on its loans to Judge Manton was \$196,283.³²⁵

The loans to Renz, to McGowen, Cassady & White, and to Judge Manton by the close of 1929 totalled \$1,583,000. They constituted more than 10%³²⁶ of the Ungerleider Financial Corporation's net contributed capital of \$13,205,575.³²⁷ Eventually, an actual loss of \$658,507.07 was suffered on these loans.

Further, all of the loans were secured by highly illiquid collateral. Default on the loans placed the corporation under the necessity of operating and of supervising the management of public utility companies, hotels, and possibly a bank. Mr. Ungerleider readily conceded that Ungerleider Financial Corporation was not "geared up" to undertake the management of business enterprises. He testified:³²⁸

Q. I am particularly interested in this type of loan [the loan to McGowen, Cassady & White]. Here is a loan you made and you ultimately wound up finding yourself in the public utility business; isn't that so?

A. Yes.

Q. You also found yourself in the real estate business in another situation; isn't that so?

A. That is right.

Q. And in connection with Bonwit Teller where you took that substantial participation you ultimately found yourself in the department store business?

A. Isn't that true when you make a loan on anything unless it is a liquid security?

Q. The problem I have is, do you think an investment trust should make that type of loan?

A. That depends a whole lot on how the investment company is geared up. If the investment company is in a good position to manage property, it may be a very good thing.

Q. How were you geared up? You weren't geared up to run a hotel?

A. No.

Q. You weren't geared up to run a public utility business?

A. We were not geared up at that time to do anything but sell securities.

Q. You were not geared up to go into the department store business?

A. No.

Q. Didn't you find yourself virtually in these businesses?

A. Right.

The experience of Ungerleider Financial Corporation in connection with its loans was described by Mr. Ungerleider as a sad one:³²⁹

Q. Well, we have covered the experience of Ungerleider Financial Corporation, in its loans.

³²⁵ Id., at 14943.

³²⁶ Id., at 14953-4. Mr. Ungerleider testified:

Q. So you had approximately \$1,600,000 in loans in situations where the collateral was not marketable securities, isn't that so?

A. Yes, sir.

Q. That was approximately 10 percent of the total assets of the Ungerleider Financial Corporation at the time, isn't that so?

A. Yes.

Q. In loans secured by collateral which was, shall we say, frozen or illiquid?

A. Frozen, I should say, most of them.

³²⁷ Id., at 14910.

³²⁸ Id., at 14960-1.

³²⁹ Id., at 14975-6.

A. Did you say "sad" experience?

Q. Did I say "sad"? I didn't say "sad," did I?

A. You should have said "sad"—I thought that you did.

e. Loans by Bankers Securities Corporation

Bankers Securities Corporation was incorporated under the laws of the Commonwealth of Pennsylvania on April 3, 1928. The corporation was sponsored by Bankers Trust Company of Philadelphia; Albert M. Greenfield, a director of the Bankers Trust Company, organizer and chairman of the Bankers Bond & Mortgage Guaranty Company of America and president of Albert M. Greenfield & Company; and by William Fox of Fox Films Company.

The corporation seems to have been organized to serve as a general securities affiliate of Bankers Trust Company of Philadelphia, the sponsoring commercial bank.³⁴⁰ Mr. Greenfield stated that he regarded Bankers Securities Corporation as an investment banking corporation primarily, rather than as an investment company. Nevertheless, the certificate of incorporation gave the corporation broad powers to engage in virtually every kind of financial and real estate business. The charter placed no limitations on the type or amount of securities or property which the corporation might own or acquire.

In its registration statement, filed under the Securities Exchange Act of 1934, the corporation stated that: "The policy of the registrant (the corporation) is to engage primarily in trading in securities. The policy of its subsidiary, Bansecor Corporation, is to engage primarily in holding for investment. The policy of City Stores Company is to act as a holding company. The subsidiaries of City Stores Company conduct general department store business or hold or operate real estate incidental thereto."

Mr. Albert M. Greenfield was the moving spirit of both the Bankers Trust Company and Bankers Securities Corporation. The two voting trusts which controlled Bankers Securities Corporation, and in which Albert Greenfield was one of the voting trustees, will be discussed separately below.³⁴¹ In three cases, Albert Greenfield was one of three co-voting trustees; in one case, Greenfield was one of two co-voting trustees, and in one case Greenfield was sole voting trustee. Two of these five voting trusts controlled the Bankers Securities Corporation itself, one of these voting trusts temporarily controlled Cities Stores Company, the largest subsidiary of Bankers Securities, and two voting trusts controlled companies affiliated with Bankers Securities through Albert M. Greenfield.

The Board of Directors at December 31, 1929, was representative of the two principal interests—the Bankers Trust Company and a group of companies controlled by the Bankers Bond & Mortgage Guaranty Company of America, a holding company organized by

³⁴⁰ The Bankers Trust Company of Philadelphia was taken into possession by the Secretary of Banking of Pennsylvania on December 22, 1930, and was in liquidation at the end of 1938. To December 31, 1938, the depositors had received cash dividends of 55%. (Moody's Manual of Investments, 1939, p. 329.)

³⁴¹ In the Bankers Securities system there were altogether, during the period 1928-1935 inclusive, five separate voting trust agreements.

Albert M. Greenfield in November 1928 to do a guarantee real estate and mortgage business. Of the twenty directors of the corporation at December 31, 1929, eight were also directors or officers of the sponsor bank. Of these eight, at least five were also associated with the Bankers Bond & Mortgage group. Of the remaining twelve directors who were not directors or officers of the sponsor bank, ten were directors of the Bankers Bond & Mortgage Guaranty Company of America. The directorate of the corporation underwent very little change in the period from 1928 through 1935. It thus appears that the Bankers Securities Corporation, the Bankers Bond & Mortgage Guaranty Company of America and the Corporation were intimately related through strongly interlocking directorates and through a leading executive in common, namely, Albert M. Greenfield.

It would appear that the corporation served largely as a vehicle for providing financial accommodation to the various enterprises with which Mr. Greenfield was identified, as well as to individuals such as Messrs. Fox and Stern with whom Mr. Greenfield evidently was closely associated. The corporation also provided an outlet for considerable amounts of securities and mortgages of real estate companies with which Mr. Greenfield was connected. The corporation served as a substantial customer of the sponsor bank which constituted one of its principal stockholders, and aided the sponsor bank in effecting one or more bank mergers.

Bankers Securities Corporation, in view of its regular practice of making large loans to persons and corporations with which it was affiliated, may be said to have carried on a specialized private banking business. It must be noted that while the company was lending such large sums to affiliated interests and insiders, it was itself borrowing large sums from banks and other sources.

During 1929, the Bankers Securities Corporation borrowed from banks alone \$6,500,000. \$4,000,000 was borrowed from the Guaranty Trust Company, \$1,000,000 from The Chase National Bank of New York, \$1,000,000 from the Philadelphia National Bank, and \$500,000 from the Franklin Trust Company of Philadelphia. Maximum loans during 1929 aggregated \$8,000,000 at the end of February. The market value of collateral security for the \$4,000,000 Guaranty Trust loan equalled \$5,000,000; for the \$1,000,000 Chase National Bank loan, \$1,250,000. The \$1,000,000 loan from the Philadelphia National Bank and the \$500,000 from the Franklin Trust Company were unsecured. The same policy of borrowing was continued in 1930 and 1931.

In 1930, \$1,500,000 was borrowed from The Chase National Bank and the market value of collateral security amounted to \$1,874,375. Also \$200,000 was borrowed from the Philadelphia National Bank as against a market value of collateral security equalling \$281,269 during the same year. Despite the small amount of loans outstanding at the year-end 1930, maximum amount of loans from banks during that year aggregated \$8,500,000 at the end of February.

In 1931, \$300,000 was borrowed from the Philadelphia National Bank with a market value of collateral security equal to \$371,737.50, and \$600,000 was borrowed from The Chase National Bank with a market value of collateral security equal to \$8,619,550.00. Maximum amount of loans during 1931 aggregated \$1,700,000 at the end of June.

The following loans extended by Bankers Securities Corporation will be discussed in detail:

- a. Loan of \$10,000,000 to Fox Theatres Corporation.
- b. Loan of \$8,000,000 to City Stores Company.
- c. Loans to Bankers Bond and Mortgage Syndicate.
- d. Loans to New York Post, J. David Stern, Joseph L. Guffey, and George H. Earle, 3rd.

f. Loan to Fox Theatres Corporation

William Fox was originally solicited by Albert M. Greenfield to invest in Bankers Securities Corporation during the first part of 1928. Mr. Fox subscribed for at least 10,000 shares of Bankers Securities Corporation preferred at sixty dollars a share or \$600,000. In all, Mr. Fox probably invested as much as \$4,000,000 or \$5,000,000 in the company. Under the original voting trust agreement of January 2, 1929, William Fox, who had been a director and member of the executive committee, was appointed co-voting trustee with the Bankers Trust Co. and Albert M. Greenfield. This voting trust controlled 29.6% of the common stock.

On January 18, 1929, Bankers Securities Corporation received an option, evidently from Mr. Fox, on 100,000 shares of Fox Theatres, Class A Stock, at \$25 a share. The Chairman of the Board of Bankers Securities Corporation, Albert M. Greenfield, was authorized to purchase 75,000 shares provided that Mr. Fox would have his life insured for a million dollars for 1 year. At that time, Fox Theatres was controlled by William Fox. The difference between the option price to Bankers Securities Corporation and the quoted market price on the New York Curb Exchange on the date of the 75,000 share purchase, represented a profit of \$328,000 to Bankers Securities Corporation.

On February 27, 1929, 1 month after the Corporation made its investment in Fox Theatres stock, a loan of \$10,000,000 to the Fox Theatres Corporation was authorized, secured by 250,000 shares of Loew's common stock valued at over \$20,000,000. The loan was due August 27, 1929. Bankers Securities Corporation was to receive a bonus of \$400,000 for this loan. Of the unexecuted balance of the original option for 100,000 shares, 10,000 shares were executed for a Mr. Harris, Jr., and 15,000 shares for Albert Greenfield. This loan was made at the time when Fox Theatres Corporation acquired a large block of Loew's, Inc. The interest rate was six percent.

On September 10, 1929, the \$10,000,000 Fox loan was extended from August 27th to November 27th, Bankers Securities Corporation receiving a fee of \$200,000 for its services.

On December 10, 1929, the \$10,000,000 Fox loan was extended for 3 months until February 27, 1930. Additional collateral was deposited and Bankers Securities Corporation received another service fee of \$200,000.

On February 28, 1930, \$4,000,000 was paid to Bankers Securities Corporation by Fox Theatres and on March 11, 1930, the remaining loan of \$6,000,000 was extended, Bankers Securities receiving a service fee of \$40,000, as well as additional collateral. At this time the

Corporation evidently took a new note of \$150,000 (interest rate unknown).

On April 8, 1930, the Fox notes, totalling \$6,150,000, were extended to April 15, Bankers Securities receiving a service fee of about \$26,000. At that time it was reported that Mr. Fox sold control of Fox Film Corporation and 87,000 shares of Fox Theatres were resold by Bankers Securities at \$25 a share, for which it received a note equalling \$2,320,000 due June 7, 1930, guaranteed by General Theatres Equipment, Inc., and Harley L. Clarke.

On April 21, 1930, Bankers Securities Corporation received a total of \$8,494,000 from Fox Theatres Corporation clearing its loans to that firm.

As of April 15, 1930, Bankers Securities Corporation also lent the Fox Film Corporation \$2,500,000 for a few days, the loan being repaid April 19th plus \$1,250 interest. This was a clearance loan for the following purpose: Lehman Brothers, Bancamerica-Blair, and another concern which were underwriting Fox enterprises at that time when Fox was having a dispute with other bankers over the payment of a loan of fifteen or twenty million dollars, requested Greenfield to advance the \$2,500,000 so that the major Fox loan, which was being called by the Midland Bank on Gaumont stock, could be cleared. Bankers Securities Corporation received as collateral a mortgage on the Fox office building and theatre in Philadelphia. Shortly after payment of this loan release of the life insurance policy of William Fox was authorized. Mr. Sundheim, a director, was paid a fee of \$25,000 for his services in handling the Fox transactions, and Bankers Securities Corporation received at least \$866,000 in service fees exclusive of interest and the life insurance policy on William Fox.

These transactions illustrate the use of the investment company's funds to finance an enterprise in which an original sponsor, director, member of executive committee, and co-voting trustee of the investment company was vitally concerned. At the time this loan was extended, the trust also had outstanding a loan of \$8,000,000 to City Stores Company, other loans to "outsiders" totalling \$1,309,000, loans to "insiders" totalling \$20,000, and call loans outstanding as at December 31, 1928, of \$7,600,000. Excluding call loans, the trust had outstanding approximately \$19,000,000 in secured and unsecured loans during 1929 equal to sixty-three percent of total assets at market.

G. LOANS TO CITY STORES COMPANY

One of the first major operations of the Bankers Securities Corporation, in the middle of 1928, was the purchase of stock control, of Lit Brothers Dept. Store of Philadelphia for about \$10,270,000. This was made possible by the fact that the previous control was held by three men well advanced in years and that when one of them in the summer of 1928 became seriously ill, they decided to sell out.³⁴² The Bankers Securities Corporation did not purchase this control for the purpose of indefinite retention, but with the object of disposing of the same at a profit. In less than 30 days, the corporation had resold the 501,000 shares at a profit of over \$2,000,000 to the City Stores Co.,

³⁴² Derived from supplementary information supplied the Commission for Bankers Securities Corporation.

a chain department store organization.³⁴³ The block was sold to City Stores for about \$13,000,000 and the Bankers Securities Corp. immediately loaned \$8,000,000, on 3-year notes due December 31, 1931, to City Stores, retaining the 501,000 shares of Lit Brothers stock as security.³⁴⁴

During the term of the note, the City Stores Co., in the opinion of Mr. Greenfield, was being mismanaged by its then president who controlled 30 to 35% of the voting stock directly and sufficiently additional stock by proxies to give him a majority.³⁴⁵ Upon the maturity of the 5-year note the City Stores Co. was carried along by Bankers Securities Corporation, as well as by Halsey, Stuart & Co., which had made the City Stores Co. an unsecured loan of \$5,000,000 simultaneously with the execution of the \$8,000,000 note to Bankers Securities Corp. by means of 4-month renewals granted by both creditors. Finally, in 1932, when the management insisted upon paying a common stock dividend of \$700,000, the bankers served notice that they would not go along any further and asked payment of their loans.³⁴⁶ This demand forced the management to turn over control of the company to the bankers who thereupon set up a voting trust with four trustees, two representing the bankers, one representing the former management, and the fourth being a large stockholder who became president.³⁴⁷ Due to the depression, City Stores suffered heavy losses in 1932 and 1933 and the bankers began to look forward to a reorganization. This was opposed by the former management and as a consequence, Bankers Securities Corp. bought out its stock interests in 1933 for about \$200,000.³⁴⁸

The reorganization, under 77B of the Bankruptcy Act,³⁴⁹ however, did not take place until December 20, 1934, when the court approved the plan which had already been approved by the stockholders on December 13 and by the bankers on August 28. Under the terms of the reorganization, the notes payable were reduced and the balance exchanged for new ones convertible into stock and the Class A and common stocks were exchanged for a new common stock, of which the Bankers Securities Corporation at the end of 1935 had acquired, in various ways, 753,055 shares, or 63% of the outstanding number of about 1,200,000.³⁵⁰ At this date, the Bankers Securities Corporation also held \$7,400,000 of City Stores 6% convertible notes out of \$10,000,000 short-term notes outstanding, giving it a still firmer grip on the control of the City Stores Co. which at this time had \$32,375,000 of assets.³⁵¹ At this date, the total assets, at market values, of the Bankers Securities Corporation were \$16,335,000.³⁵²

The Bankers Securities story demonstrates how an investment company may become involved in a special situation to the extent of 46% of its total assets at market through the extension of loans. Bankers

³⁴³ Ibid.

³⁴⁴ Ibid.

³⁴⁵ Ibid.

³⁴⁶ Ibid.

³⁴⁷ Ibid.

³⁴⁸ Ibid.

³⁴⁹ Ibid.

³⁵⁰ Ibid.

³⁵¹ Ibid.

³⁵² Ibid.

Securities Corporation apparently had no intention of becoming involved in the department store business which was forced to assume control of City Stores Co. in order to protect its original \$8,000,000 loan.

h. Loans to Bankers Bond & Mortgage Guaranty Company of America

The Bankers Bond & Mortgage Guaranty Company of America was a holding company organized by Albert M. Greenfield, subsequently chairman of the board of directors, and associates in November 1928 to do a guaranty, real estate, and mortgage business. It soon acquired by exchange of stocks, or otherwise, the Bankers Bond and Mortgage Company, of Philadelphia, the U. S. Title and Mortgage Company of Newark and the Bankers Bond and Mortgage Company of New York and organized other wholly owned subsidiaries for real estate holding purposes. Many members of this initial group were also participants in the organization of the Bankers Securities Corporation and were stockholders in both companies. At the end of 1929, thirteen of the twenty directors of Bankers Securities Corporation were also directors of the Guaranty Company and constituted a majority of its board, the two companies thus being affiliated by interlocking directorates and a leading executive (Greenfield) in common.

The Guaranty Company sold \$2,000,000 of its \$12,000,000 of stock directly to investors; and, in January 1929, it sold the balance of \$10,000,000 to a syndicate organized by Albert Greenfield and associates. The Bankers Securities Corporation was authorized by its directors to loan \$750,000 to this syndicate, the loan to be secured by pledge of stock. Compensation to the corporation was to be 6% on the loan and one-fourth of the profits of the syndicate.

The Bankers Securities Corporation also purchased the stock of the Bankers Bond & Mortgage Guaranty Company in the market, adding to its holdings in each year 1929-1935, inclusive. At the end of 1935, it held nearly 81,000 common shares of the Guaranty Company, equivalent to over 20% of the outstanding number of voting shares. The cost of these shares was \$665,000 and their market value \$102,000. At this date, eight of the directors of the Bankers Bond & Mortgage Guaranty Company, constituting over one-third of the latter's board of twenty-one directors. At this time, also, Albert Greenfield was chairman of the boards of both companies and the president of the Securities Corporation was secretary and treasurer of the Guaranty Company.

Under these circumstances, it would appear not only that the two companies were closely affiliated, but that the Bankers Securities Corporation exercised working control of its real estate affiliate. At the end of 1935 the corporation was still carrying this loan in the amount of \$466,680, some of the collateral stock having been taken over in partial discharge of the obligation.

i. Other Loans

In 1928 David Stern bought the Philadelphia Record from the Wanamaker Estate for \$2,500,000. Albert Greenfield, through Bankers Securities Corporation, helped David Stern finance this

venture by taking up a six-percent debenture issue of the Philadelphia Record Company of the face amount of \$1,200,000. Bankers Securities Corporation purchased these debentures at ninety percent of their face value. The market value of the \$1,200,000 of Philadelphia Record debentures as of the year-end 1929 was \$1,080,000. At December 31, 1930, Bankers Securities Corporation carried in its portfolio Philadelphia Record 6's 1930-40 at a cost value of \$1,100,000 (market and balance-sheet values \$990,000). A gradual reduction of this investment occurred until at the year-end 1935 the debentures were carried at a cost of \$563,000 (market value \$506,700). In addition, Bankers Securities Corporation evidently purchased \$1,600,000 of preferred stock and about 60,000 shares of common stock.

During 1934 Bankers Securities Corporation lent the Courier Post Company \$250,000 secured by \$250,000 of New York Post bonds. At the year-end 1935, the Bankers Securities portfolio carried Courier Post Company 6's 1935-40 at a value of \$227,000 (cost and market).

In addition to the foregoing investments in or loans to the David Stern enterprises, Bankers Securities Corporation during 1934 evidently loaned \$100,000 to the New York Post. This amount was increased by another \$100,000 during 1935 and was further increased during 1936. All loans to the New York Post were made on an unsecured basis except for the indorsement of David Stern.

Although Bankers Securities Corporation received a ten-percent commission for putting out the million dollars of New York Post bonds, and although Mr. Greenfield stated that it was the duty of Bankers Securities Corporation to sell this issue, he also definitely stated that Bankers Securities Corporation did not underwrite the issue; the Corporation was merely a financial agent for the New York Post.

Senator Joseph L. Guffey and Governor George H. Earle, 3rd, bought apparently \$50,000 of New York Post bonds each from Bankers Securities Corporation, on which the latter received a ten-percent commission; then Bankers Securities Corporation lent the \$50,000 to each of these individuals, taking as collateral its own preferred stock and the same New York Post bonds. The procedure was apparently similar to that employed in the earlier purchase of the Philadelphia Record. The loans to Governor Earle and Senator Guffey have been repaid.³⁵³

³⁵³ See pp. 2608-2609 for loans made by Utility and Industrial Corporation to H. M. ByDesby and Company and affiliated interests.

V. INVESTMENT IN THE SECURITIES OF OTHER INVESTMENT TRUSTS AND INVESTMENT COMPANIES

This section will discuss the abuses in the management of investment companies which result from the ownership by one investment company of the securities of another such company. At the outset, however, the magnitude of the investment by investment companies in the securities of other investment companies will be indicated.

A. Magnitude of Investment in Other Investment Companies

To a substantial extent the assets of investment trusts and investment companies between 1927 and 1936 included investments in the securities of other investment trusts and investment companies.¹ Investments in other investment companies (including both management investment companies proper and investment-holding companies²) not controlled by majority stock ownership, during the period 1927 to 1936 ranged from 4% to 7½% of the combined portfolios of management investment companies proper, other than the companies included in the Atlas Corporation and The Equity Corporation groups.³ The market value of such investments rose from \$12,300,000 in 1927 to a high of \$98,200,000 in 1929, and after a severe

¹ The State general incorporation laws, under which investment companies are incorporated, usually permit corporations without limitation to acquire the securities of any other corporation. See *Parker Corporation Manual* (1939) § 42 passim; *Del. Rev. Code* (1935) C-65 § 78. The Delaware law, for example, states:

Any corporation organized under the laws of this state, whether created by this Chapter, special Act of Legislature, or general law may guarantee, purchase, hold, sell, assign, transfer, mortgage, pledge, or otherwise dispose of the shares of the capital stock of, or any bonds, securities, or evidence of indebtedness created by any other corporation or corporations of this state or any other state, country, nation, or government, and while owner of said stock may exercise all the rights, powers, and privileges of ownership, including the right to vote thereon.

At present, therefore, no limitations, other than the voluntary limitations which may exist in the charters, by-laws, or trust indentures creating and defining the powers of investment trusts and investment companies, are imposed upon the powers of such companies or trusts to purchase the securities of other investment trusts and companies. The charters and by-laws of none of the 161 corporate management investment companies proper which replied to the Commission's questionnaire prohibited investments in the securities of other investment companies and trusts. Of the 161 companies, only 38 imposed any restrictions upon the investment policies which might be pursued by the corporate management. Of these 38 companies, only 5 set maximum limits for investments in the securities of other investment companies. Three companies specifically exempted investment company securities from the general limitations imposed upon their investment policies; one exempted investment company subsidiaries from its general restrictions or investments, and the charters of three companies expressly sanctioned the acquisition of controlling blocks of the securities of other investment companies. Part VI of the recently enacted Australian companies Act of 1938 (3 Geo. VI, No. 4602), entitled "Investment Companies Act, 1938" (3 Geo. VI, No. 4621, § 559), passed on December 22, 1938, to become effective on May 1, 1939, prohibits the purchase by any investment company of the shares or debentures of any other investment company. The Act defines an investment company as "any company which is engaged primarily in the business of investment in marketable securities for the purposes of revenue and for profit, and not for the purpose of exercising control. *Id.*, § 564.

² For the definitions of "management investment companies proper" and "investment-holding companies," see Part One of this report, *Nature, Classification, and Origins of Investment Trusts and Investment Companies* (1938), p. 26.

³ Part Two, Ch. VIII, pp. 561-2.

decline from 1930 to 1931 rose gradually to \$65,500,000 at the end of 1936. The following table⁴ indicates the market value at year-ends from 1927 to 1936 of the portfolios of all management investment companies proper (exclusive of the companies in the Atlas Corporation and The Equity Corporation groups) as well as the percentage and total value of such portfolio investments represented by the securities of other investment companies:

Year end	Market value total portfolio (\$000,000)	Percent invest- ment in securi- ties of invest- ment and invest- ment hold- ing companies	Approximate market value of holdings in investment and investment holding com- panies
1927.....	299.7	4.1	12.3
1928.....	590.9	4.6	27.2
1929.....	1,309.6	7.5	98.2
1930.....	1,027.4	6.0	61.6
1931.....	524.9	5.7	29.9
1932.....	472.0	6.0	28.3
1933.....	729.8	4.9	35.8
1934.....	753.2	3.7	27.9
1935.....	1,105.8	5.0	55.3
1936.....	1,423.5	4.6	65.5

Most of the management investment companies proper invested to some extent in the securities of other investment companies. At the end of 1927, 29 of 43 companies studied by the Commission or 67% had some investment in another investment company. At the end of 1929, of 116 companies studied at that year-end, 89, or 77% had such investments. After 1929 the proportion of all management investment companies proper holding securities of some other investment company declined so that at the end of 1936 there were only 88 such companies or about one half of all companies studied at that year end.⁵

In a number of management investment companies proper such investments made up a substantial part of the entire portfolio. At the end of 1929 there were 25 out of 116 companies or 22% of all investment companies in which investments in other investment companies represented over 10% of the value of the portfolio. In 1930 and 1931, the corresponding proportion remained about the same but after 1931 the relative number of companies with more than 10% of their portfolios so invested declined until, at the end of 1936, there were only 22 such companies or 13% of the 164 then included.⁶

In numerous instances the holdings by investment companies of the securities of other investment companies either constituted abso-

⁴ The figures in this table are derived from Part Two, Ch. VIII, Tables 206 and 207 (pp. 644-7).

⁵ Part Two, Ch. VIII, Table 210 (p. 654).

⁶ Part Two, p. 562. Most of these companies with a relatively large proportion of investment-company securities in their portfolios were of the closed-end leverage type. At the end of 1929, 20 of the 25 companies investing in other investment companies to the extent of more than 10% of their portfolio were of this type, and at the end of 1936 the corresponding securities of closed-end leverage companies was 16 as compared with the total of 22 companies. (Ibid.)

lute voting control or practical control. Investments and advances by management investment companies proper (other than the companies which were acquired and absorbed by The Equity Corporation and Atlas Corporation between 1929 and 1936) to parents and subsidiaries and investments in companies which subsequently became subsidiaries, at book values, rose from \$32,592,000 at the end of 1928 to \$37,924,000 in 1929, decreased to \$26,861,000 in 1931 and increased to \$26,642,000 in 1936.⁷ These figures include investments and advances to non-investment company subsidiaries. They do not, however, include the investments made by The Equity Corporation and Atlas Corporation in their one-time subsidiary investment companies and the investments of such subsidiaries in the securities of each other. Atlas Corporation and its investment company subsidiaries, in the course of the extensive program of Atlas Corporation between 1930 and 1936 to acquire and to absorb the assets of other investment companies by dissolution merger or consolidation⁸ expended approximately \$64,790,000 in the purchase of securities of other investment companies.⁹ In addition, Atlas Corporation, by exchanges of its own shares, acquired securities of its acquired and absorbed companies having an asset value at the date of the exchange of approximately \$53,348,000.¹⁰ Similarly The Equity Corporation and its subsidiaries between 1933 and 1935 expended a total of approximately \$7,105,000 in the purchase of controlling blocks of the stocks of United Founders Corporation (which itself was the parent company of five other investment companies), Reliance International Corporation and American, British & Continental Corporation.¹¹ In addition, The Equity Corporation acquired by exchanges of its own shares, securities of its subsequently merged or consolidated subsidiaries, having an asset value at the dates of the various exchanges of approximately \$7,539,000.¹²

All of the investment companies acquired by the Atlas Corporation had been dissolved or consolidated with Atlas Corporation at the end of 1936.¹³ The Equity Corporation, however, at the end of 1939 owned 60% of the common stock of American General Corporation, which was formed in 1935 as a consolidation of United Founders Corporation and its subsidiaries.¹⁴ American General Corporation recently reacquired voting control of General Invest-

⁷ Part Two, Ch. II, p. 69. A large proportion of these amounts is represented by the investment in 1928 of \$10,000,000 by the Dillon, Read & Company-controlled United States and Foreign Securities Corporation in 80% of the common stock of United States and International Securities Corporation. See Part Three, Ch. V, of this part of the Report, pp. 1715-17.

⁸ See Part Three, Ch. IV.

⁹ Public Examination, Atlas Corporation; Commission's Exhibit No. 1963.

¹⁰ Id., Commission's Exhibit No. 1962.

¹¹ See Part Three, Ch. IV, of this Report, and Part VII of the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938), at 216-7.

¹² Part VII of the Commission's Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees (1938) at p. 208.

¹³ See Part Three, Ch. IV.

¹⁴ See Part Three, Ch. IV, pp. 1485-99.

ment Corporation¹⁵ and in conjunction with General Investment Corporation acquired 49% of the common stock of Utility Equities Corporation.¹⁶

Excluding American General Corporation, 22 of 122 management investment companies proper in existence at the end of 1935, which were analyzed by the Commission, were the subject of substantial voting stock ownership by other investment companies.¹⁷ Of these 22 companies the voting stock of 18 was owned to the extent of more than 10% by other investment companies.¹⁸ In other words, investment companies were the parent companies of 18 other investment companies owning blocks of sufficient size to permit the exercise of influence or control.¹⁹ In addition to the fact that one out of every six management companies proper out of the 122 such companies analyzed was an "underlying" company of another affiliated investment company, the 22 underlying companies accounted for \$275,000,000, or approximately 27%²⁰ of the \$1,004,353,000 total assets of the 122 management investment companies. Of these 22 underlying investment companies, 18 were closed-end leverage companies with assets of \$234,000,000 (as com-

¹⁵ As of Dec. 31, 1939, American General Corporation held 64.6% of the preferred stock, 97.5% of the class A common stock, and 46.0% of the common stock of General Investment Corporation. See Hearings before a subcommittee of the Committee on Banking and Currency of the U. S. Senate, 76th Cong., 3rd Sess., in S. 3580, Pt. 3, p. 1102.

¹⁶ *Ibid.*

¹⁷ Part Two, Ch. V, at p. 414 et seq.

¹⁸ *Id.*, Table 123. The leverage companies substantial blocks of the equity voting securities of which were held by other investment companies at the end of 1935 were: American Capital Corporation, whose stock was 10.6% owned by Pacific Southern Investors, Inc., the common stock of which in turn was 39% owned by Pacific Investors, Inc., American London & Empire Corporation, whose common stock was 98.9% owned by Standard Investing Corporation; Atlantic Securities Co. of Boston, 100% of the common stock of which was held by Beacon Participations, Inc., Blue Ridge Corporation, 38.5% of the common stock of which was jointly held by American Cities Power & Light Corporation and Electric Shareholdings Corporation, both of which were controlled by Central States Electric Corporation through majority ownership of their voting stock; Illuminating and Power Securities Corporation, the common stock of which was 99.5% owned by Light and Power Securities Corporation; The Investment Company of America, 24.3% of the common stock of which was controlled by Pacific Southern Investors, Inc., 39% of the voting stock of which was in turn held by Pacific Investors, Inc.; Oils & Industries, Inc., 47.8% of whose common stock was controlled by Home & Foreign Securities Corporation; Public Utilities Corporation, 100% of the common stock of which was held by Light and Power Securities Corporation. Second Investors Corporation, 43.9% of the common stock of which was controlled by Investors Corporation; Second National Investors Corporation, 33.3% of the common stock of which was owned by National Investors Corporation; Securities Corporation General, 24.1% of the common stock of which was held by American Equities Co.; Selected Industries, Inc., with 24.8% of its common stock controlled by Tri-Continental Corporation; United States & International Securities Corporation, with 80% of its common shares controlled by United States & Foreign Securities Corporation, and Western New York Securities Corporation with 30.9% of its common stock controlled by Liberty Share Corporation. (*Ibid.*) The nonleverage companies whose stock was held in substantial blocks by other investment companies at the end of 1935 were: National Aviation Corporation, 19.7% owned by Aviation Securities Corporation of New England; Reybarn Co., Inc., 22% owned by Reynolds Investing Co., Inc., and Third National Investors Corporation 12.7% owned by National Investors Corporation. (*Ibid.*) National Investors Corporation, Second National Investors Corporation and Third National Investors Corporation, together with Fourth National Investors Corporation were consolidated in 1937 to form the present National Investors Corporation, an open-end management investment company. See Part Three, Ch. IV, pp. 1460-80.

¹⁹ Part Two, Ch. V, p. 414.

²⁰ *Ibid.*

pared with a total of 71 closed-end leverage companies with assets of \$602,000,000 included in the 122 companies studied) and 4 were closed-end nonleverage with total assets of \$209,000,000.²¹

To sum up, from 4% to 7½% of the total market value of the portfolios of management investment companies proper (excluding companies as the Atlas and Equity groups) for the 10-year period, 1927 to 1936, consisted of the securities of other investment companies.²² At the end of 1936 the dollar amount of investments in less than majority controlling blocks of other investment companies was still in excess of \$65,000,000. Over \$26,000,000 in addition was invested in the securities of subsidiaries, largely other investment companies, so that it can be estimated that a total of approximately \$90,000,000 at the end of 1936 was invested by investment companies proper in the securities of other investment companies.²³ This sum was over 5.7% of the total assets of \$1,566,200,000²⁴ held at the end of 1936 by management investment companies proper, excluding the companies in the Atlas Corporation and the Equity Corporation groups.

The lack of economic justification for the investment by one investment company in the securities of other investment companies and the unsound pyramiding of investment companies which has resulted will now be described.

B. Nonjustification for Investments in Securities of Other Investment Companies

1. UNWARRANTED DELEGATION OF MANAGEMENT FUNCTION AND DUPLICATION OF MANAGEMENT AND OPERATING EXPENSES

The essential function of a management investment company is the management and investment of the funds of its stockholders.²⁵ Presumably the investor purchases the securities of a particular company on the basis of his estimate of the management ability to invest his funds profitably, and at minimum expense. To the extent that the investors' funds are placed in non-controlling securities of other independently managed investment companies there is an unauthorized delegation of management function to the managers of the investment companies, the securities of which have been purchased.²⁶

²¹ Ibid. In no instance was an open-end company an underlying company, although the 122 companies studied included 27 open-end companies with aggregate assets of \$194,000,000. (Ibid.)

²² See supra.

²³ Ibid.

²⁴ See Part Two, Ch. II, p. 131.

²⁵ Earle Bailie, the chairman of the board of directors of Tri-Continental Corporation, testified (Public Examination, Tri-Continental Corporation, at 18874-5):

Q. I think you concurred in the idea that the most important element, of course, is management. That is all there is.

A. Exactly. * * *

²⁶ In its "statement on Investment Trusts" (See Part Two, Ch. IV, Appendix E, of this Report) issued on April 22, 1931, the Committee on Stock List of the New York Stock Exchange, said:

In the case of the acquisition of interests in other Investment Trusts the feeling of the Committee is that this procedure should in general be discouraged as containing within itself the possibility of unsound pyramiding, and an involving to a degree, the delegation to others of a responsibility for the investment of funds which the management had assumed in connection with the operations of their own company.

For this reason, James Rattray, a vice president of Vick Financial Corporation testified that his company had ceased to invest in the securities of other investment companies after 1930.²⁷

Q. Do you have any reactions on the advisability or feasibility of one investment trust purchasing the stock of another trust?

A. Well, our directors decided early in 1930 to dispose of all of our holdings in other investment trusts, and since then it took a little time to clean these things out.

Q. What motivated them in that decision?

A. Well, it was just the idea that people who owned our stock were looking to our management and if they wanted the management of another trust they would buy the stock of another trust.

Q. So that, isn't there really another element there in that they are not really getting your management but somebody else's management and are also being subjected to two investment-management loads?

A. Well, I think the element of the expense would be minor.

Q. In your case that would be so because you had no management contract?

A. Yes.

Q. But on the other hand, you could have the condition of the stockholders being subjected to a double load.

A. I can see that; yes.

Q. With the management of their own corporation relieving themselves of the investment obligations by acquiring stock in another investment trust?

A. Yes.

The investment in the securities of other investment companies also provides a means by which managements of investment companies with restricted investment policies may avoid such restrictions. On this point, Erwin Rankin, an officer and director of the various companies in the group formerly headed by United Founders Corporation,²⁸ testified:²⁹

Q. What do you think generally of investment trusts purchasing investments in other investment trusts?

A. I think on a general policy it is not wise to do so * * *

Q. But obviously isn't it, Mr. Rankin, that such purchases in other investment trusts really amount to a delegation?

It is suggested that the extent of such investment has some bearing on the propriety of them and on this account it is felt that investment trust management should keep their investment in other investment trusts within such bounds as to clearly relieve them of any possible justifiable criticism.

However, it must be noted that only 24 stock issues and 9 bond issues of investment companies were listed on the New York Stock Exchange at the end of 1936. (Part Two, Ch. IV, Table 91.) However, at the end of 1936 there were 404 management investment companies in existence. (Part Two, Ch. II, Table 2.) Furthermore, the only sanction possessed by the New York Stock Exchange to enforce compliance with its regulations is the delisting of the securities of offending companies.

²⁷ Public Examination, Vick Financial Corporation, at 3586-7.

²⁸ These companies, in addition to United Founders Corporation, included; American Founders Corporation; Investment Trust Associates; International Securities Corporation of America; Second International Securities Corporation; United States and British International Co., Ltd.; American and General Securities Corporation, and American and Continental Corporation. (See Part One, p. 100.) In November of 1935, United Founders Corporation and several of its subsidiaries were consolidated to form American General Corporation under the control of The Equity Corporation. See Part Three, Ch. IV, Section D.

²⁹ Public Examination, American General Corporation, at 24865-6.

A. That is right, it is unwise generally.

Q. We understand it to mean the delegation of the management?

A. That is right.

Q. Also it has a further disadvantage which may be the means of defeating investment restrictions, that is, if they have a company like International [International Securities Corporation of America, one of the companies in the Founders group] which has a restriction in dealing except in seasoned securities, you could easily avoid that by purchasing securities of investment trusts that have been in existence a long time but whose present portfolio consisted of unseasoned securities.

A. I never thought of that, but I agree with that thought.

Q. It is a way of delegating judgment and possibly delegating restrictions, a new corporate membrane to put in between yourself and it would be a possible way of avoiding restrictions, isn't that true?

A. Yes; I agree.

In addition to this delegation of management functions which is inherent in the investment by one investment company in a minority block of the stock of another such company, such investments also engender an uneconomic duplication of management and other operating expenses with a resulting diminution of the profits and income available for distribution to stockholders. Since the average ratio of operating expenses (including management expenses) of management investment companies to total assets of such companies was approximately 1%,³⁰ the total duplication of expenses based on year-end market values of the securities of other investment companies may be estimated to be in excess of \$4,400,000 for the ten-year period 1927 to 1936, inclusive.³¹ This figure was in excess of 5% of the total operating expense of \$86,000,000³² for all management investment companies proper for the same period. The \$4,400,000 figure moreover is an estimation of the duplication of expenses entailed by non-majority voting stock ownership of one investment company by another. It does not include the duplication of ex-

³⁰ See Part Two, Ch. II, p. 80, of this Report.

³¹ The following schedule indicates the market value of investment trust securities held in non-controlling blocks by other investment companies (see subsection A supra) and the estimated duplication of expenses, including management fees involved in such holdings on the basis of a ratio of expense to total assets of investment companies of approximately 1% :

Year	Approximate market value of holdings of other investment companies	Estimated duplication of expenses and management fees
1927	\$12,300,000	\$123,000
1928	27,300,000	272,000
1929	98,200,000	982,000
1930	61,600,000	616,000
1931	29,900,000	299,000
1932	26,300,000	263,000
1933	35,800,000	358,000
1934	27,900,000	279,000
1935	55,300,000	553,000
1936	65,500,000	655,000
Estimated total duplication of expense		4,420,000

³² Part Two, Ch. II, p. 80, of this Report.

penses involved in the superimposition one upon the other of investment companies controlling each other by majority voting stock ownership. The uneconomic non-elimination and duplication of expenses incident to holding company systems of investment companies will be described and illustrated later in this section.

William J. Thorold, the president of Federated Capital Corporation,³³ testified that his company did not invest in the securities of other investment companies because he "did not want to put a double load on management." Mr. Thorold testified:³⁴

Q. What was the reason for not including investment trusts [in the portfolio of Federated Capital Corporation]?

A. I think we considered that we could get the advantages of an investment trust by investing in these securities [the noninvestment company securities in the portfolio of Federated Capital Corporation].

Q. That is, you didn't want to put a double load on the management?

A. * * * Well, you have said it, we didn't want to put a double load on the management.

Raymond D. McGrath, a director of General American Investors Company, Inc., an investment company jointly sponsored and until 1935 jointly controlled by Lazard Frères and Lehman Brothers, two New York investment banking firms, testified that an investment by his company in 1929 of \$3,082,500 in 30,000 shares of the capital stock of The Lehman Corporation³⁵ was on hindsight an undesirable one. This investment, the largest individual investment ever made by General American Investors Company, Inc., constituted 7½% of the company's total assets at the time. Although General American Investors Company, Inc., had no management contract as such with its sponsors, it had compensated such sponsors for their management by issuing to them warrants to purchase 500,000 shares of its stock.³⁶ In addition, General American Investors Company, Inc., had its own research and other expenses. For the years 1930 to 1932, inclusive, during which the 30,000 shares of the stock of The Lehman Corporation were held intact by General American Investors Company, Inc., taxes paid and accrued and "other expenses" were, respectively, \$196,713, \$131,903, and \$138,025,³⁷ or a total of \$466,641. The total expenses of The Lehman Corporation from September of 1929 to June of 1932, including management fees paid to Lehman Brothers pursuant to a management contract, were \$1,378,859.³⁸ Since the stock of The Lehman Corporation held by General American Investors Company, Inc., was 3%³⁹ or more of total outstanding stock of The Lehman Corporation from 1929 to

³³ This company was organized by Mr. Thorold in 1927 but control of the company was acquired by Atlas Corporation in 1931. In 1935, Federated Capital Corporation, then more than 90% owned by Atlas Corporation, was dissolved. See Part Three, Ch. IV, p. 1278, et seq.

³⁴ Public Examination, Federated Capital Corporation, at 14522.

³⁵ Public Examination, General American Investors Company, Inc., at 5301-2.

³⁶ Id., at 5747, 5772.

³⁷ Reply to the Commission's questionnaire for General American Investors Company, Inc., Part I. (Annual Reports 1930-1932, inclusive.)

³⁸ Reply to Commission's questionnaire for The Lehman Corporation, Part I, Exhibits 8, 10, and 12.

³⁹ Id., Exhibits 7, 9, 11, and 13.

1932 inclusive, it can be estimated that \$41,366 of the total expenses of The Lehman Corporation from 1929 to 1932 or a sum equivalent to slightly less than 10% of the total expense of General American Investors Company, Inc., for the same period in effect represented a duplication of management and other expenses borne by the stockholders of General American Investors Company, Inc. Mr. McGrath testified as follows with respect to the undesirability of the ownership of the stock of one investment company by another such company:⁴⁰

Q. Do you think it is a wise thing, generally speaking, for an investment trust to invest in another investment trust?

A. At the present time, I do not.

Q. Doesn't it tend to double up management cost when you do a thing of that sort?

A. That becomes a very complicated discussion. I don't see why today in principle, that one investment trust should buy another. It doesn't seem correct in principle. There may be extenuating circumstances in individual situations.

In at least one case, that of American Investment Company of Milwaukee, substantial investments in the securities of other investment companies were made notwithstanding the fact that the purchasing company's income from interest and dividend on portfolio securities were insufficient to meet its operating and management expenses. During the year 1936 the income derived by American Investment Company as interest and dividends on its portfolio holdings was \$2,038.⁴¹ The company's operating expenses for the same year totaled \$3,128, of which \$2,175,⁴² a sum which in itself exceeded the company's income from portfolio holdings, was paid as management fees to Lando-Host & Company, the fiscal agents of American Investment Company. Moreover, during the year 1936 American Investment Company suffered a loss on the sale of portfolio securities of \$29,148.⁴³ From its inception in 1914 to December 31, 1926, the company had accumulated an operating deficit of \$540,793.52.⁴⁴

Nevertheless, despite the financial condition of the company, a substantial portion of its assets were invested in the securities of other investment companies with a consequent duplication of expenses. Of a total portfolio having a market value of \$75,384, approximately 33 $\frac{1}{3}$ %, or \$24,668, was represented by holdings of the securities of other investment companies.⁴⁵

⁴⁰ Public Examination, General American Investors Company, Inc., at 5805-6.

⁴¹ Reply to the Commission's questionnaire for American Investment Company, Annual Report, for the year ended December 31, 1936.

⁴² Ibid.

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Ibid. The securities held were the common stock and warrants of Air Investors, Incorporated; the common stock of American International Corporation and of Associates Investment Company; the common stock and warrants of Atlas Corporation; the common stock of The Equity Corporation; Investors Alliance Corporation, Mutual Investors Company; National Aviation Corporation; the common stock and warrants of National Investors Corporation and the common stocks of United States & Foreign Securities Corporation and United States & International Securities Corporation.

During 1937 a substantial amount of the investment company securities held by American Investment Company were sold,⁴⁶ and were replaced by the securities of industrial companies.⁴⁷ As at December 31, 1937, of a portfolio having a total market value of \$41,671,⁴⁸ only \$10,924, or 26% of the market value of the entire value of the entire portfolio, was represented by investment company securities. It is interesting to note that the decline in the holdings of investment company securities was accompanied by an increase in income derived from dividends and interest in portfolio securities. During 1937 the gross income from these sources was \$3,213, as compared with \$2,111 in the previous year.⁴⁹ And during the year 1937 the net income derived from dividends and interest in contrast to the previous year was in excess of operating expenses and management fees.⁵⁰

2. UNECONOMIC AND UNSOUND "PYRAMIDING" OF INVESTMENT COMPANIES

Of far greater significance than the considerations which have already been described is the fact that the unrestricted ability of one investment company to purchase the shares of a similar company opens the way to the application to investment companies of the holding-company device as a means for the centralization of the control and management of such companies. Fundamentally, the use of investment companies as holding companies for other investment companies is a denial of the purported economic function of such companies. Ostensibly, the purpose of the typical investment company is the investment of the funds contributed by its shareholders in a portfolio of diversified securities purchased in amounts which will not militate against their ready marketability. The purchase by one investment company of a large block of securities of another investment company violates the principle of diversification in that the investment, since it represents a majority or a substantial block of the outstanding securities of another company, and is not readily marketable. To argue that diversification of investments is effected through the medium of the subsidiary is merely to question the necessity for the holding company. Thus Ray Vance, formerly a director of Yosemite Holding Corporation, which was organized in November of 1929 with the express purpose of engaging in the acquisition of control and the management of other investment companies, testified:

Q. What economic justification is there for a holding company in investment trusts?

A. You want my personal opinion on that?

Q. Yes.

⁴⁶ The investment company securities sold were blocks of the common stock of Air Investors, Incorporated; Associates Investment Company and Atlas Corporation as well as warrants of National Investors Corporation. Reply to the Commission's questionnaire for American Investment Company, Annual Reports 1936 and 1937.

⁴⁷ Among such securities were the stocks of American Car & Foundry Company; American Zinc Lead and Smelting Company; Baldwin Locomotive Works; Boeing Airplane Company; Borg-Warner Corporation and Celanese Corporation of America. Holdings of Anaconda Copper Mining Company were also increased during the year. (*Ibid.*)

⁴⁸ *Ibid.* (Annual Report, American Investment Company, 1937.)

⁴⁹ *Ibid.*

⁵⁰ *Ibid.*

A. I don't think there is any. That was not my opinion six years ago, however; it is hindsight.

Q. It has no contribution to make, isn't that so?

A. I may be rather radical when I say there is no contribution made. It may be that there are situations set up which can be more readily carried out through a holding company than not. I don't have much to do in my work with that sort of stuff which is called negotiation work. From the standpoint of a man trying to handle a fund, I don't see much justification for a holding company. * * *

Q. From that idea I assume that ordinarily you would see no justification for pyramiding one trust on another.

A. You are asking my opinion again?

Q. Yes.

A. I don't think one trust should be pyramided on another under any ordinary conditions or any conditions that I can think of.

As will be described later, the pyramiding of investment companies intensifies management problems as well as increases the cost of management. In fairness to their stockholders, the varying and often conflicting capital structures of the controlled companies may require diverse rather than unified investment policies. Expenses and management fees of the companies in the group are also uneconomically duplicated.

a. Unsound Motivations for Pyramiding

(1) PERSONAL PROFITS IN SALE OF ONE COMPANY TO ANOTHER

In the past, pyramided groups of investment companies have been erected for reasons which have little justification from the standpoint of the investors in the constituent companies of the groups. In several instances, tiers of investment companies under common control have been constructed purely as a means of deriving personal profits for the controlling individuals. Thus, controlling individuals have personally purchased dominating blocks of the securities of other investment companies and have resold them at a profit to their controlled investment companies.⁵¹

⁵¹ For example, Wallace Groves acquired a control stock interest of Interstate Equities Corporation which he resold to Chain & General Equities, Inc., another of his controlled companies, at a profit. The controlling stock of Chain & General Equities, Inc., was in turn resold by Mr. Groves to Yosemite Holding Corporation, another of his controlled companies at a profit. At the conclusion of these profitable self-dealing activities on the part of Mr. Groves, Yosemite Holding Corporation controlled Chain & General Equities, Inc., which in turn controlled Interstate Equities Corporation. In December of 1932, Mr. Groves transferred his controlling interest in Yosemite Holding Corporation to The Equity Corporation in return for a controlling block of the latter's stock. The stock of The Equity Corporation was sold in May of 1933 by Mr. Groves to David Milton and his associates at a profit to Mr. Groves in excess of \$900,000. See Part Three, Ch. II, pp. 181-227.

Similarly, Philip A. Frear, Vincent Ferretti, and George H. Clayton derived substantial personal profits in the erection of a pyramided group of investment companies headed by Fiscal Management Company, Ltd., a personal holding company of these individuals, and including First Income Trading Corporation, Continental Securities Corporation, Corporate Administration, Inc., Administered Fund Second, Inc., and Reynolds Investing Company, Inc. See Part Three, Ch. II, pp. 354-437.

By the use of similar tactics, Donald P. Kenyon brought under his control a group of management investment companies and fixed and semifixed investment trusts at a substan-

(2) AS AN INTERMEDIATE STEP IN PROGRAMS OF MERGER AND CONSOLIDATION

In other instances, pyramided groups of investment companies were created particularly after 1929 as an intermediate step in programs engaged in by some investment companies to acquire control of, and eventually to dissolve, merge, or consolidate, a substantial number of investment companies.⁵² The purpose of these moves was to acquire additional assets at a total cost less than the actual value of such assets.⁵³ In the course of such activities which, to a substantial extent prior to 1941, were unregulated by any administrative or judicial authority, stockholders of controlled companies suffered a substantial reorganization of their rights, privileges, and monetary participations in the assets of their companies.⁵⁴ On the other hand, "insiders" were enabled to transfer their controlling shares to other investment companies for a consideration far in excess of the actual value of their shares. In fact, frequently the holdings of "insiders" had no asset values.⁵⁵ Frequently, the "insiders" after the sale of their holdings aided the acquiring investment company in the accomplishment of its objectives.⁵⁶ Morton H. Fry, at one time the director and president of Reliance International Corporation which eventually was absorbed by The Equity Corporation,⁵⁷ testified:

A. * * * Generally speaking, I think the practice of one investment trust acquiring substantial blocks of another investment trust is pernicious.

Q. Why?

A. Well * * * that is a long story.

Q. Will you tell us the principal points briefly?

A. Well, with very few exceptions, I have never known anybody to pay out good money for anything unless he expects to be reimbursed, to reimburse himself. With very few exceptions, the history of the acquisition of one investment

tial profit to himself. The companies pyramided one after the other by Mr. Kenyon included Alpha Shares, Inc., Monthly Income Shares, Inc. (New Jersey); Monthly Income Shares, Inc. (New York); United Sponsors, Inc., Universal Shares, Ltd., United Standard Oilshares Corporation; Investors Fund of America, Inc., and United Standard Oil Fund of America, Inc. See Part Three, Ch. II, pp. 309, 349.

⁵² The leading companies engaged in these programs were The Equity Corporation and Atlas Corporation. The Equity Corporation acquired control of, and absorbed or consolidated into a more simplified system, a total of 14 investment companies. Atlas Corporation absorbed a total of 22 investment companies. This use of the holding company is common also in other fields. "Although there are many cases throughout the history of business corporations where a merger or amalgamation has sprung at once in full blown existence, there are probably more cases, at least in recent years, where stock control has first been centralized in a pure holding company or in a parent company, later to be displaced by a complete fusion of the constituent companies." (Bonbright and Means, *The Holding Company* (1932) at 50.) The authors also state that "The promoters of the fusion have frequently made large individual purchases of the stocks of constituent companies. These purchases have usually been secretly made and the promoters have also frequently made confidential agreements with large stockholders and with some or all of the directors and officers of the constituent companies, whereby the latter persons have agreed to do all in their power to induce the other stockholders to assent to the fusion." (Ibid.) For instances of this character, in the field of investment companies, see Part Three, Ch. IV.

⁵³ See Part Three, Ch. IV.

⁵⁴ Ibid.

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Public Examination, The Equity Corporation at 1255-6, 1263.

trust by another during the period here under review will indicate that where the control was acquired it was acquired through the purchase of common stocks that had little, if any, asset value. They were acquired for sums of money in any event that were substantially in excess of their asset value. The history in most instances, I think, will also show that such acquisitions were inevitably followed by exchange offers [of securities]. The net result of which was to make up for the acquirer the amount of the premiums that he had paid for the underwatered stocks.

Q. That worked out often for the disadvantage of the person who was asked to make the exchange, did it not?

A. That is difficult to say. In some cases I think, undoubtedly, a better management was obtained. In other cases, the stockholder who was asked to make the exchange by making it, he got into a situation that had greater potentialities, assuming that he felt the markets were going to rise, and very often he got into an exchange of his security for a security that had a better marketability.

Q. But when you say that the acquirer having paid for the common stock more than the asset value which in some instances he subsequently made up by an exchange, it seems to me that that implies some disadvantage to the person on the other end of the deal.

A. That in itself implies some disadvantage, yes, but on the other hand, you have to balance against that disadvantage whatever advantage he may have subsequently by making the exchange. If he obtained advantages that were real, then he of course would expect to pay something for them.

* * * * *

I don't mean to imply that an offer of exchange or the amalgamation of two investment trusts is necessarily vicious. The terms of this exchange can be made on a basis that is mutually advantageous but, generally speaking, this paying of substantial premiums by one investment trust in order to acquire voting control of another one, I think in theory is a vicious one. * * *

(3) CENTRALIZATION OF CONTROL OF WEALTH AND INDUSTRY BY DEVICES OF PYRAMIDING AND CIRCULAR OWNERSHIP

Another important factor which motivated the formation of a holding-company system of investment companies, particularly leverage investment companies, is its effectiveness as a device to centralize in a few individuals an extensive control over wealth and industry.⁵⁸ Control of a parent leverage investment company can be

⁵⁸ For detailed instances of this use of systems of investment companies see Part Four "Control of Industry by, and Economic Significance of, Investment Companies." The acquisition of control of The Equity Corporation and its subsidiaries by David Milton, Ellery Huntington, and their families is illustrative of the effectiveness of investment company systems as a means of acquiring control of large aggregates of wealth without the necessity of a substantial investment in the enterprise. During 1932 Messrs. Milton and Huntington on a personal investment of approximately \$175,000 and the use of the funds of Atlantic and Pacific International Corporation (see Part Three, Ch. IV, pp. 1120-38) a publicly owned investment company, control of which had been obtained by Messrs. Milton and Huntington without any expenditure of their own funds (ibid.) had acquired through personal holding companies a controlling interest in two inactive life insurance companies. In May of 1933, Messrs. Milton and Huntington agreed to purchase for \$900,000 the controlling block of the common stock of The Equity Corporation held by Wallace Groves. At this time, The Equity Corporation controlled Allied General Corporation, Yosemite Holding Corporation, Chain & General Equities, Inc., and Interstate Equities Corporation, all of which were leverage investment companies largely through the ownership of their negative asset value common stock. The total assets subject to the

acquired by relatively small investment in its equity securities as compared with the capital contributed to the company by the sale of senior securities to the public. With the funds thus derived from the public investments can be made in the equity securities of other leverage investment companies. In this manner large sums of public funds with only a limited interest in the profits of the enterprise and without any effective voting interest in the system of companies can be brought under the control of an individual or group of individuals whose financial stake in all of the constituent companies of the group is comparatively nominal.⁵⁹

Perhaps for this reason the pyramiding of investment companies predominantly involved leverage companies. As has already been indicated, of the 18 investment companies at the close of 1935 which were the subject of voting stock ownerships in amounts of 10% or more by other investment companies, 15 were closed-end leverage companies.⁶⁰ The voting stock of these underlying companies not only controlled funds applicable to all the voting stock, but the funds applicable to the senior securities which usually had no effective vote.

An analysis was made of 17 of these underlying investment companies, more than 10% of whose total outstanding voting stock was held by other investment companies. Five companies, representing 29.4% of the number and 27.4% of the total assets of the group of 17 companies, had more than 50% of their voting stock held by affiliated investment companies, while 10 companies, representing 58.8% of the number and 56.5% of the total assets of the 17 companies, had more than 30% of their voting stock held by affiliated investment companies, leaving 7 companies in which from 10% to 30% of the voting stock was owned by affiliated interest.⁶¹ With respect to the three cases where one top or controlling investment company was in turn con-

control of The Equity Corporation were approximately \$6,500,000, the bulk of which were held by Interstate Equities Corporation and which on any dissolution of Interstate Equities Corporation would have inured entirely to its preferred stock, which was almost entirely held by the public. To acquire control of The Equity Corporation, Messrs. Milton and Huntington with at least the tacit consent of Wallace Groves sold the controlling blocks of the stocks of the two insurance companies in which they had personally invested \$175,000 to Interstate Equities Corporation for \$900,000. The \$900,000 was then turned over to Mr. Groves as consideration for the transfer by Mr. Groves of his controlling block of the common stock to companies controlled by Milton and Huntington. By this transaction Messrs. Milton and Huntington retained control of the two insurance companies and acquired control without any further investment of an additional \$6,000,000 of assets. With these assets Milton and his associates were enabled to acquire (1) a 38.7% voting interest in American General Corporation (which was formed in 1935 as a consolidation of United Founders Corporation and its subsidiaries) and which possessed assets of \$53,677,648; (2) a 36% voting interest in General Reinsurance Company which controlled the North Star Insurance Company and which possessed gross assets on a consolidated basis of \$14,942,490; and (3) a 93% interest in General American Life Insurance Company which at the end of 1935 had assets in excess of \$124,392,388. (Public Examination, The Equity Corporation, at 7877-9.) At the end of 1935 Milton and his associates, whose total investment in The Equity Corporation group of investment and insurance companies did not exceed \$175,000, were in control of assets having an aggregate value of approximately \$205,000,000. See Part Three, Ch. IV, pp. 1039-43.

⁵⁹ Compare the amount of the investments made by Henderson Brothers, Harrison Williams, Jonathan Lovelace and his associates, and J. & W. Seligman & Company with the total assets of the groups of investment companies which are under their control. These groups of investment companies are discussed in this section.

⁶⁰ See *supra*, p. 2726.

⁶¹ See Pt. Two, Ch. V, p. 415.

trolled by another investment company, the degree of control held by the top company was greater than the control held by the intermediate company.⁶²

These 17 investment companies were the subject of voting stock ownership by affiliated investment companies numbering 19 in all and having combined assets of \$271,000,000. Of these companies, 15 were top companies and 4 intermediate companies. All of these 19 companies were closed-end companies, of which 7 were of the investment-holding company type. With respect to the intermediate companies, 3 of the number were nonleverage and 16 were leverage. These 3 nonleverage companies accounted for only 3.7% of the total assets of the 19 companies, while the 16 leverage companies represented 96.3% of these assets. With respect to the 15 top companies, only 2 were nonleverage and 13 were leverage companies. The total assets of these 15 top companies were \$198,000,000, of which the two nonleverage companies accounted for only 1%, while the 13 leverage companies accounted for 99%.⁶³

It is clear, therefore, that parent investment companies were predominantly leverage companies, just as the underlying investment companies were leverage companies. So, too, the parent companies were leverage companies where the funds of the senior security holders controlled by the common stock could be used to acquire control of underlying investment companies. The technique usually employed, therefore, was to superimpose a company with leverage capital structure upon a company with a leverage capital structure. By this method the public's funds could be used to purchase control of the underlying leverage company with resultant control of its senior security holder's funds.

The centralization of control of a group of investment companies may also be intensified by the device of having the companies in the group own substantial blocks of each other's voting securities. By the employment of this device of circular ownership the interlocking board of directors of the companies may perpetuate their management.⁶⁴ Under such an arrangement the difficulties of a successful stockholders' opposition is greatly increased, for a successful attempt to dislodge this control would necessarily require that it be launched simultaneously in each corporation, in order to avoid being crushed by the reciprocal influence of the common management.⁶⁵

⁶² *Ibid.*

⁶³ *Id.*, at 418.

⁶⁴ Other aspects of the problem of circular ownership will be discussed later in this section.

⁶⁵ The state corporation laws commonly forbid the management of corporations to vote treasury shares—that is, shares which have been issued and reacquired by the corporation. See e. g., Del. Rev. Code (1935), C. 65, § 19. Where the cross holdings constitute a majority of the voting shares of the companies involved, the courts have condemned the arrangement as a device to separate management from ownership of the corporation. It has been held under the Delaware Law, *supra*, which provides that “shares of its own stock belonging to the corporation shall not be voted upon directly or indirectly” that parent company held by a 99% controlled subsidiary could not be voted to elect directors of the parent company. *Italo Petroleum Corporation of America v. Producers Oil Corporation*, 20 Del., Ch. 283, 174 Atl. 276 (1934); see also *O'Connor v. International Silver Co.*, 68 N. J. Eq. 67, 59 Atl. 321 (1904), *aff'd*, 68 N. J. Eq. 680, 62 Atl. 408 (1905). And the New Jersey Court of Chancery has held that an arrangement for cross holdings of majority stocks of two corporations under common control for the purpose of perpetuating such control violates general principles of equity jurisprudence. In *Robotham v. Prudential Ins. Co. of America*, 53 Atl. 842

Circular ownership has not been uncommon among investment companies. For example, at December 31, 1935, Consolidated Oil Corporation held 39% of the voting shares of Petroleum Corporation of America, and the Petroleum Corporation held 11.3% of the voting shares of Consolidated Oil Corporation. This situation established a circular arrangement by which the management of these corporations was aided in perpetuating its control over both. Concerning this situation, Hunter Marston, a director of Petroleum Corporation, testified:⁶⁶

Q. The situation at the present time is, is it not, Mr. Marston, that Consolidated Oil Corporation owns approximately 39% of Petroleum Corporation, which in turn owns approximately 11.3% of Consolidated Oil Corporation. Isn't that so?

A. I believe that is correct.

(1903), the directors of The Prudential Life Insurance Company, who were also the owners of a majority of its voting stock, devised a scheme to perpetuate their control for the purpose, it was alleged, of putting "The assets of the company forever beyond the reach of ruthless speculators, who, when the stock has become scattered, might acquire it, even at fancy prices, for the purpose of manipulating its assets * * *." The plan devised was to cause the Fidelity Trust Company, half of whose directors were the directors of the Prudential Insurance Company, to acquire a majority of the shares of the insurance company from such directors and other stockholders of the insurance company. Thereafter the Prudential Insurance Company was to purchase a majority of the stock of the Fidelity Trust Company. In addition, it was planned that "the annual meetings of the two companies will be so arranged, and other arrangements will be so made that The Prudential Company will forever be the dominant factor, as, of course, it should be." On the suit of minority stockholders of Prudential Life Insurance Company the court issued an injunction restraining the insurance company from purchasing the majority of the stock of the Fidelity Trust Company.

In its opinion, the court said:

without undertaking to discuss further the interesting legal questions to which such cross purchases of stock may hereafter give rise, I desire merely to point out that, under general principles which already have been established in our courts of equity, the scheme which these ingenious men have proposed for, excluding the beneficial owners of the stock of The Prudential Company from the management of its affairs, might, after all, prove abortive if now or at a later stage of its development it should be put to the test. The whole scheme is built upon fictions which our law maintains as necessary and valuable for many purposes, but which equity nowadays frequently casts aside for the prevention of fraud and the accomplishment of justice. It is true that, in every case where one corporation acquires a majority of the stock of another corporation, the board of directors of the latter may be chosen, not by a majority but by a minority of all persons beneficially interested in its stock, but in every such case at least a majority of a majority in interest ultimately controls the election of directors; nor does the situation involve a self-perpetuating syndicate not necessarily based on a substantial interest in the properties which it controls.

It seems to me that the disqualification of these * * * directors to adjudicate finally that their scheme for exchange of control is advantageous to the Prudential Company is clear and absolute. That the proposed scheme, if carried into effect, will directly and necessarily benefit these * * * directors and secure to them great emoluments and power, is a fact beyond dispute. The salaries and other advantages controlled by the directors of an insurance company holding today nearly \$60,000,000 of assets * * * constitute a personal prize of very great magnitude. It is not an answer to this proposition to say that these directors already hold the prize in their possession. They do not hold it in perpetuity for themselves and those successors whom they will personally select from time to time as death makes vacancies in their board. The effect of the scheme is to prevent them and their chosen successors from losing the prize after they have ceased to own beneficially the majority interest in the stock which now keeps the prize in their possession. These * * * directors have never made an independent and unselfish adjudication that this scheme will be beneficial to the Prudential Company. They do not exclude themselves from the charmed circle which their scheme contemplates. They propose to sit therein to the exclusion of other stockholders.

A similar result would apparently be reached where the cross holdings did not represent majority control, but constituted an effective "working" control. However, in the latter situations the minority stockholder may be burdened with the difficult task of proving "working" control and domination of the various corporations by the common management.

Even if treasury-held or subsidiary-held voting shares are stripped of voting power the result is to decrease the number of shares needed to exercise control.

* Public Examination, Petroleum Corporation of America, at 2859-60.

Q. The merger has been effected, has it not?

A. Yes, sir.

Q. And I assume one of the purposes of the trust has been accomplished, namely, the effecting of the merger which took place in March 1932?

A. Yes.

Q. Do you know the reason why Petroleum still holds that 1,582,000 shares of Consolidated Oil Corporation stock?

A. I think it is my hope, speaking individually that this Consolidated Oil stock is eventually going to retrieve its decline and that this consolidation will achieve a pretty good record of earnings. * * *

Q. Here we have a situation, Mr. Marston, where over 60% of the stockholders' interest in Petroleum Corporation is represented by the Consolidated Oil Corporation, isn't that so?

A. Correct.

Q. Why—and I am just thinking out loud—isn't Petroleum Corporation dissolved and the stockholders given their aliquot interest in Consolidated Oil Corporation, because substantially that is what they are—stockholders in Consolidated to the extent of over 60% of the assets anyway.

A. The Petroleum Corporation engages in other activities. They buy and sell shares in other oil companies * * * and the holding of Consolidated Oil stock is being continued on the theory that there is going to be an appreciation.

Q. And isn't it also one of the consequences that * * * the dominant interest in the Consolidated Oil Corporation maintains control of the Consolidated Oil Corporation, by virtue of the fact that they control Petroleum Corporation, which in turn controls over 11% of Consolidated Oil; isn't that so?

A. I wouldn't say they controlled. They have a dominant interest so far as percentages go.

Mr. Marston conceded⁶⁷ that by reason of the wide diffusion of the Petroleum Corporation stock (the next largest stockholder after Consolidated Oil Corporation owned only 44,600 shares, less than 2½% of the total amount outstanding)⁶⁸ Consolidated Oil Corporation had "potential working control in any situation." He testified further:⁶⁹

Q. By virtue of the fact that they owned this 39% of Petroleum Corporation, which in turn owns 11% of Consolidated Oil Corporation, the management of Consolidated Oil Corporation can, if it sees fit, have the stock of Consolidated Oil Corporation owned by Petroleum Corporation voted as they see fit; isn't that so?

A. Subject to—if it were at the request and with the approval of the Board of Directors.

Q. And if the Board of Directors did not do what they were told there would be another election at the end of the year; isn't that so?

A. I don't know. I doubt it.

Q. * * * if the most substantial stockholder owning 39% does not like what the board of directors does, he pretty much can turn them out at the next annual election. Is there any doubt about that, Mr. Marston?

A. Well, if there were not a proxy fight.

⁶⁷ Id., at 2863.

⁶⁸ As at Dec. 31, 1935, Petroleum Corporation had 2,010,160 shares of stock outstanding. (Reply to the Commission's questionnaire for Petroleum Corporation, Item 28.)

⁶⁹ Public Examination, Petroleum Corporation of America, at 2863-4.

Q. Well, in order to beat him you would have to get substantially every other stockholder of the corporation to oppose him, isn't that so?

A. You would have to get a very substantial amount.

Q. If, on the other hand, Petroleum Corporation were dissolved, and if you had a distribution of its portfolio securities and Consolidated Oil Corporation was to get its proportionate share of the Consolidated Oil Corporation's stocks in the portfolio of Petroleum Corporation, that stock would then become treasury stock and it could not vote it at all; isn't that so?

A. I don't know the legal status on that.

* * * * *

Q. The point I am trying to make is: Isn't it to the interest of the management of Consolidated Oil Corporation that this arrangement be kept alive, because by virtue of their ownership of 39% in the Petroleum Corporation they control 11% of Consolidated Oil Corporation.

A. I don't know. I haven't discussed that situation.⁷⁰

At the end of 1929, substantial cross-holdings of voting stock erected among Reybarn Company, Investors Equity Company, Inc., Reynolds Investing Company, Inc., and Selected Industries, Inc., all of which were cosponsored and managed by Reynolds & Company and C. D. Barney & Co., members of the New York Stock Exchange. Of the voting stock of Reybarn Company 21.8% were held with this group of companies; 10.6% of the voting securities of Investors Equity Company, Inc., was held within the group; 13.5% of the voting stock of Reynolds Investing Company, Inc., was held by the other companies and 7.7% of the common stock and 17.7% of the preferred stock (which had voting rights) of Selected Industries, Inc., was held within the group. Similarly from July to December 9, 1929, Shenandoah Corporation, the common stock of which was 40% controlled by Central States Electric Corporation and 40% controlled by The Goldman Sachs Trading Corporation, held in its portfolio approximately 5% of the voting stock of The Goldman Sachs Trading Corporation and approximately 5% of the voting stock of Central States Electric Corporation.⁷¹ And during the year 1933 the American Capital group of investment companies,⁷² that is, American Capital Corporation, Pacific Southern Investors, Inc., and The Investment Company of American, all held cross-holdings of each others' securities in blocks of sufficient size virtually to perpetuate the control of the common management of the companies. At the end of 1933 American Capital Corporation held 40% of the voting stock of Pacific Southern Investors, Inc., which in turn held 45.9%

⁷⁰ On the same subject Earl Sinclair testified (id., at 3097):

Q. The Sinclair Consolidated Oil Corporation does not vote its stock, treasury stock, on any matters involving corporate affairs, does it?

A. No.

Q. Of course, if there had been a distribution of the Consolidated Oil Corporation shares and Consolidated Oil Corporation was to get its 39 percent of Consolidated Oil Corporation stock, which is held by Petroleum Corporation, of course, the Consolidated Oil Corporation could not vote that stock on any matters, could it?

A. Oh, no.

Q. But by virtue of the fact that it owns 39 percent of the Petroleum Corporation, which in turn owns 11 percent of Consolidated Oil Corporation, substantially Consolidated Oil Corporation can vote that stock; isn't that so?

A. We have never seen the necessity yet for the Petroleum Corporation proxies. I might tell you at our last stockholders meeting we had proxies for something in excess of 10,000,000 shares.

⁷¹ See *infra* this section.

⁷² See *infra* this section.

of the voting stock of Investment Company of American which, in turn, held 10.4% of the voting stock of American Capital Corporation. As will be described later, during the year 1934 these links of circular ownership were severed but in a manner which did not disturb the future control of these companies by their common management.

(4) INEQUITABLE DISTRIBUTION OF PROFITS OF PYRAMIDED COMPANIES TO ORGANIZERS

In addition to its usefulness as a means of concentrating control of public funds in the hands of a few individuals as a minimum of personal investment, the superimposition one upon another of leverage investment companies insures to the individuals controlling the parent company a major participation in the profits of the entire group of companies because of the fact that an appreciation in the value of the assets of leverage investment companies causes a greater appreciation in the asset value of the common stocks of such companies.⁷³

In a pyramided group of leverage companies, large blocks of the common stock of each member of the group are held by one or more of the other companies in the group, and the majority of the common stock of the parent company is usually concentrated in a few individuals, who, because of the superimposition of "leverage" stocks upon leverage stocks, are placed in a position to derive a substantial proportion of the profits of the entire group of companies after payment of the fixed charges upon the senior securities issued by such companies.⁷⁴ The public which had purchased the senior securities of the company normally has received only a comparatively small block of the common stocks of the various companies in a pyramided group.

The pecuniary advantage to controlling groups of the pyramiding of leverage common stocks of investment companies is exemplified by the history of the creation of United States & Foreign Securities Corporation and United States & International Securities Corporation, two management investment companies controlled by Dillon, Read & Company, New York investment bankers.⁷⁵

United States & Foreign Securities Corporation was organized in Maryland on October 9, 1924, under the sponsorship of Dillon, Read & Company. Its capitalization consisted of a 6% cumulative dividend first preferred stock with a liquidating preference in assets of \$100 a share and without voting right, except in a default in the payment

⁷³ The term "leverage" . . . is applied to investment companies which have outstanding senior securities with fixed or relatively fixed maximum participations in the corporate assets and earnings. Because these claims, while having precedence over the rights to the company's assets belonging to the holdings of the common stock, yet are to fixed or only slightly variable amounts of money, any increase or decrease in the value of the total assets of a leverage company will be reflected in its entirety in the equity of the common stock. As a consequence, a given change in the total assets will give rise to a more than proportionate change of the equity of the common stock. (Part One, p. 28, of this Report.)

⁷⁴ However, because of "leverage" a decline in the value of the assets of the pyramided group of leverage investment companies would cause a greater decline in the asset value of the common stock of such stock companies. (Ibid.)

⁷⁵ For other illustrations see the discussion of the Central States Electric Corporation group of investment companies and investment holding companies, *infra*, and Part Three, Ch. V.

of four consecutive dividends; a 6% cumulative dividend second preferred stock with a similar liquidating preference, and without voting rights; and a common stock.⁷⁶ The company's securities were distributed as follows: 250,000 shares of the first preferred stock and 250,000 shares of common stock were sold to the public by Dillon, Read & Company for \$25,000,000 of which \$1,000,000 was retained as underwriting commissions by Dillon, Read & Company and the dealers associated with them in the distribution of the securities.⁷⁷ Dillon, Read & Company retained \$339,000 as its share of the \$1,000,000 selling commission.⁷⁸ Dillon, Read & Company itself purchased all of the issued 50,000 shares of the second preferred stock and 250,000 shares of common stock for \$5,000,000. The various partners of Dillon, Read & Company purchased 500,000 shares of common stock for a total consideration of \$100,000, or at a price of 20 cents per share.

At the conclusion of the financing of United States & Foreign Securities Corporation it had received \$29,100,000 and had issued in consideration therefor 250,000 shares of first preferred stock; 50,000 shares of second preferred stock and 1,000,000 shares of common stock. The public which had contributed \$24,000,000 to the capital of the corporation, after deducting \$1,000,000 retained by Dillon, Read & Company and its associate bankers as selling commission, had received securities representing only 25% of the voting power of the corporation. Dillon, Read & Company on the other hand had received 75% of the investment company's securities on an investment of \$5,100,000 or about one-sixth of the investment made by the public in the company. Furthermore, after payment of the fixed dividends on the first preferred stock held by the public and on the second preferred stock held entirely by Dillon, Read & Company, the firm and its partners individually as the holders of 75% of the common stock would be entitled to 75% of the profits of, and appreciation in, the assets of the investment company. This disproportionate share in the profits and appreciation in assets of the investment company would accrue to Dillon, Read & Company largely in the result of any profitable investments made by the company with the funds of the public stockholders who had contributed in excess of 80% of the total capital paid.

At the inception of United States & Foreign Securities Corporation, its common stock had no asset value since its total assets of \$29,100,000 was exceeded by the new liquidating preference in assets of \$30,000,000 of the first and second preferred stocks. In fact, the assets of the company were insufficient by \$900,000 to cover the liquidating preference of the second preferred stock held by Dillon, Read & Company. However, by September 30, 1928, the total assets of United States & International Corporation had increased to about \$52,950,000. After deducting the amount of liquidating preferences on the two classes of junior securities the common stock had an asset value of \$22,950,000. The 750,000 shares of common stock of the investment company which Dillon, Read & Company and its partners

⁷⁶ Public Examination, United States & Foreign Securities Corporation, Commission's Exhibit No. 1160.

⁷⁷ Public Examination, United States & Foreign Securities Corporation, at 11722-23.

⁷⁸ Hearings before Committee on Banking and Currency, U. S. Senate, 73d Cong., Stock Exchange Practices, Pt. 4, p. 1566.

had acquired for a total consideration of \$100,000 had, largely because of the "leverage" made possible by the investment public's funds contributed to the company for its senior securities, acquired an asset value of approximately \$17,213,000.

At this point, however, the proportion of the corporate assets applicable to the common stock was almost equal to that applicable to the company's senior securities.

However, in October of 1928, Dillon, Read & Company organized United States & International Securities Corporation and sold its first preferred stock and 500,000 shares of its common stock to the public for proceeds of \$50,000,000, to the new corporation. United States & Foreign Securities Corporation invested \$10,000,000 in the purchase of all of the second preferred and 80% of the common stock of the new company. This \$10,000,000 so invested by United States & Foreign Securities Corporation might have been utilized to pay dividends on its common stock, 25% of which was held by the public.¹⁹ However, the flotation of United States & International Securities Corporation was advantageous to Dillon, Read & Company. In addition to deriving net commissions of \$1,065,000²⁰ on the sale of the new company's first preferred stock to the public, Dillon, Read & Company, by the device of causing United States & Foreign Securities Corporation to purchase for \$10,000,000 a controlling voting interest in the new company, acquired ultimate control of in excess of \$100,000,000 of funds and derived a substantial portion of the leverage imparted to the common stock of United States & Foreign Securities Corporation by the \$50,000,000 of funds contributed by the public for the senior securities of its new subsidiary. Moreover, following the organization of United States & International Securities Corporation, members of the firm of Dillon, Read & Company succeeded in selling 120,552 shares of their holdings of the common stock of United States & Foreign Securities Corporation to the public for proceeds of \$6,843,380, a sum \$1,743,380 in excess of the total investment of \$5,100,000 made by the firm and its individual partners. In other words the firm and its partners had made a profit of \$1,743,380 in their investment in United States & Foreign Securities Corporation and still retained all of the second preferred stock and 629,448 shares of the common stock of United States & Foreign Securities, or 62.9% of such stock outstanding. This remaining security interest in United States & Foreign Securities Corporation thus ultimately cost Dillon, Read & Company and its partners nothing. Yet it enabled them to retain control and to derive the leverage advantage of \$75,000,000 of public funds contributed to the two companies as consideration for their senior securities. The funds of United States & International Securities Corporation which were used in 1929 to acquire substantial blocks of the voting stocks of the St. Louis-San Francisco Railway Company and of the Chicago, Rock Island & Pacific Railway Company may have been at least a factor in the acquisition of a portion of the banking business of these roads by Dillon, Read & Company in 1931.

¹⁹ See Report of U. S. Senate Committee on Banking and Currency on Stock Exchange Practices, pp. 340-1.

²⁰ *Id.*, p. 338.

b. Development of Major Existing Pyramided Groups

(1) THE HENDERSON BROTHERS GROUP

The history of the acquisition of control of a system of investment companies by Henderson Brothers of Boston illustrates the ease with which large sums of public funds may be dominated by a small group having only a comparatively nominal investment in the various companies and who are without previous experience in the operation and management of investment companies.

Prior to July 1934 Henderson Brothers of Boston, who were then primarily engaged in the retail distribution of radios, electric refrigerators, and washing machines⁸¹ had a substantial interest in only one small investment company known as the World Investment Trust.⁸² Thereafter between July 1934 and March 1937, Henderson Brothers acquired at a nominal expenditure of between \$40,000 and \$80,000 control of Beacon Participations, Inc., Atlantic Securities Company of Boston, Allied International Investing Corporation, Standard Investing Corporation, International Equities Corporation, General Investment Corporation, and Utility Equities Corporation. The aggregate assets of these companies, allocable almost entirely to the public holders of the senior securities of these companies, were approximately \$35,000,000.⁸³

The first company included in the Henderson Brothers system was Beacon Participations, Inc.

Beacon Participations, Inc., an investment company of the general management type, sponsored by the Beacon Trust Company,⁸⁴ was organized under the laws of Massachusetts in May 1928, with a capitalization of 100,000 shares of Class A participating preferred stock, 25,000 shares of Class B participating preferred stock, and 25,000 shares of no par value common stock having sole voting power.⁸⁵ All of the authorized Class B stock and common stock was issued to the Beacon Trust Company of Boston for \$500,000.⁸⁶ As of July 1934 the First National Bank of Boston held all of the Class B and common stock and 1,743 shares out of 42,092 shares outstanding of the Class A participating preferred stock.⁸⁷

At the end of 1933, the market value of the assets of Beacon Participations, Inc., was \$266,557, having shrunk from \$2,450,912, the original capital contributed to the company. The asset value of the Class A participating preferred stock was only \$6.50 per share although such stock was entitled upon liquidation to \$20 per share and accrued unpaid dividends which in June 1934 totaled \$2 per share.⁸⁸ Accordingly, the Class B participating preferred stock and the common stock

⁸¹ Public Examination, General Investment Corporation, at 15311-12.

⁸² Id., at 15313-14.

⁸³ Public Examination, General Investment Corporation, at 15348.

⁸⁴ Reply to the Commission's questionnaire for Beacon Participations, Inc.

⁸⁵ Ibid.

⁸⁶ Ibid.

⁸⁷ The Beacon Trust Co. was merged into the Atlantic National Bank in July 1930 and the assets of this latter bank were taken over by the First National Bank of Boston in May 1932.

⁸⁸ Reply to the Commission's questionnaire for Beacon Participations, Inc., Part IV (letter to stockholders of Beacon Participations, Inc., June 19, 1934).

held at this time by the First National Bank of Boston were without asset value,⁸⁹ and, in addition, had no market value.⁹⁰

Nevertheless, on June 29, 1934, Henderson Brothers purchased from the First National Bank of Boston its holdings of 25,000 shares of the Class B participating preferred stock and the 25,000 shares of the common stock of Beacon Participations, Inc., for \$10,000, which was supplied in part by Henderson Brothers personally and in part by their controlled World Radio Corporation.⁹¹ By virtue of the acquisition of all of the issued and outstanding common stock for the comparatively small sum of \$10,000, Henderson Brothers were in a position to control the \$266,000 of assets of Beacon Participations, Inc.

That the power to control the investment of the entire assets of Beacon Participations, Inc., was the motivating factor in the purchase of its negative asset value common stocks is evident from the following testimony of Ernest F. Henderson:⁹²

Q. So that the stock you bought for \$10,000 had no asset value at all?

A. That is correct.

Q. And the fact of the matter was the preferred stock would have to come back three-fourths before the stock you bought was worth a nickel?

A. Have to come back four-fold.

Q. Before your common stock would be worth a nickel?

A. That is right.

Q. For which you paid \$10,000?

A. Yes, sir.

Q. For that reason it was worth \$10,000 of the World Radio's money to get control of a quarter million dollars?

A. We considered it an investment. We thought some time or other we would make money.

Q. The assets of that corporation would have to increase four-fold before you would ever see a dime?

A. In the form of liquidating value of assets applicable to it.

Q. The only way you can make money out of stock is either there is money behind the stock or in the treasury or market value?

A. That isn't correct, because a stock always has a value even if it has no asset value.

Q. It always has a value because people like Henderson Brothers and World Wide Radio are willing to pay that money in order to get control of the money in the corporation; isn't that so?

A. That is a difficult question.

Q. I intended it as a difficult question. You said there wasn't a dime behind that stock. The fact of the matter, the preferred was three quarters under water and the assets would have to come back four-fold before you came in there and got a nickel.

A. That is true.

Q. The other way you could get money for that security was there was somebody in the market willing to buy.

A. That is right.

⁸⁹ Public Examination, General Investment Corporation, at 15316-18.

⁹⁰ *Ibid.*

⁹¹ *Id.*, at 15315.

⁹² *Id.*, at 15316.

Q. You say it always has a value even though there is no market and even if there is no liquidating value, and it seems to my mind the only value it has is of course there is a quarter of a million dollars there and you would be able to manage that.

A. That is an involved question. We worked on the theory except in liquidation where naturally all securities would be wiped out they always have an interest.

Q. Let's see what your interest is. How could you put your hand on that money except in liquidation? And in the event of liquidation the preferred stockholders would get the money?

A. In event of liquidation we would be wiped out completely.

Q. That was the time I was talking about. You would not get a nickel through liquidation and the stock had no market value.

A. It didn't have a market value because we had all the stock.

Q. I am not making a very light assumption when I say you were prepared to pay \$10,000 for stock that had a minus value to the extent the assets would have to come back four-fold before your interest would have any liquidating value?

A. That is right.

Q. Another thing I am curious about. It seems to me on a fund of \$250,000 with preferred three-quarters under water and where assets have to recover four-fold, you would have to engage in some very, very speculative transactions or engage in some activity where the chances for profit would have to be extremely great, isn't that so?

A. I think that is a fair assumption.

Q. So there is no doubt about the fact when you paid \$10,000 to get a substantial interest, and by substantial you mean the controlling interest, that you were in a position where you could control the \$250,000 and the nature of your activities if you were to make money on the stock had to be such that you would have to manage the \$250,000 in such manner that you would have to make big profits if you ever hoped to see any assets behind the common stock. That is true, isn't it?

A. Yes, sir.

The acquisition of control of Beacon Participations, Inc., constituted the first step in the Henderson Brothers' program of acquiring "control of companies that were very sick,"⁹³ that is, of companies whose assets were insufficient to cover funded indebtedness and the liquidating preferences of these senior securities.

The second company of this character of which control was acquired by Henderson Brothers was Atlantic Securities Company of Boston. That company was an investment company of the general management type. It was organized under the laws of Massachusetts on March 16, 1928⁹⁴ with a capitalization of 50,000 shares of common stock⁹⁵ which had the sole voting power, 50,000 shares of Class A stock and debentures with a face amount value of \$2,000,000.⁹⁶ As of March 1935, all of the common stock of Atlantic Securities Com-

⁹³ Id., at 15319.

⁹⁴ Reply to the Commission's questionnaire for Atlantic Securities Company of Boston, Part I.

⁹⁵ Originally the authorized share of common stock was 10,000 shares, which was increased to 50,000 (February 20, 1931).

⁹⁶ Reply to the Commission's questionnaire for Atlantic Securities Company of Boston, Part I.

pany of Boston was held by the Chase National Bank,⁹⁷ which also held 8,013 shares of the outstanding Class A stock and 50% of the outstanding \$1,477,000 face amount of debentures of Atlantic Securities Company of Boston.⁹⁸ At this time the market value of the assets of Atlantic Securities Company of Boston was \$450,000,⁹⁹ having depreciated approximately 84% from the net capital of \$2,770,000 originally contributed to the company by its security holders.¹⁰⁰ The assets thus were insufficient to cover the face amount of the debentures outstanding. The outstanding Class A stock and common stock were without asset value.¹⁰¹

In March 1935, when the common stock and the Class A stock was thus "under water," Henderson Brothers purchased 60% of the common stock from The Chase National Bank for approximately \$2,000, an amount which represented the transfer taxes on the conveyance of the stock.¹⁰² Subsequently they purchased the balance of the 40% of the common stock for approximately \$7,000.¹⁰³ In addition, they purchased 50% of the Class A stock for approximately \$20,000.¹⁰⁴ The net cost to Henderson Brothers for control of the \$450,000 of assets was thus only \$29,000.

The funds to purchase this control were supplied not only by Henderson Brothers themselves and their company, the World Radio Corporation, but also by Beacon Participations, Inc., the investment company which they had acquired. This was thus the "first manifestation" of the practical significance of the investment of \$10,000 in the "worthless" stock of Beacon Participations, Inc., which had approximately a quarter of a million dollars in assets. Ernest F. Henderson testified:¹⁰⁵

Q. So this was at least some of the first manifestations of the value of Beacon Participations, Inc., and by reason of the fact it permitted you to take the money of the Beacon Participations, Inc., and invest it in Atlantic Securities Company of Boston?

A. Yes, sir; the investment was very small.

Q. Small or otherwise, that was the first manifestation perhaps why you were willing to buy and pay \$10,000 for stock which had a minus liquidating value, isn't that so?

A. No; absolutely no. We paid the \$10,000 because we thought we could make the \$10,000 grow into a great deal more money.

⁹⁷ Public Examination, General Investment Corporation, at 15320. Originally, these shares were owned by the Atlantic Corporation, of Boston, an investment affiliate of the Atlantic National Bank of Boston. In 1931, these shares were turned over to the Chase National Bank by the Atlantic National Bank of Boston as additional security for a collateral loan. When the Atlantic National Bank of Boston withdrew from business in 1932 and merged with the First National Bank of Boston, this stock became the property of the Chase National Bank.

⁹⁸ *Id.*, at 15320.

⁹⁹ *Id.*, at 15321.

¹⁰⁰ Reply to the Commission's questionnaire for Atlantic Securities Company of Boston, Part II.

¹⁰¹ Public Examination, General Investment Corporation, at 15320.

¹⁰² *Ibid.*

¹⁰³ *Id.*, at 15321.

¹⁰⁴ *Ibid.*

¹⁰⁵ *Id.*, at 15323-4.

Q. One of the first things you did to accomplish that purpose was to take the Beacon Participations, Inc., and have it buy 40% of the common and 20% of the Class A convertible stock in the Atlantic Securities Corporation?

A. We never heard of the Atlantic Securities Corporation at the time we bought Beacon Participations, Inc.

Q. I am not unmindful of that, but when that situation did arise there was no doubt Beacon Participations, Inc., money was used to acquire Atlantic Securities Company of Boston?

A. That is correct.

These two investment companies, Beacon Participations, Inc., and Atlantic Securities Company of Boston, constituted the initial companies in what Mr. Henderson reluctantly described as an "aggregation" of investment companies.¹⁰⁶

Two years later, in February 1937, Henderson Brothers acquired control of a third investment company, Allied International Investing Corporation. That corporation was organized under the laws of Delaware in April 1927 by the investment banking house of Kean, Taylor and Company and Baker, Kellogg & Co., Inc., security dealers.¹⁰⁷ Its capital structure consisted of 35,000 shares of \$3 convertible preferred stock entitled upon liquidation to \$50 per share and 130,000 shares of common stock which had the sole voting power.¹⁰⁸ As of December 31, 1936, there were outstanding 29,754 shares of the preferred stock and 90,385 shares of common stock.¹⁰⁹

The market value of the assets of Allied International Investing Corporation as at December 31, 1936, was \$1,066,572,¹¹⁰ having depreciated approximately 67% from the original gross capital of \$3,271,370 contributed to the company.¹¹¹ The assets of the company would thus have to recover \$421,128, or \$14.15 per share, before there would be sufficient funds to cover the liquidating value of the outstanding preferred stock. In addition, the preferred stock was in arrears in dividends to the extent of \$14.90 per share.¹¹² Accordingly, the preferred stock was "under water" to the extent of \$29.05 per share. The common stock was without asset value.

In February 1937 Henderson Brothers caused their already acquired investment companies, Beacon Participations, Inc., Atlantic Securities Company of Boston, and the World Investment Trust, to invest \$100,000 in the purchase of 36,000 shares of the negative asset value common stock of Allied International Investing Corporation.¹¹³ Again the funds of already acquired investment companies were used by Henderson Brothers to further their program of developing

¹⁰⁶ Id., at 15324.

¹⁰⁷ Reply to the Commission's questionnaire for Allied International Investing Corporation (Part I).

¹⁰⁸ Ibid.; originally the capital structure provided the issuance of 60,000 shares of participating preferred stock and 10,000 no par value shares of deferred stock. The capital structure was then changed to provide for 100,000 shares of \$3 convertible preferred stock and 500,000 shares of common stock.

¹⁰⁹ Reply to the Commission's questionnaire for Allied International Investing Corporation (Annual Report, December 31, 1936).

¹¹⁰ Ibid.

¹¹¹ Id., Semi-Annual Report, June 30, 1928.

¹¹² Id., supplemental information.

¹¹³ Moody's Manual on Banks, etc. (1937), at 1739; Public Examination, General Investment Corporation, at 15325-6.

a pyramid of investment companies whose combined assets as at December 31, 1936, were approximately \$2,000,000.

Moreover, in December 1936, prior to the acquisition of control of Allied International Investing Corporation but during the negotiations for the acquisition therefor, Henderson Brothers organized Central Capital Corporation "for the purpose of going into some joint ventures on behalf of the three companies, Atlantic Securities, Beacon Participations, and Allied."¹¹⁴ At the outset Beacon Participations, Inc., and Atlantic Securities Company of Boston contributed \$50,000.¹¹⁵ Subsequently these two companies and the Allied International Investing Corporation made further contributions to Central Capital Corporation so that ultimately the total capital contributed to Central Capital Corporation by these companies was \$600,000,¹¹⁶ Mr. Henderson testified:¹¹⁷

Q. This is another instance where the funds to carry on the business of Central Capital Corporation, which ultimately turned out to be the acquisition of other investment trusts, came from other investment companies control of which was obtained by purchasing stock that had no liquidating value?

A. That is correct, except Beacon Participations, Inc., shares did have liquidating value at the time Central Capital was formed.

Q. Originally?

A. Originally, no.

The first venture of Central Capital Corporation was the acquisition in March 1937 of control of Standard Investing Corporation from General Investment Corporation which was controlled by International Equities Corporation which, in turn, was controlled by Ernest B. Warriner. As has been indicated in an earlier chapter of this report, Standard Investing Corporation at this time had liquid assets of approximately \$9,000,000, and had outstanding \$2,941,000 principal amount of debentures, 55,156 shares of preferred stock with a liquidating preference of \$7,384,010 and 394,591 shares of common stock.¹¹⁸ Therefore the outstanding common stock of Standard Investing Corporation was without asset value.¹¹⁹

However, in accordance with Henderson Brothers' policy of acquiring control of the negative asset value common stocks of companies which had substantial liquid assets, Henderson Brothers on March 2, 1937, caused Central Capital Corporation to acquire 240,000 shares or 62% of the outstanding common stock of Standard Investing Corporation for \$850,000.¹²⁰ The initial payment of \$400,000 was supplied by Central Capital Corporation,¹²¹ which as has been indicated, had derived its funds from Beacon Participations, Inc., Atlantic Securities Company of Boston, and Allied International Investing Corporation. As a result of the addition of this company to the Henderson Brothers' system of investment companies Henderson Brothers acquired control of a further "pool" of liquid funds in the amount of

¹¹⁴ Id., at 15327-9.

¹¹⁵ Id., at 15329.

¹¹⁶ Id., at 15329-31.

¹¹⁷ Id., at 15330.

¹¹⁸ See Part Three, Ch. II, pp. 613-8.

¹¹⁹ Ibid.

¹²⁰ Id., Commission's Exhibit No. 1582.

¹²¹ Id., at 15341-2. The balance of \$450,000 to be paid over a period of several months.

\$9,000,000, thus increasing the total amount of the funds under their domination to \$11,000,000.

Two weeks after Henderson Brothers had effected their acquisition of control of Standard Investing Corporation, Henderson Brothers caused Standard Investing Corporation to acquire from Mr. Warriner control of International Equities Corporation, which in turn controlled General Investment Corporation, which in turn then held a 26% voting interest in Utility Equities Corporation.¹²² The total purchase price of \$2,000,000 for control of International Equities Corporation was derived from funds resulting from the liquidation of portfolio securities of Standard Investing Corporation. Mr. Henderson testified:¹²³

Q. So that as far as Standard Investing Corporation is concerned, it had a diversified portfolio? Did it not?

A. Yes.

Q. And you liquidated enough of the portfolio to raise \$2,000,000, is that right?

A. Yes.

Q. And then you had \$2,000,000 invested in the International Equities stock?

A. That is right.

The total assets, which were brought under the control of Henderson Brothers, were approximately \$35,000,000.¹²⁴

International Equities Corporation had originally acquired control of General Investment Corporation from American General Corporation in 1936 on the representation of Ernest F. Warriner, then in control of International Equities Corporation, that Wallace Groves was in no way associated with him in his acquisition of control of International Equities Corporation and of General Investment Corporation. In fact, however, Mr. Groves supplied Mr. Warriner with funds to acquire control of International Equities Corporation and participated with Mr. Warriner in the management of International Equities Corporation and General Investment Corporation after their control was acquired by Mr. Warriner. In July 1937, after control of International Equities Corporation and General Investment Corporation had passed to the Henderson group of investment companies, American General Corporation brought suit to rescind its sales contract of General Investment Corporation to International Equities Corporation. This suit was settled in June 1939 by the re-transfer of control of General Investment Corporation to American General Corporation and the sale by the Henderson group of companies of a controlling block of the stock of Utility Equities Corporation to American General Corporation.¹²⁵

As a consequence Henderson Brothers are now in control of World Investment Trust, Beacon Participations, Inc., Atlantic Securities Company of Boston, Allied International Investing Corporation, Standard Investing Corporation, and International Equities Corporation. The aggregate assets of these companies as at December 31, 1939, totaled approximately \$12,000,000.

¹²² Id., at 15342-3.

¹²³ Id., at 15351.

¹²⁴ Id., at 15348. This figure of \$35,000,000 includes the assets of Utility Equities Corporation in which General Investment Corporation then held only a 26% voting interest.

¹²⁵ See Part Three, Ch. II, note 564, p. 591.

Control of this large aggregate of funds was vested in Henderson Brothers whose personal financial stockholdings in these investment companies did not exceed \$80,000.¹²⁶ The group possessed exclusively all of the possible emoluments incident to the control of this \$5,500,000, such as the power to determine salaries and management fees.¹²⁷ Moreover, since all of these companies were leverage investment companies and their controlling stocks were held almost entirely within the system, the leverage advantage accrued almost entirely to Henderson Brothers; the public's interest in these companies was represented almost entirely by the ownership of senior securities. The smallness of the financial interest of the controlling group in these companies coupled with the leverage preferential in the system might, as Mr. Henderson conceded, result in a speculative policy of investment which might cause substantial losses to the public who, in effect, had no voice in the determination of the future investment policies of the system of companies:¹²⁸

Q. * * * Do you think that this set-up is a healthy one?

A. I think that it is perfectly healthy, if it is in the hands of people who are running it legitimately and honestly, and I admit that it is probably what you would like me to admit, that there are elements of danger in a situation like that, if it is improperly handled.

Q. Now you are talking about improperly handled. From the improper aspect we have a situation where individuals with initial investment roughly from \$40,000 to \$80,000—and I am willing to take what your investment is at the present time in this situation, of approximately \$72,000. You are in a position to substantially influence or control \$25,000,000, isn't that so?

A. We are in a position to control that.

Q. And you have seen in your own case, right in this picture, what may transpire when individuals are in control of wealth, isn't that so?

A. I have seen some terrible records made by some of these people in the past.

Q. And aside from eliminating the improper handling even with honest management, you see no objection to this pyramiding of investment trusts?

A. A set-up like that has great possibilities for making a lot of money for the stockholders, and it also has elements of danger.

Q. Let us see; a set-up like that has great possibilities for making money, and has precisely the same possibilities for losing it, isn't that so?

A. I don't know how you can quite compare them like that.

Q. Let us see: You say it has this great possibility that way because of the leverage, isn't that so?

A. As far as the leverage is concerned, it is true that the leverage works both ways.

Q. Just as fast down as up.

A. As far as leverage is concerned; yes.

Q. Now talking from the point of view of a capital structure or intercorporate set-up, per se, the possibility for losing is precisely as much for gaining, isn't that so?

¹²⁶ Public Examination, General Investment Corporation, at 15359-61.

¹²⁷ As of May 1937, however, Henderson Brothers had not received any salaries, director or management fees. (Id., at 15388.)

¹²⁸ Id., at 15359-61.

A. It depends upon whether you expect a rising or falling market.

Q. That is right. Now, the fact is that history has been against it, hasn't it?

A. Well, history certainly didn't follow for the last four years.

Q. But taking it from the point of view of investment trusts in this country from 1924, down to 1937, it has been against these high leverages, complicated structures, isn't that so?

A. The great majority of them were started in 1927 and a great many of them collapsed, and a great many of them collapsed a lot faster than their leverage was responsible for.

Although, from the standpoint of Henderson Brothers, the pyramided group of investment companies under their control has undoubted advantages, the complicated structure was disadvantageous to their public stockholders, who have only the senior securities of their companies, and thus have no share in the leverage potentialities inherent in the pyramided group. Moreover, they have no voice in the determination of the investment policies of their companies. In fact the very erection of the pyramided group itself involved a substantial change in the investment policies of their companies as their diversified portfolios of marketable securities were liquidated to provide funds for investment in the negative asset value leverage blocks of stocks of other investment companies. Under the management of Henderson Brothers the remaining assets of their companies have been invested largely in real estate.

Mr. Henderson testified that it was desirable to collapse this pyramided structure of investment because of the complexities in relationship which exist in the management of the group of companies.¹²⁹

Q. Do you intend to leave this structure this way?

A. If we can possibly find a method of collapsing it on a basis that is fair to everybody, we would like very much to collapse the whole thing, and have one company.

Q. Well, then it seems to me that your desire to collapse it must be based upon some urgent reason because you were telling me that this has certain beneficial aspects that you wouldn't have out of a single unit.

A. No; the beneficial aspect there is getting a larger aggregate of funds to work with so that larger structures can be handled if you have got larger capital.

(2) THE AMERICAN CAPITAL GROUP

A second illustration of the technique used by a small group of individuals to acquire large pools of investment trust funds with a comparatively nominal investment is represented by the activities of J. B. Lovelace and his associates. By December 31, 1935, Lovelace and his associates, with a total investment of \$139,000, had acquired control of Pacific Investors, Inc., Pacific Southern Investors, Inc., The Investment Company of America and American Capital Corporation, whose combined assets were approximately \$16,000,000. They were enabled to control this \$16,000,000, in which their personal investment of \$139,000 had an asset value of only \$88,000, by effecting a series of mergers and consolidations of four independent invest-

¹²⁹ Id., at 15361-2. In April 1941 the Henderson Brothers system of investment companies was collapsed. See Investment Company Act Release No. 100, April 2, 1941.

ment companies, terminating in a complex pyramid structure. Originally, these four independent companies were The Investment Company of America, Pacific Investing Corporation, Southern Bond & Share Corporation, and American Capital Corporation.

The Investment Company of America was the first company to be organized. Incorporated on March 27, 1926, as a common-law trust to operate under the laws of Michigan,¹³⁰ it was sponsored by E. E. MacCrone & Co., a Detroit investment banking firm which was also a member of the New York Stock Exchange.¹³¹ The trust indenture which created the organization of the company vested the sole power of management and control in the trustees,¹³² E. E. MacCrone, J. B. Lovelace, and C. J. Collins, all of whom were partners in E. E. MacCrone & Company.¹³³ They became three of the five trustees of The Investment Company of America.¹³⁴ The net capital contributed to the company between 1927 and 1930 was \$13,831,658¹³⁵ derived from the sale of \$5,000,000 face amount debentures, 60,000 shares of 7% \$100 par value preferred stock, and 137,827 shares of common stock.¹³⁶ Of this amount E. E. MacCrone & Co. did not contribute in excess of \$180,000 or 1.4% of the company's total amount of the capital. Nevertheless, they had 100% control of the company by virtue of the provisions of the trust indenture whereby the trustees who were the partners of that firm had perpetual control.¹³⁷

In April 1927 Pacific Investing Corporation was organized in Los Angeles, California, and was sponsored by J. B. Lovelace, one of the partners of E. E. MacCrone & Co. and his associates.¹³⁸ Between 1928 and 1930 there was a net capital contribution to the company of \$13,410,742¹³⁹ derived from the sale of \$5,000,000 face amount debentures, 60,000 shares of 8% first preferred stock, 30,000 shares of \$6 second preferred stock, and 1,928,285 shares of common stock. The sponsors contributed only \$325,000 or 2.4% of the total contributed capital to the company, but obtained 16.8% of the voting power.¹⁴⁰ Although E. E. MacCrone & Co. had nothing to do with

¹³⁰ Public Examination, American Capital Group, at 7001 and Commission's Exhibit No. 667.

¹³¹ *Id.*, at 6994-5.

¹³² *Id.*, Commission's Exhibit No. 667.

¹³³ *Id.*, at 7000.

¹³⁴ *Id.*, at 7025-6. The two remaining trustees were Raymond K. Dykema, counsel for E. E. MacCrone & Company (*ibid.*), and Dr. Albert J. Hettinger, the head of the Investment Research Department of E. E. MacCrone & Company (*id.*, at 7118), and the president of Investment Research Corporation, a company formed by E. E. MacCrone to supply investment advice to various investment companies, including The Investment Company of America. (*Id.*, at 7028 and Commission's Exhibit No. 670.)

¹³⁵ Reply to Commission's questionnaire for The Investment Company of America, Part IV, Item 21.

¹³⁶ *Id.*, at 7023-4 and supplemental information supplied the Commission for The Investment Company of America. The gross contribution was \$14,581,658, of which \$550,000 was retained by E. E. MacCrone & Company (*id.*, at 7016 et seq. and supplemental information supplied the Commission for The Investment Company of America), and \$200,000 was retained by Bonbright & Company, which had offered to the public the \$5,000,000 of face amount debentures.

¹³⁷ *Id.*, Commission's Exhibit 667 (Article III, Section 3 (g)).

¹³⁸ *Id.*, at 7080-1.

¹³⁹ The gross capital contributed was \$13,879,850.

¹⁴⁰ Reply to the Commission's questionnaire for Pacific Investing Corporation.

the organization of this company, Mr. Lovelace and his associates availed themselves, in the management of the company, of the services of Investment Research Corporation, controlled by E. E. MacCrone & Co.¹⁴¹

A year later, on May 19, 1928, Mr. McKee and his associates, who had participated in the organization of Pacific Investing Corporation, organized American Capital Corporation, since the first company had been so successful.¹⁴² The American Capital Corporation "was looked on as having further expansion possibilities."¹⁴³ Mr. Lovelace testified:¹⁴⁴

Q. You don't know why they had two companies in the first place, do you?

A. I think if they were doing it again, they would not have two, but I think that at that time, they put out prospectuses on Pacific Investing as a certain unit, and it was all sold, and they felt that they could launch another one with a larger potential capital, and it may have been the fact that Blyth Witter were not available as bankers, had something to do with American Capital being formed, and I presume if Pacific Investing bankers would have been willing to go ahead and sell more, and expand, and get an increased authorization, they probably would have gone into it that way, and so it was in 1930 that they decided to try and merge the two companies.

A total of \$15,477,963 was contributed to the company by the sale of 60,000 shares of \$5.50 junior preferred stock, 120,000 shares of \$3 preferred stock, and 99,999 shares of Class A common stock, and 465,523 shares of B stock.¹⁴⁵ The sponsor contributed \$420,000, or 2.8% of the total contributed capital, and had 45.2% of the voting power. American Capital Corporation was also managed by Investment Research Corporation.

On July 17, 1928, E. E. MacCrone, J. B. Lovelace, and their associates organized the fourth of these investment companies, Southern Bond & Share Corporation. This company was organized to do business in and around Alabama in an effort, as Mr. MacCrone testified "to extend our research connections through members of the board there, and also it helped to support our research."¹⁴⁶ A net total of \$3,120,000 was contributed to the company by the sale of 40,000 shares of \$3 preferred stock, 40,000 shares of Class A common stock, and 110,000 shares of Class B common stock. The sponsors contributed \$233,500, or 7.5% of the total contributed capital but acquired 50.1% of the voting control of the company. This company availed itself of the management services supplied by the Investment Research Corporation.

Mr. MacCrone thus participated with Mr. Lovelace in the organization of two of the investment companies, The Investment Company of America and Southern Bond & Share Corporation. Mr. Lovelace, independently of Mr. MacCrone, but with other associates on the Pacific Coast had organized American Capital Corporation and Pacific Investing Corporation. The four companies, however, were all

¹⁴¹ Id., at 7082 and Commission's Exhibit No. 673.

¹⁴² Id., at 7094.

¹⁴³ Ibid.

¹⁴⁴ Id., at 7354.

¹⁴⁵ Id., at 7097-8.

¹⁴⁶ Id., at 7040.

managed by Investment Research Corporation, the management company organized by E. E. MacCrone & Company.

In 1930 there occurred the first modification in the set-up of these four independent companies in an effort, as Mr. Lovelace testified, to collapse the system:¹⁴⁷

Q. Now, did you during this period or did anyone make specific offers to Mr. MacCrone to acquire control of the Investment Company of America?

A. I had several discussions with him, and I think that we both felt that the picture would be a sounder one if it could be put together in one unit.

Q. Just what did you contemplate putting into one unit, all four of them, Southern Bond & Share, Pacific Investing, American Capital and Investment Company?

A. Those were just discussions that that was a desirable thing to do, and as I remember it * * *.

Q. When did those discussions, or when did you conclude that that was a desirable thing to do? What year was that; around 1930?

A. Yes; and I think Mr. MacCrone discussed first the acquisition of American Capital, on some basis of merger, and I never felt that it had gotten quite to the point of a deal, and he talked to Mr. McKee, and he may have had some understanding beyond anything with me, because I was * * * I had only a small interest in the picture, and didn't feel the responsibility of a sponsor of that company.

Q. The first gesture on the merging of these companies was a discussion about the possibility of merging The Investment Company of America and American Capital Corporation in 1930, is that so?

A. Yes.

Q. That never came to pass?

A. No.

Q. Do you know why it didn't?

A. No; I don't.

Mr. Lovelace and his associates took steps to merge their two Pacific Coast companies, American Capital Corporation and Pacific Investing Corporation, which were organized by the same group, had the same persons on their respective boards of directors, and were managed by the same company. Mr. Lovelace testified:¹⁴⁸

A. * * * About that time, or a little before that time, the American Capital started their plans for merging with Pacific Southern, to clear up that picture there.

Q. There wasn't any Pacific Southern at this point?

A. Merging with Pacific Investing Corporation.

Q. At that point there were their coincidental Boards, were there not?

A. Yes.

Q. So that each of those Boards had been separately sponsored a short period apart by the identical group, is that so?

A. Yes. * * *.

Q. But the McKee group had sponsored Pacific Investing April '27 and American Capital in May of 1928?

A. Yes.

¹⁴⁷ Id., at 7352-3.

¹⁴⁸ Id., at 7353-4.

Q. Now, in 1930 they came to the conclusion that those two companies had better be one, is that so?

A. Yes.

The initial step in the contemplated merger was an exchange of the securities of Pacific Investing Corporation for the securities of American Capital Corporation.¹⁴⁹ The exchange offer provided for the issuance of 2.4 shares of American Capital Corporation Class B stock for each share of common stock of Pacific Investing Corporation.¹⁵⁰ A total of 109,763 shares out of a total of 128,285 shares, or 85% of the common stock of Pacific Investing Corporation were turned into American Capital Corporation.¹⁵¹ Since the common stock of Pacific Investing Corporation had the sole voting power, American Capital Corporation acquired 85.7% of the voting control of Pacific Investing Corporation. The effect of this transaction was to centralize in Mr. Lovelace and his associates the control of Pacific Investing Corporation. Heretofore their control of these companies followed merely from the fact that there were interlocking directorates between the two companies. However, by this exchange Mr. Lovelace and his associates had direct voting control of Pacific Investing Corporation, by virtue of the stock interest of American Capital Corporation in Pacific Investing Corporation which was increased in 1931 to 86.3%.¹⁵² Until May 1931 both of these companies, however, retained their service contracts with Investment Research Corporation, which provided for a fee equal to four-tenths of 1% of the company's "investment fund" defined as funded debt, capital stock, and surplus. As a result, the stockholders of American Capital Corporation were subject to a duplication of management fees, by virtue of the fact that as large stockholders of Pacific Investing Corporation they bore the cost of that company's fee to Investment Research Corporation as well as the fee they were paying as stockholders of American Capital Corporation.

Instead, however, of merging Pacific Investing Corporation with American Capital Corporation, Mr. Lovelace and his associates took steps to acquire control of Southern Bond & Share Corporation, one of the companies controlled by Mr. MacCrone, and to merge that company with Pacific Investing Corporation. In anticipation of this merger, American Capital Corporation acquired, in 1931, 12,625 shares of the Class B stock of Southern Bond & Share Corporation from E. E. MacCrone & Company at a price of \$2.50 a share when the market bid at this time for the stock was 25¢ a share.¹⁵³ Some months later, in March 1932, American Capital Corporation purchased 37,500 shares of Class B common stock of Southern Bond & Share Corporation from E. E. MacCrone & Company and 2,500 shares from J. B. Lovelace at \$5.00 a share.¹⁵⁴ At this time the market price of this stock was 5¢ per share. Thus the price of \$5 a share, at which E. E. MacCrone & Company and J. B. Lovelace sold their shares of Southern Bond & Share Corporation

¹⁴⁹ *Id.*, at 7354-5.

¹⁵⁰ *Id.*, at 7356.

¹⁵¹ Derived from reply to the Commission's questionnaire for American Capital Corp.

¹⁵² *Ibid.*

¹⁵³ Derived from supplementary information supplied the Commission.

¹⁵⁴ *Ibid.*; accompanying the 40,000 shares of Southern Bond & Share Corporation Class B common stock acquired by American Capital Corporation in April 1932 were 82,955 warrants delivered to American Capital Corporation by E. E. MacCrone & Co.

to American Capital Corporation represented a profit of 150% over the price of \$2 per share they originally paid for the stock in 1928 and was over 100 times the market price of this stock.

By April 1932 American Capital Corporation held the following securities of Southern Bond & Share Corporation: 4,856 shares of \$3 preferred stock, 2,600 shares of Class A common stock, 59,328 shares of Class B common stock, and 82,955 warrants,¹⁵⁵ which constituted a minority control block of the stock (8.4%) of Southern Bond & Share Corporation. Thereupon, American Capital Corporation, which held an 86.3% interest in Pacific Investing Corporation, caused a merger of Pacific Investing Corporation into Southern Bond & Share Corporation, which was effected on the following basis: (a) a new company was organized under the laws of Delaware on April 25, 1932, and was known as Pacific Southern Investors, Inc.; (b) it issued its preferred stock and Class A and B common stocks on a share-for-share basis to stockholders of Southern Bond & Share Corporation; (c) it issued two-thirds of a share of \$3 preferred stock with two and a quarter shares of Class A common stock for each share of Pacific Investing Corporation 6% \$100 par first preferred stock, six shares of Class B common stock for each share of Pacific Investing Corporation \$6 second preferred stock, and two shares of Class B common stock for each share of Pacific Investing Corporation common stock; (d) it assumed the debenture obligation of Pacific Investing Corporation; and (e) warrant holders of both predecessor trusts received an equal number of warrants to purchase Class B common stock of the new corporation at \$10 a share on or before June 30, 1930.¹⁵⁶ As a result

¹⁵⁵ *Ibid.*

¹⁵⁶ *Id.*, at 7362-7365., Commission's Exhibit No. 686. Although Mr. Lovelace testified that the merger worked out to the advantage of both companies (*Id.*, at 7362-7365), actually an analysis of the effects of the consolidation on the security holders of the two companies in the light of conditions prevailing at the time seems to disclose that the merger appears to have favored owners of securities in Pacific Investing Corporation. American Capital Corporation, the then top holding company of the system, had its principal interest in Pacific Investing and only a small interest in Southern Bond & Share. At the time the merger was consummated, on April 25, 1932, coverage on the bonds was increased from approximately 128.6% to over 160%. Holders of first preferred stock on April 25, 1932, received the equivalent of about \$21 in new \$3 preferred stock, plus some Class "A" common stock, as against an estimated asset value of \$17.50 for their old stock. Owners of second preferred stock and common stock who, because of the "touch-off" clause on the bonds, could at best have hoped only for a come-back long delayed, were not able to participate in the recovery; with the added coverage for the bonds, funds could be shifted from cash items to securities sooner than it would otherwise have been possible. Even warrant holders of Pacific Investing Corporation appear to have gained by the exchange, although their warrants, which enabled them to purchase one share of Pacific Investing Corporation common stock at \$10, were exchanged for only an equal number of warrants to purchase Pacific Southern Class "B" common stock at \$10 while each share of Pacific Investing Corporation common stock received two shares of Class "B" common stock in the new corporation. However, the Pacific Investing Corporation warrants expired on April 15, 1937; whereas the Pacific Southern Investors warrants run to June 30, 1940. The quotation for Pacific Southern Investors Class "B" common stock was 4-4½ in the latter part of October 1936.

On the other hand, security holders of Southern Bond & Share Corporation can hardly be said to have received comparable benefits. The company, apparently in anticipation of the merger, had sold securities and accumulated cash, prior to April 1932. While this policy might have inured to the benefit of shareholders had the company been able to reenter the market, stockholders in the new corporation could not take full advantage of the low prices prevailing in the security markets in the summer of 1932, because of the assumption of the Pacific Investing Corporation bonds. The \$3 preferred stock, which was the senior security of the predecessor company, was now subject to the prior claim of bondholders. Its asset

of this merger American Capital Corporation acquired 39.5% interest in Pacific Southern Investors, Inc.¹⁵⁷

In the latter part of 1932, Mr. Lovelace commenced acquisition of his direct interest in The Investment Company of America, the last of the independent companies controlled by Mr. MacCrone. This step Mr. Lovelace characterized as "the beginning of all my troubles and why the chart¹⁵⁸ looks so bad."¹⁵⁹ By June of 1932 the net assets of The Investment Company of America had declined to approximately \$4,580,000¹⁶⁰ from the approximately \$13,830,000 originally contributed to the company.¹⁶¹ As the net assets of the company declined in value and the debentures merely had a 129% coverage¹⁶² a sharp dispute arose among the trustees and members of the advisory board¹⁶³ as to the investment policy to be pursued, whether to liquidate the entire portfolio and "sit there until * * * convinced that the tide had definitely turned,"¹⁶⁴ or to repurchase the debentures which were then selling at a 40% discount from their face value¹⁶⁵ in order to increase the asset coverage of the remaining debentures and to free the corporation funds for investment in an effort to enhance the asset value of the company's preferred and common stockholders.¹⁶⁶ Messrs. MacCrone and Collins, two trustees, supported the first view. Messrs. Dykema and Hettinger supported the second view.¹⁶⁷ Mr. Lovelace, the fifth trustee, who had severed his relationship with E. E. MacCrone & Company in September 1929¹⁶⁸ and had become active, as above indicated, in the two Pacific companies, American Capital Corporation and Pacific Southern Investors, Inc.,¹⁶⁹ did not apparently participate actively in the affairs of Investment Company of America.

During this period Mr. MacCrone was apparently desirous of selling to outside interests his interest in The Investment Company of

value declined 20%, or from \$33.30 to \$26.25, as a result of the merger. The Class "A" and Class "B" common stocks had their leverage positions greatly accentuated. Although the expiration date of the warrants remained the same, their position was changed due to the addition of bonds to the capital structure and the change in ratio of warrants to common stock outstanding.

¹⁵⁷ On exchange American Capital Corporation received 8,161 shares of \$3 preferred stock, 9,441 shares of Class A common stock, 260,556 shares of Class B common stock, and 82,955 warrants of American Capital Corporation.

¹⁵⁸ The reference is to Public Examination, American Capital Group, Commission's Exhibit 680A.

¹⁵⁹ *Id.*, at 7367.

¹⁶⁰ *Id.*, Commission's Exhibit No. 683.

¹⁶¹ By December 31, 1931, the company had paid out \$1,286,000 for the repurchase of \$1,508,500 principal amount of its debentures, and 2,742 shares of its preferred stock. (Reply to Commission's questionnaire for The Investment Company of America, Pt. V.) The net assets of the company at the end of 1931 were approximately equal to 40% of its net contributed capital.

¹⁶² *Id.*, Commission's Exhibit No. 683. The debentures of The Investment Company of America contained a provision to the effect that a default would occur on such debentures if at any time the net assets of the company were less than 125% of the face amount of the outstanding debentures. (*Id.*, at 7151.)

¹⁶³ The advisory board, consisting of 10 prominent businessmen, had merely the power to veto, by a vote of a majority of its members, proposed transactions between this trust and its trustees. (*Id.*, Commission's Exhibits Nos. 667, 682.)

¹⁶⁴ *Id.*, at 7240-1.

¹⁶⁵ *Id.*, at 7152.

¹⁶⁶ *Id.*, at 7153-6.

¹⁶⁷ *Id.*, at 7154.

¹⁶⁸ *Id.*, at 7320.

¹⁶⁹ See *supra*.

America, including the fiscal agency contract with The Investment Company of America, the remaining 116,287 warrants to purchase stock of that company and the interest of E. E. MacCrone & Co. in Investment Research Corporation, which supplied research services to The Investment Company of America.¹⁷⁰ The Advisory Board was, however, opposed to the contemplated sales by Mr. MacCrone to "outside interests,"¹⁷¹ and thereupon contacted Mr. Lovelace.¹⁷²

Mr. Lovelace presented to the Advisory Board a plan for the elimination of Mr. MacCrone and Mr. Collins as trustees of The Investment Company of America. Mr. Lovelace and certain associates¹⁷³ who owned 140,000 shares of the Class B stock of American Capital Corporation, the stock then having no asset value¹⁷⁴ and a market value of \$1.50¹⁷⁵ a share, proposed to transfer such stock to E. E. MacCrone & Company in return for the firm's fiscal agency contract with The Investment Company of America, the firm's holdings of 116,287 warrants to purchase common stock in The Investment Company of America and the firm's 80% interest in Investment Research Corporation.¹⁷⁶ Messrs. MacCrone and Collins were to resign as trustees.

The plan was finally consummated on August 24, 1932. On the same day Mr. Lovelace and his associates transferred 140,000 shares of the Class B stock of American Capital Corporation to E. E. MacCrone & Company in return for 116,287 warrants to purchase common stock of the Investment Company of America which "were of no present value,"¹⁷⁷ 80% of the stock of Investment Research Corporation which the Lovelace group regarded as having no value¹⁷⁸ and the fiscal agency contract between E. E. MacCrone & Company and The Investment Company of America. The Investment Company of America purchased from E. E. MacCrone & Company for \$300,000 or \$4 a share, 75,000 shares of the 140,000 shares of the Class B stock of American Capital Corporation, which had no asset value but had a total market value of approximately \$112,500.¹⁷⁹

The effect of this transaction was threefold. In the first instance, Mr. MacCrone was removed from the management of the investment company. Secondly, The Investment Company of America had itself paid to E. E. MacCrone & Company \$300,000 in order to remove Mr. MacCrone from the management of the investment company. And thirdly, Mr. Lovelace and his associates became the controlling group of The Investment Company of America, which now held a 11% interest in American Capital Corporation, which in turn held a 40%

¹⁷⁰ For details respecting the financial status of Mr. MacCrone, and the reason why, and effort for, the sale of his interest in The Investment Company of America, see Part Three, Ch. IV, pp. 1237-47.

¹⁷¹ Public Examination, American Capital Group, at 7378.

¹⁷² *Id.*, at 7156, 7369-71.

¹⁷³ *Id.*, at 7375; see reply to Commission's questionnaire for The Investment Company of America, supplemental information, Item 34.

¹⁷⁴ *Id.*, Commission's Exhibit No. 682.

¹⁷⁵ Reply to the Commission's questionnaire for The Investment Company of America, Part VII, Item 70.

¹⁷⁶ Public Examination, American Capital Group, Commission's Exhibits Nos. 682, 683.

¹⁷⁷ *Id.*, at 7377 and Commission's Exhibit No. 683.

¹⁷⁸ *Id.*, at 7379.

¹⁷⁹ See *supra*.

interest in Pacific Southern Investors, Inc.¹⁸⁰ The total assets of these three companies were approximately \$14,000,000.¹⁸¹

In the latter part of 1933 a further modification was effected in this pyramided structure of investment companies which now was controlled exclusively by Mr. Lovelace and his associates. In October 1933, a capital readjustment and reorganization of The Investment Company of America was effected, which provided for (a) the creation of a new corporation, known as The Investment Company of America which took over the assets and liabilities of the old company, which had been organized as a business trust; (b) the assumption by the new company of the 5% debentures of the old company; (c) the exchange of the preferred stock of the old company for the common stock of the new company, on a share for share basis; (d) the issuance to the common stockholders of the old company of perpetual warrants to buy an equal number of common shares of the new company at \$115 a share; (e) the issuance of warrants of the new company to warrant holders of all class of securities of the old company, providing for the purchase of the common stock at 155 a share on or before December 31, 1942, and (f) the purchase by Pacific Southern Investors, Inc. of 45,000 shares or 15.8% of the outstanding company stock of the new company for approximately \$1,000,000.¹⁸²

The final effect of this new plan was to give Pacific Southern Investors, Inc. a 45.8% interest in The Investment Company of America which already held a 10.4% interest in American Capital Corporation, which in turn held a 40% interest in Pacific Southern Investors, Inc. In other words, there resulted an instance of circular ownership between these companies which not only made it difficult for the stockholders to ascertain the value of their respective interests in these companies, but subjected them to a duplication of management fees following from these interrelationships. Mr. Lovelace explained the reorganization of The Investment Company of America on the grounds that it was "the desirable way of getting in new money" into the company.¹⁸³ However, he admitted that "If I had to do it again * * * I wouldn't have gone into the picture at all,"¹⁸⁴ apparently recognizing the eventual "unsoundness in the thing [the set-up] structurally".¹⁸⁵

In 1934 there was a further rearrangement of these companies, since "it seemed desirable to break the circle at this point".¹⁸⁶ Mr. Lovelace and his associates on May 1, 1934, organized a new company known as Pacific Investors, Inc., to take over from American Capital Corporation that company's holdings of Pacific Southern Investors, Inc., which at that time amounted to approximately 40% control of Pacific Southern Investors, Inc.¹⁸⁷ In consideration for the stock

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² Id., Commission's Exhibit No. 687-C.

¹⁸³ Id., at 7382.

¹⁸⁴ Id., at 7387.

¹⁸⁵ Ibid.

¹⁸⁶ Id., at 7397.

¹⁸⁷ The holdings of American Capital Corporation in the securities of Pacific Southern Investors, Inc., taken over by Pacific Investors, Inc. in May 1934: 3,500 shares of \$3 preferred stock; 9,441 shares of Class "A" common stock and 260,556 shares of Class B common stock.

of Pacific Southern Investors, Inc., transferred to Pacific Investors, Inc., American Capital Corporation received 141,000 shares of the common stock of Pacific Investors, Inc., constituting its entire outstanding stock.¹⁸⁸ American Capital Corporation offered these shares of stock in Pacific Investors, Inc., to its own stockholders on the basis of one share of the stock of the new company at \$2.20 for each ten shares of the stock or warrants owned in American Capital Corporation.¹⁸⁹

At about the time of the offer American Capital Corporation had 5,900 stockholders, each holding on an average of 147 shares and 12 warrant holders each owning on an average of 44,786 warrants.¹⁹⁰ If all the stockholders of American Capital Corporation had exercised their rights, each stockholder would have obtained an average of less than 15 shares of Pacific Investors, Inc., common stock. In contrast, each warrant holder would have been entitled to buy 4,478 shares of Pacific Investors, Inc., common stock.

A letter was sent on July 21, 1934, advising the shareholders of American Capital Corporation of their rights to subscribe to the 141,000 shares of Pacific Investors, Inc. This offer was to be exercised within fifteen days, or by August 4, 1934. Only about 250 shareholders and warrant holders out of the 5,900 subscribed to the offer of American Capital Corporation.¹⁹¹ Of these subscribers, Messrs. McKee, Morton, and Lovelace, directors of American Capital Corporation and its affiliate, Pacific Southern Investors, Inc., acquired 63,220 shares of the 141,000 offered, or 45% of the company's entire outstanding stock.¹⁹²

The cost of this block of stock to Messrs. McKee, Morton, and Lovelace, which had an asset value of \$88,000, was about \$139,000. However, by virtue of this investment Mr. Lovelace and his associates, who thus held 45% of the voting control of Pacific Investors, Inc., were enabled to control Pacific Southern Investors, Inc., 40% of whose stock control was held by Pacific Investors, Inc., The Investment Company of America, 46.3% of whose stock control was held by Pacific Southern Investors, Inc., and American Capital Corporation, 11% of whose stock control was held by The Investment Company of America.

In 1935 there was a further rearrangement in the relationship of these four companies to each other in an effort, as Mr. Lovelace testified, to "simplify the picture"¹⁹³ and to free The Investment Company of America from "any ownership of any subsidiary company"¹⁹⁴ which at this point in the history of this company, held a 10.9% interest in American Capital Corporation. As part of this rearrangement The Investment Company of America sold to Pacific Southern Investors, Inc., 16,761 shares of the preferred stock and 75,000 shares of the Class B stock of American Capital Corporation for a total of \$452,334.75. Pacific Southern Investors, Inc., sold to The Investment Company of America 13,409 shares of the common stock of The Investment

¹⁸⁸ *Id.*, at 7397.

¹⁸⁹ *Id.*, at 7397.

¹⁹⁰ Derived from supplementary information supplied by American Capital Corporation.

¹⁹¹ *Ibid.*

¹⁹² *Ibid.*

¹⁹³ *Id.*, at 7400.

¹⁹⁴ *Ibid.*

Company of America for a total of \$452,334.75.¹⁹⁶ As a result of this exchange, therefore, Pacific Southern Investors, Inc., held a 38.2% control of The Investment Company of America and a 20.1% interest in American Capital Corporation.

(3) TRI-CONTINENTAL CORPORATION GROUP

The Tri-Continental Corporation group of investment companies, having aggregate assets as of December 1935 in excess of \$150,000,000, is a further example of a pyramided system of investment companies which was created at a comparatively nominal cost to the investment banking firm, J. & W. Seligman & Co.

The basic company in this structure is Tri-Continental Corporation, which was a consolidation of Tri-Continental Allied Company, Inc., and Tri-Continental Corporation (old).¹⁹⁸ It was organized on December 27, 1929,¹⁹⁷ as an investment company of the general management type, under the laws of Maryland and was sponsored by J. & W. Seligman & Co. and Tri-Continental Corporation (old).¹⁹⁸

Tri-Continental Corporation (old) had been organized on January 4, 1929, under the laws of Maryland, as an investment company of the general management type, and was sponsored by J. & W. Seligman & Co.¹⁹⁹ It authorized the issuance of 3,250,000 shares of which 250,000 shares were \$100 par value 6% cumulative preferred stock and 3,000,000 shares of no par common stock.²⁰⁰ Each class of stock had voting rights.²⁰¹ In addition the board of directors was authorized to issue warrants in connection with the issuance of the preferred stock providing for the purchase of 250,000 shares of common stock at \$27 a share on or before December 31, 1943, and detached warrants in connection with the issuance of 1,000,000 shares of common stock providing for the purchase of 575,000 shares of common and the 250,000 shares of preferred stock at \$27 per share on or before December 31, 1943.²⁰²

Tri-Continental Corporation (old) raised a total of \$53,000,000,²⁰³ of which \$26,000,000 was contributed by the sale of 250,000 shares of preferred stock at \$104 a share and \$27,000,000 was contributed by the sale of 1,000,000 shares of common stock at \$27 a share.²⁰⁴ The net capital contributed to the company was, however, \$50,000,000,

¹⁹⁶ Ibid.

¹⁹⁷ Id., Commission's Exhibit No. 2080.

¹⁹⁸ Public Examination, Tri-Continental Corporation, Commission's Exhibit No. 2080.

¹⁹⁹ Id., at 18529.

²⁰⁰ Id., at 18518, Commission's Exhibit No. 2073.

²⁰¹ Id., Commission's Exhibit No. 2073.

²⁰² Ibid.

²⁰³ Ibid. The articles of incorporation provided that the \$27 price for a warrant might be altered if any shares of common stock are issued in excess of 1,000,000 shares at a price less than \$27 per share. The adjusted price of the warrants shall be determined by "Multiplying 1,000,000 by 27 and adding to the product thereby obtained a sum equal to the aggregate amount of money in dollars, or the fair value in dollars of the property or other consideration, if any, received by the Corporation upon the issue of the additional shares, the resulting total shall be divided by 1,000,000 increased by the number of such additional shares, and the resulting quotient shall be the adjusted warrant purchase price per share."

²⁰⁴ Id., at 18518.

²⁰⁵ Reply to the Commission's questionnaire for Tri-Continental Corporation (old) Part V.

since \$3,000,000 was retained by J. & W. Seligman & Co. as an underwriting commission.²⁰⁵

In addition to the \$3,000,000 received by the bankers as an underwriting commission, J. & W. Seligman & Co. received the 575,000 warrants for the purchase of 575,000 shares of common stock at \$27 per share. Of this amount the sponsors themselves retained 525,000 warrants and distributed the balance of 50,000 warrants to the directors of the company.²⁰⁶ The issuance of these warrants to the officers and directors of J. & W. Seligman & Co. was disclosed to the stockholders of Tri-Continental Corporation (old).²⁰⁷

Tri-Continental Allied Company, Inc., was organized approximately six months later on August 15, 1929, by J. & W. Seligman & Co., and Tri-Continental Corporation (old). Its authorized capital structure provided for the issuance of 3,500,000 shares of stock, of which 500,000 shares were 6% cumulative preferred stock with a \$50 par value and 3,000,000 shares of no-par common stock. Both the preferred and common stock had one vote each per share.²⁰⁸ In addition, just as in the case of Tri-Continental Corporation (old) the board of directors of Tri-Continental Allied Company, Inc., were authorized to issue 500,000 detached warrants providing for the purchase of 500,000 shares of common stock at \$33 per share, exercisable on or before August 15, 1939.²⁰⁹ Tri-Continental Corporation (old) purchased for \$3,750,000 in cash 150,000 shares of common stock and warrants to purchase an additional 500,000 shares of the common stock, and J. & W. Seligman & Co. purchased 100,000 shares of common stock of the company for \$2,500,000.²¹⁰

The new company raised a gross total of \$57,000,000: \$50,750,000 from the sale of 500,000 shares of 6% cumulative preferred stock and 750,000 shares of common stock which were sold in units of one share of preferred stock and one and a half shares of common stock²¹¹ and \$6,250,000 from the sale of 250,000 shares of common stock and warrants for the purchase of 500,000 shares of common stock. Of this amount only \$50,000,000 constituted the net capital contribution to the company. J. & W. Seligman & Co. retained \$7,000,000 as a gross underwriting commission for distributing securities of Tri-Continental Allied Company, Inc.²¹² This payment of the \$7,000,000 commission to J. & W. Seligman & Co. was more than twice as much as the commission which was paid to the same firm for raising almost the same amount of capital as was raised for Tri-Continental Corporation (old).

Mr. Bailie, when examined on the underwriting commissions, testified:²¹³

Q. Coming back to this difference between these two underwriting spreads, as I understand it, J. & W. Seligman determined in both cases these spreads; is that right?

²⁰⁵ Public Examination, Tri-Continental Corp., at 18518-9.

²⁰⁶ *Id.*, at 18519-20.

²⁰⁷ *Id.*, Commission's Exhibit No. 2072.

²⁰⁸ *Id.*, Commission's Exhibit No. 2075.

²⁰⁹ *Ibid.*

²¹⁰ *Id.*, Commission's Exhibit No. 2072.

²¹¹ *Ibid.*

²¹² *Ibid.*

A. That is correct.

Q. And the outside directors did not determine them; is that right; they were brought on after the spread had been determined?

A. There were no outside directors at the time Tri-Continental and Allied were formed. They came on afterwards. The outside directors of old Tri-Continental approved the formation and approved the plan. Therefore they approved the set-up we suggested, but it was our set-up.

Q. So that is one situation where, in the relation between a banking house and an investment trust, the bankers needed the integrity of a Solomon in order to determine what is a fair price for their underwriting spread. I am not suggesting this was unfair, but I am just endeavoring to point out the possibility. That was a 4-percent spread in the second case?

A. Yes.

Q. Which was quite a high spread even in those days?

A. I don't think so, in comparison with some of the others, but let us say it is sizable.

Q. Under that situation where you have the duty of deciding, you are on both sides of the picture, aren't you?

A. In a sense, yes.

Tri-Continental Allied Company, Inc., was an investment company similar to Tri-Continental Corporation (old) which had already been offered to the public. Both companies were sponsored by the same banking house; their capital structures were practically identical; their purpose and form of organization were the same; the nature of the distribution of their securities were identical; the net capital contributed of \$50,000,000 to each company was the same in both companies; the board of directors of the "Allied" Company was identical with that of Tri-Continental Corporation, of which 6 out of the 15 members were partners of the firm of J. & W. Seligman & Co.²¹⁴ The "Allied" Company was to be managed by Tri-Continental Corporations (old) and not by J. & W. Seligman & Co.²¹⁵ but actually Tri-Continental Corporation (old) was itself managed by J. & W. Seligman & Co.²¹⁶ so that indirectly J. & W. Seligman would manage the new company, Tri-Continental Allied Company, Inc.

Earle Bailie, a partner of J. & W. Seligman & Co., when examined as to the necessity of forming a new investment company, testified:²¹⁷

Q. Why was it necessary to form a new company when, as I see it, the capital structure was exactly the same as the old company? Why weren't there more securities of the old company offered to the public?

A. I don't think there was any convincing reason why not. It could have been done in one of several ways. This was the way we chose to do it.

Q. I can give you your own reasons as set forth in your minutes.

A. I would be glad if you would.

²¹⁴ Id., at 18521.

²¹⁵ Id., at 18530.

²¹⁶ Id., Commission's Exhibit No. 2072. The prospectus of Tri-Continental Corporation (old) states specifically that "It is contemplated that after the completion of this financing the Board of Directors of the Corporation will consist of not less than eleven members, five of whom will be partners of the firm of J. & W. Seligman & Co. The Corporation plans to do business with J. & W. Seligman & Co."

²¹⁷ Id., at 18531-2.

Q. That there was too great a cost of the preferred or debentures of the old Tri-Continental, and if debentures or preferred were issued it would be too great a sacrifice of Tri-Continental common stockholders' equities.

A. Those seem to be good reasons.

Q. And the debentures or preferred could not be marketed unless they had common attached.

A. Yes; at that time no one would look at an investment security as such. That was the reason why we put our preferred stock and our common stock into a package, with the hope that by making the people who were buying take a share of preferred in their package we would avoid the people who just came in for a ride.

Q. But the fact remains that here is a situation where you could not sell any additional stock of your original company, so you indirectly do the same thing by forming a new company, and you have seen it over and over again here that they call it a different name and a different set-up and they are able to sell the securities of that company.

A. And you see that was redounded to the advantage of the old Tri-Continental because they were getting these 500,000 of warrants for its management.

On December 27, 1929, four months subsequent to the organization of Tri-Continental Allied Company, Inc., Tri-Continental Corporation (old) and Tri-Continental Allied Company, Inc., were consolidated into one company known as Tri-Continental Corporation (new). The letter to stockholders of Tri-Continental Corporation (old) recommending the exchange recognized the fact that "there exists a considerable identity of interest between the two corporations as your corporation (Tri-Continental Corporation (old)) holds a substantial interest in the Allied Company, through stock and purchase warrants, and provides its management; the Boards of Directors of the two corporations are identical and many stockholders of your corporation are also stockholders of the Allied Company."²¹⁸ Implicit in this recommendation is the recognition that there was no further economic justification for the two separate entities. J. & W. Seligman & Co. received a fee or commission of \$75,000 for effecting this consolidation but they were in a position to manage the assets of this new company which aggregated approximately \$76,000,000.

²¹⁸ Id., Commission's Exhibit No. 2081. In connection with the consolidation of these two companies the 500,000 warrants and 150,000 shares of the common stock of Tri-Continental Allied Company, Inc., held by Tri-Continental Corporation (old) were canceled. (Id., at 18542.) J. & W. Seligman & Co. turned in 123,800 of the warrants of Tri-Continental Allied Company, Inc. (Ibid.)

The capital structure of the new company provided for the issuance of 433,650 shares of 6% cumulative preferred stock with a \$100 par value, 6,000,000 shares of common stock, and 1,008,650 warrants for the purchase of common stock. There were issued and outstanding after the exchange offer 433,650 shares of preferred stock, and 2,020,150 shares of common stock, and 1,008,650 warrants.

An Exchange was effected whereby one share of the preferred stock of Tri-Continental Corporation (new) was exchanged for one share of the preferred stock of Tri-Continental Corporation (old) and one-half share of the preferred stock of Tri-Continental Corporation (new) for one share of the preferred stock of Tri-Continental Allied Company, Inc.; one and a half detached warrants of Tri-Continental Corporation (new) for one attached warrant of Tri-Continental Corporation (old); one-half detached warrant of Tri-Continental Corporation (new) for one-half attached warrant of Tri-Continental Allied Company, Inc.; 1.2 shares of the common stock of Tri-Continental Corporation (new) for one share of Tri-Continental Corporation (old); one share of the common stock of Tri-Continental Corporation (new) for one share of the common stock of Tri-Continental Allied Company, Inc.; and detached warrant of Tri-Continental Corporation (new) for one detached warrant of Tri-Continental Corporation (old) (id., at 18541, and Commission's Exhibit No. 2081).

From inception to 1931 Tri-Continental Corporation²¹⁹ was managed by J. & W. Seligman & Co. Although there was no formal management contract between the investment company and J. & W. Seligman & Co. until 1931, the following management functions were performed by Seligman & Co.: (1) served as adviser with respect to the purchase and sale of securities; (2) supervised and assisted in the general management of the company; (3) made six persons of its firm available to the company to serve as directors and members of the executive committee; (4) acted as broker for the company; (5) served as principal agent for the safekeeping of the company's securities; and (6) acted as the company's dividend disbursing agent.²²⁰

These relationships, however, were formalized on October 9, 1931, when Tri-Continental Corporation with J. & W. Seligman & Co. entered into a management contract.²²¹ By the terms of the contract J. & W. Seligman & Co. was to "supervise and assist in the management of the usual business and affairs of the Corporation" and were to "nominate and provide" at least six persons to serve as directors and members of the executive committee of Tri-Continental Corporation. In consideration for these services Tri-Continental Corporation was to continue to use the brokerage facilities of J. & W. Seligman & Co., at the customary brokerage fees and, further, it was to use its best effort to cause "any and all other corporations owned, controlled, or managed by it" to use these facilities of J. & W. Seligman & Co. on this same basis. With this management contract, together with the fact that J. & W. Seligman & Co. held approximately 6% of the voting control of Tri-Continental Corporation, together with a sufficient number of warrants to insure effective voting control, that firm was in a position to maintain effective management control over Tri-Continental Corporation.

As Tri-Continental Corporation acquired control of other investment companies, J. & W. Seligman & Co. entered into similar management contracts with those companies so that it had effective management control of all of the companies in the Tri-Continental Corporation Group.

Commencing in January 1931, Tri-Continental Corporation invested substantial portions of its assets in the acquisition of control of other investment companies, and thus was commenced the development of the Tri-Continental Corporation system of investment company. Between 1931 and 1935 Tri-Continental Corporation acquired control of and absorbed three investment companies, Wedgwood Investing Corporation (Jan. 1931), Investors Equity Company, Inc. (May 1932), and Graymur Corporation (January 1933), the total assets of which companies aggregated approximately \$12,500,000; and acquired control of and maintained an interest in four other investment companies, Selected Industries, Inc., Broad Street Investing Co., Inc., Capital Administration Company, Ltd., and Blue Ridge Corporation, the total assets of which companies aggregated approximately \$100,000,000.²²²

²¹⁹ Hereinafter, reference to Tri-Continental Corporation relates to the presently existing company.

²²⁰ Derived from questionnaire reply for Tri-Continental Corporation.

²²¹ *Id.*, Part I, Exhibit I-7.

²²² There has been excluded from this consideration the companies, other than investment companies, which were acquired by Tri-Continental Corporation, to wit: Globe & Rutgers Fire Insurance Company, Park Properties Corporation, and General Properties Corporation.

The first of the companies acquired and subsequently dissolved by Tri-Continental Corporation was Wedgwood Investing Corporation.²²³ The assets of Wedgwood Investing Corporation at the time of acquisition by Tri-Continental Corporation (December 1930) were approximately \$3,067,000.

In May 1931 Tri-Continental Corporation acquired from C. D. Barney & Company control of Selected Industries, Inc., whose assets at this time aggregated approximately \$53,500,000.²²⁴ Selected Industries had outstanding 428,527 shares of the \$5.50 dividend prior preferred stock, with no par value, 426,328 shares of no par convertible stock, and 2,115,217 shares of no par common stock, and warrants to purchase 336,671 shares of common stock at \$15 per share.²²⁵ The convertible stock was \$15 "under water"²²⁶ and the common stock had a minus asset value.

Tri-Continental Corporation purchased for approximately \$6,500,000, 377,440 shares of common stock of Selected Industries, or 18% of the total outstanding common stock, and 160,000 shares, or 37½% of the total outstanding shares of the convertible stock which was "under water" to the extent of \$2,400,000.²²⁷ Mr. Bailie conceded that Tri-Continental Corporation paid a premium of at least \$2,000,000 for the acquisition of this stock interest in Selected Industries, Inc. Mr. Bailie stated that this purchase was effected in order to bring under the control of Tri-Continental Corporation assets in excess of

²²³ Wedgwood Investing Corporation was organized in Delaware under the name of Wallman General Investing Corporation, on October 19, 1928, as an investment company of the general management type. Wallman General Investing Corporation issued its total authorized capital stock to John C. Martin, vice president of Curtis Martin Newspapers, Inc., in exchange for 8,000 shares of Curtis Publishing Company common stock, then selling at 200 and worth approximately \$1,600,000. The name of the company was changed to Wedgwood Investing Corporation on October 26, 1929, and the authorized amount of preferred stock was increased to \$3,000,000, of which \$2,910,000 was sold to W. A. Harriman & Co., Inc., and Joseph Walker & Sons at par. (Derived from supplementary information supplied by Tri-Continental Corporation.) At the time that Tri-Continental Corporation acquired control of Wedgwood Investing Corporation, December 31, 1930 (Public Examination, Tri-Continental Corp., at 18553) the assets of the latter at market were worth approximately \$3,067,000, and the assets of Tri-Continental Corporation were approximately \$63,000,000 (Id., at 18555). The assets of Wedgwood Investing Corporation were acquired at a cost to Tri-Continental Corporation of approximately \$3,140,000 (Id., at 18553-4) which issued in exchange for 27,769 shares of the preferred stock and 165,000 shares of common stock of Wedgwood Investing Corporation 27,769 shares of the preferred stock and 55,000 shares of the common stock of Tri-Continental Corporation.

Mr. Bailie justified this purchase of the assets of Wedgwood Investing Corporation on the ground that "it would spread the cost of management over that further amount of assets" (Id., at 18556) since the assets of Tri-Continental Corporation as a result of the acquisition was increased to \$66,000,000. As part of the transaction Tri-Continental Corporation promised Joseph Walker & Sons, a sponsor of Wedgwood Investing Corporation the right to 8.76% of the brokerage business of Tri-Continental Corporation.

²²⁴ Derived from supplementary information supplied the Commission for Tri-Continental Corporation.

²²⁵ Ibid.

²²⁶ The \$5.50 dividend prior preferred stock was entitled to \$100 per share upon involuntary liquidation, and the 426,328 convertible shares of stock were entitled to \$30 per share upon liquidation. (Ibid. and Id., at 18563.)

²²⁷ Derived from supplementary information supplied the Commission by Tri-Continental Corp. Thus the assets of Selected Industries, Inc., were insufficient to the extent of \$6,427,610, or \$15 per share, to cover the liquidating value of the convertible stock.

\$53,000,000 over which there could be spread the cost of management services supplied by Tri-Continental Corporation.²²⁸

Q. What justification was there for Tri-Continental paying \$2,000,000 more?

A. Because we thought that that block of securities was an attractive investment for you must realize that not only did we have securities which on December 31, last year, showed us a profit, I am glad to say, but during this period, during the period when our own assets had declined we had a base of assets which we were managing, which we were getting a fee for managing, which allowed us to build up the research and statistical organization without which we thought we could not operate, and the main reason for the acquisition and the reason why we felt happy about it, even though the market went down, was the fact that we had spread our asset base sufficiently so that from that time on we could afford our research organization.

Q. At the time you took over Selected Industries what was the total assets of Tri-Continental?

A. I do not know.

Q. Approximately?

A. In May 1931 about \$50,000,000.

Q. You acquired the control for the management of how many assets?

A. About the same amount.

Q. Almost \$50,000,000?

A. Yes.

Q. That shot you up to \$100,000,000?

A. That is right.

Q. You paid \$6,000,000 for the common stock?

A. And preferred.

Q. And preferred?

A. And warrants.

As another condition of the purchase contract, Selected Industries, Inc., entered into a service contract with Tri-Continental Corporation whereby Tri-Continental Corporation agreed to furnish Selected Industries, Inc., with management services in consideration of a fee to Tri-Continental Corporation of $\frac{1}{2}$ of 1% of the gross assets of Selected Industries, Inc.²²⁹ Thus, on the basis of assets of \$50,000,000, Tri-Continental Corporation would derive a fee of \$250,000 annually for Selected Industries, Inc. In addition as part of the arrangement, Tri-Continental Corporation agreed to receive 50% of the brokerage business of Selected Industries, Inc., and C. D. Barney & Co. was to receive the balance of 50% of the brokerage commissions, because, as Mr. Bailie testified, "that comes about because of the Selected Industries' transaction which was brought to us in the first instance by C. D. Barney & Co."²³⁰

By April 1932 the assets of Tri-Continental Corporation and its affiliated companies had suffered a severe depreciation, having shrunk

²²⁸ Id., at 18565-6.

Selected Industries, Inc., was organized on December 15, 1928, as an investment company of the general management type. (Id., at 18570.) It was sponsored by five investment banking houses; Charles D. Barney & Co., Stone & Webster and Blodgett, Inc., Kidder, Peabody & Co., Lehman Bros., and Brown Bros. & Co. (Derived from supplementary information supplied the Commission by Tri-Continental Corp.)

²²⁹ Derived from supplementary information supplied the Commission by Tri-Continental Corporation. Further, Tri-Continental Corporation received warrants to purchase 200,000 shares of the common stock of Selected Industries, Inc., at \$15 a share, at any time during the life of the contract. (Id., at 18559.)

²³⁰ Id., at 18678.

from approximately \$100,000,000 to \$50,000,000.²³¹ Thus, on the basis of these assets Tri-Continental Corporation would only derive a fee of \$250,000, whereas the cost of their research facilities averaged between \$400,000 and \$500,000.²³² In order to spread the cost of these research facilities over a broader base of assets it was essential for Tri-Continental Corporation to acquire control of, or absorb additional investment companies having liquid funds requiring investment advice.

On April 21, 1932, Tri-Continental Corporation entered into an agreement with Investors Equity Company, Inc., providing for the purchase of the major portion of the assets of Investors Equity Company, Inc., which at that time amounted to approximately \$6,500,000. The company was finally dissolved on May 18, 1932, by Tri-Continental Corporation.²³³

In June 1932, Tri-Continental Corporation succeeded in adding an additional \$6,000,000 to the assets under its control when it purchased for \$302,000 a block of 128,000 shares or 64%²³⁴ of the outstanding common stock of Broad Street Management Corporation, Ltd.,²³⁵ which managed two investment companies, Capital Administration Company, Ltd., and Broad Street Investing Co., Inc.²³⁶

As of the date when Tri-Continental Corporation acquired its interest in Capital Administration Company, Ltd., the assets of Capital

²³¹ *Id.*, at 18582.

²³² *Id.*, at 18584.

²³³ Investors Equity Company, Inc., an investment company of the general management type, had net assets of \$6,444,589. (Derived from supplementary material supplied the Commission by Tri-Continental Corporation.) Investors Equity Company, Inc., then had outstanding \$5,128,900 principal amount of 5% debentures, Series A & B, 580,936.5 shares of common stock. (*Ibid.*)

In consideration for the acquisition of the assets of Investors Equity Company, Inc., by Tri-Continental Corporation, Tri-Continental Corporation assumed payment of the principal and interest of all the outstanding Series A & B 5% debentures of Investors Equity Company, Inc., having as above stated a face amount of \$5,128,900. In addition Tri-Continental Corporation issued 290,489 shares of its common stock to the holders of 580,936.5 shares of the common stock of Investors Equity Company, Inc. (*Ibid.*) Tri-Continental Corporation also agreed to issue to the holders of option warrants to buy 118,620 shares of the common stock of Investors Equity Company, Inc., at \$16%, option warrants providing for the purchase of 59,310 shares of the common stock of Tri-Continental at \$24 per share up to March 1, 1939, and further Tri-Continental Corporation agreed to issue to holders of option warrants for the purchase of 6,328 shares of the common stock of Investors Equity Company, Inc., at \$30, 3,164 option warrants providing for the purchase of the common stock of Tri-Continental Corporation at \$45 per share up to April 1, 1948. (*Ibid.*)

²³⁴ On September 17, 1935, Tri-Continental Corporation purchased the remaining 36% of the stock of Broad Street Management Corporation for \$180,000. J. & W. Seligman & Co. received \$9,600 commission on 128,000 shares of Broad Street Management Corporation. This was equivalent to the regular stock exchange commission. (Derived from supplementary material supplied by Tri-Continental Corporation.)

²³⁵ Broad Street Management Corporation, a Delaware Corporation, was organized to succeed to Security Management Company, originally organized in New York by Messrs. Maynard, Oakley and Lawrence. (*Id.*, at 18455 and 18464.)

²³⁶ Capital Administration Company, Ltd., an investment company of the general-management type, was organized by Messrs. Maynard, Oakley and Lawrence on October 9, 1928. (*Id.*, at 18460.) Broad Street Investing Company, Inc., is the result of a consolidation of First Investment Fund and Second Investment Fund, both organized by Maynard, Oakley and Lawrence. (*Id.*, at 18452.) Broad Street Management Corporation owned 165,000 shares or 69% of Capital Administration Company, Ltd., class "B" common stock, which carried the sole voting power. (*Id.*, at 18463 and 18464.)

Administration Company, Ltd., at market value were \$4,891,000.²³⁷ Capital Administration Company, Ltd., had outstanding 5% debentures with a face amount of \$3,423,000, 43,400 shares of 6% preferred stock and 143,405 shares of Class A stock and 240,000 shares of Class B stock.²³⁸

Broad Street Investing Co., Inc., which was an open-end investment company, at June 1932 had assets of \$1,252,000 and 105,343 shares of common stock outstanding.²³⁹

Broad Street Management Corporation had a management contract with Broad Street Investing Co., Inc., and Capital Administration Company, Ltd., which provided that Broad Street Management Corporation service both of these investment companies in consideration of a fee equivalent to $\frac{1}{2}$ of 1% of the net assets of these companies.²⁴⁰ As part of the contract whereby Tri-Continental Corporation agreed to acquire 64% of the outstanding common stock of Broad Street Management Corporation, the latter company agreed to pay Tri-Continental Corporation one-half of the gross service fees which Broad Street Management Corporation received from Capital Administration Company, Ltd., and Broad Street Investing Co., Inc.²⁴¹ Tri-Continental Corporation agreed to supply, in consideration thereof, advice to Broad Street Management Corporation with respect to the management policies to be pursued by Capital Administration Company, Ltd. and Broad Street Investing Co., Inc. In addition, Tri-Continental Corporation was to recommend four persons to serve as officers and directors of Broad Street Management Corporation, Capital Administration Company, Ltd., and Broad Street Investing Co., Inc.

The effect of this relationship to Broad Street Management Corporation was to put under the management control of Tri-Continental Corporation an additional fund of \$6,000,000. This tended to further increase the assets to be managed by Tri-Continental Corporation, and thereby decrease the cost to stockholders of Tri-Continental Corporation for their research facilities. Mr. Bailie testified:²⁴²

Q. But the effect of that, as far as Tri-Continental was concerned, was to raise how many millions more of assets under its supervision?

A. I think the figure this morning was \$4,500,000.

Q. \$4,500,000 for Capital Administration Company, Ltd., and \$1,500,000 for Broad Street Investing Company, Ltd.

A. You are quite right, or \$6,000,000.

Q. Making a total of \$6,000,000.

A. You are right.

Q. Of course all of these acquisitions you say went to help spread the overhead?

²³⁷ Derived from supplementary information supplied the Commission by Tri-Continental Corporation.

²³⁸ Ibid., and reply to Commission's questionnaire for Tri-Continental Corporation, Pt. I, Exhibit I-8-P. The Class B stock constituting the principal asset of Broad Street Management Corporation had a minus asset value and no ascertainable market value. [The predecessor company of Broad Street Management Corporation had acquired the B stock of Capital Administration Company, Ltd., for \$58,000. (Public Examination Tri-Continental Corporation at 18462-3.)]

²³⁹ Derived from supplementary information supplied by Tri-Continental Corporation.

²⁴⁰ Ibid.

²⁴¹ Ibid.

²⁴² Id., at 18584.

A. That is right.

Q. So you could maintain this \$400,000 a year research?

A. That is right, and not have it cost the stockholders of the Tri-Continental too much; that was the purpose.

Q. If you were alone you would have to get up \$80,000,000, would you not?

A. Yes; if we stayed at \$400,000. We actually found it cost us near \$500,000 as the organization developed. * * *

On January 3, 1933, Tri-Continental Corporation entered into an agreement with Graymur Corporation,²⁴³ an investment company of the general management type, providing for the acquisition by Tri-Continental Corporation of substantially all of the assets of Graymur Corporation, which at that time were, at market value, \$2,773,000.²⁴⁴

In November 1935, Tri-Continental acquired a 25% interest in Blue Ridge Corporation, an investment company of the general management type, in which Central States Electric Corporation and American Cities Power & Light Corporation, companies controlled by Harrison Williams, and The Chicago Corporation had each acquired a 25% interest.²⁴⁵ Tri-Continental Corporation itself purchased 1,877,519 shares of the common stock out of a total of 7,500,000 shares outstanding, at \$3.25 a share or for a total of \$6,101,936.²⁴⁶ At the same time Selected Industries, Inc., a company controlled by Tri-Continental Corporation, also acquired 6% interest in Blue Ridge Corporation by purchasing 469,390 shares of its common stock.²⁴⁷ Blue Ridge Corporation at this time had assets of \$39,000,000.²⁴⁸ Following from this acquisition by Tri-Continental Corporation of a minority interest in Blue Ridge Corporation, Tri-Continental Corporation entered into a service contract with Blue Ridge Corporation²⁴⁹ providing for an annual fee of $\frac{1}{5}$ of 1% of the assets of Blue Ridge Corporation.²⁵⁰

²⁴³ Derived from supplementary material supplied the Commission by Tri-Continental Corporation.

²⁴⁴ Public Examination, Tri-Continental Corp., at 18586. In consideration for this acquisition, Tri-Continental Corporation issued to the stockholders of Graymur Corporation \$2,400,000 face amount 5% convertible debentures Series A, and 123,000 of the common stock of Tri-Continental Corporation. Graymur Corporation had outstanding at this time 123,000 shares of common stock, and each holder of the common stock received one convertible debenture, having a par value of \$20 and one share of the common stock of Tri-Continental Corporation. On January 25, 1933, Graymur Corporation was dissolved. (Derived from supplementary material supplied the Commission by Tri-Continental Corp.)

With respect to the acquisition of Graymur Corporation, J. & W. Seligman & Co. received a commission of \$12,875 which is equivalent to the regular stock exchange commission which would have been paid by Tri-Continental Corporation if it had purchased the shares of Graymur Corporation on the exchange. (Derived from supplementary material supplied the Commission by Tri-Continental Corporation.)

²⁴⁵ Tri-Continental Corporation resold 635,000 of these shares at a profit, thus retaining 17% or 1,200,000 shares of the common stock of Blue Ridge Corporation. (Public Examination, Tri-Continental Corp., at 18593.)

²⁴⁶ Derived from supplementary material supplied the Commission by Tri-Continental Corp.

²⁴⁷ *Ibid.*

²⁴⁸ *Id.*, at 18593.

²⁴⁹ Derived from supplementary material supplied the Commission by Tri-Continental Corporation. The service contract provided that both Tri-Continental Corporation and Northern Shares Co., Inc., a New York corporation, affiliated with the Harrison Williams group of companies (see *infra* for description of this group of companies), would both manage the assets of Blue Ridge Corporation. (*Id.*, at 18609.) Tri-Continental Corporation for the most part managed that portion of the company's portfolio which was not public utilities, and Northern Shares serviced that part of the corporation's portfolio which was public utilities.

²⁵⁰ *Id.*, at 18608.

As a result of this arrangement Tri-Continental Corporation acquired management powers over an additional pool of funds which was approximately \$18,000,000.²⁵¹ The following chart represents graphically the companies included in the Tri-Continental Corporation group of companies as of December 31, 1939.²⁵²

J. & W. Seligman & Co. in effect was at the top of this (Tri-Continental Corporation group) structure with approximately \$150,000,000 of funds as of December 1935 through its management contract with Tri-Continental Corporation and through its ownership of a minority control block of Tri-Continental stock. Mr. Bailie testified:²⁵³

Q. * * * Do you dispute that there is, shall I say, an intangible benefit to J. & W. Seligman & Co. by virtue of the fact that it manages \$170,000,000 to \$200,000,000 of funds rather than \$25,000,000 to \$50,000,000?

A. Of course, there is an advantage.

Q. There is?

A. There is an advantage. It is not an advantage that I can put a dollar and cents value on, but there is no doubt that there is an advantage.

Q. In the prestige?

A. Whatever you want to call it, whatever word you want to use, you may say "prestige," or managing large amounts of other people's money in a way that does not dissatisfy them. It does lengthen the shadow of the person who does it.

As has already been indicated, J. & W. Seligman & Co. was to receive all of the brokerage business of Tri-Continental Corporation and its subsidiaries involving brokerage commissions from portfolio turnover of the various companies, company acquisitions, company mergers, etc. Mr. Bailie described the sources of brokerage fees to J. & W. Seligman & Co. as follows:²⁵⁴

Q. * * * There is brokerage, isn't there?

A. Then there is the brokerage business.

Q. And that brokerage business, as I have it, falls into seven different categories, the type of brokerage that occurs. * * *

A. Right.

Q. You have the brokerage from day to day, portfolio turn-over; that is, the purchase and sales in the ordinary course of business?

A. Right.

Q. You remember there is \$25,000,000 of preferred stock which is repurchased by the corporation of its own preferred stock.

A. Yes; out of which we made \$60,000.

Q. You got the brokerage. I am trying to see the different types of brokerage that then occurred.

A. Right.

²⁵¹ The remaining portion of the assets—\$21,000,000—of Blue Ridge Corporation consisted of public utilities and were serviced by Northern Shares Corporation.

²⁵² See Hearings before subcommittee of the Committee on Banking and Currency of the United States Senate on S. 3580 (76th Cong., 3d Sess.)

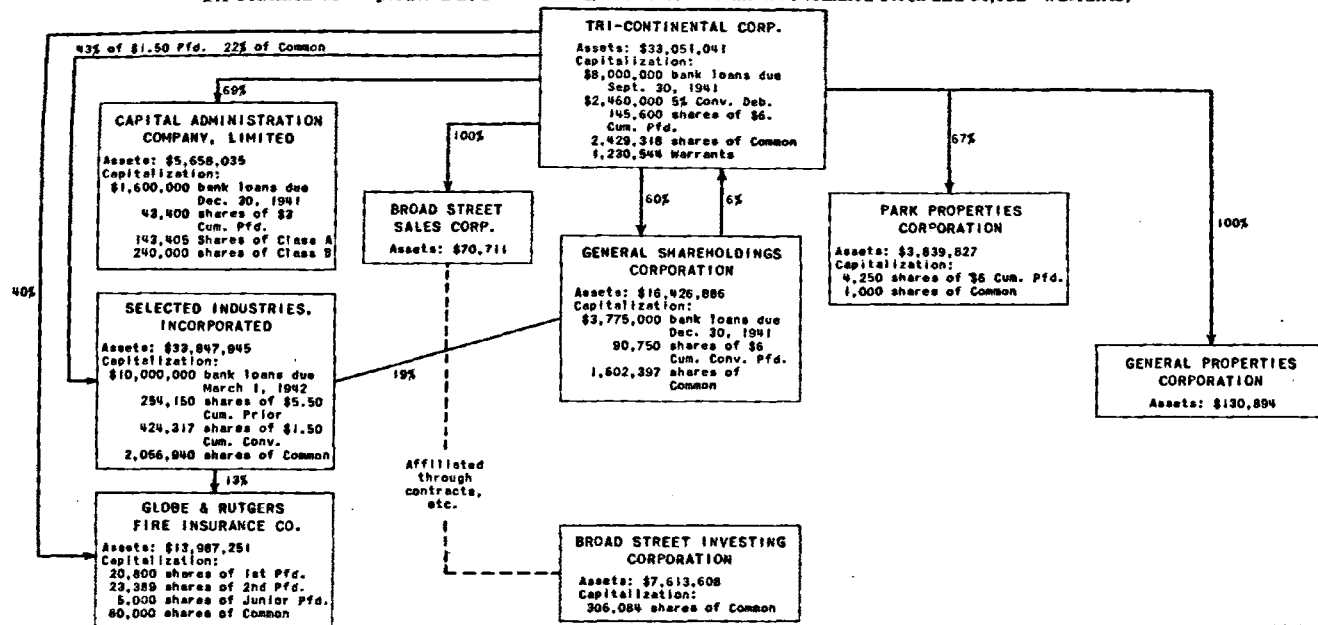
²⁵³ Id., at 18625.

²⁵⁴ Id., at 18671-5.

CHART 13

J. & W. Seligman & Co. Group, December 31, 1939

(Maximum investment of J. & W. Seligman & Co. in Tri-Continental Corporation, \$2,500,000 Holdings of J. & W. Seligman & Co. and partners in Tri-Continental Corporation at December 31, 1939: 8,600 shares of common stock and 36,122 warrants)



Q. You got brokerage, I suppose, from the portfolio readjustments when you acquired these companies, didn't you?

A. To the extent we did the buying; yes.

Q. That is to say, when Selected Industries came in with an account where the portfolio was not in order, it required a drastic change to put those accounts in shape?

A. Sometimes.

Q. And also you had to sell four and a half million dollars of securities to buy Selected Industries, if I remember rightly?

A. Quite true.

* * *

Q. * * * Now, you got some brokerage from portfolio companies, didn't you? That is to say, you got some business. I thought, from some of the underlying insurance companies. I also thought there were some one or two cases where you got brokerage from the sale of Government bonds.

A. J. & W. Seligman bought and sold Government bonds for the Lorillard Company²⁵⁵ over a period of years, and still do, although the Lorillard holdings have been disposed of for two years, and the reason given is that they think Seligman & Co. know how to buy and sell Government bonds very well, and the company made something like three-quarters of a million dollars out of the transaction.

Q. You had not been getting brokerage business before, had you, from Lorillard?

A. No.

Q. And you went on the board, didn't you?

A. That is correct.

Q. Wouldn't it be fair to say that the fact that you had large stockholdings, that you went on the board and you got the brokerage business after that date, there was probably some connection? I don't say it is the only cause.

A. Yes; I think that is very fair to say. * * *

In 1936 Tri-Continental Corporation received \$500,054 in management fees from the subsidiary companies in the Tri-Continental Corporation group, whereas the cost of maintaining these services by Tri-Continental Corporation was \$524,000.²⁵⁶ Therefore, Tri-Continental Corporation was the only company in the system which receives free management facilities from J. & W. Seligman & Co. as a "quid pro quo" for the brokerage business supplied to that firm.²⁵⁷ The remaining companies paid Tri-Continental Corporation for the management services which it afforded them, and at the same time gave all their brokerage business to J. & W. Seligman & Co. Mr. Bailie testified:²⁵⁸

Q. They pay one-half of one percent and they get no quid pro quo. You recognize that the brokerage is worth something to the company in this contract in regard to the other companies which you control, but you do not give any recognition to the value of the brokerage?

A. If you ask me whether I think the Tri-Continental Corporation stockholders are somewhat better off under their contract, my answer is "yes."

Apparently in recognition of the problems involved in these management arrangements, particularly with respect to the comparative

²⁵⁵ Selected Industries, Inc., had a large holding in P. Lorillard Company.

²⁵⁶ Id., at 18627.

²⁵⁷ J. & W. Seligman & Co. in its investment banking activities made free use of the research facilities of Tri-Continental Corporation.

²⁵⁸ Id., at 18633-34.

cost of management among the various companies in the Tri-Continental group, Tri-Continental Corporation, commencing on January 1, 1940, had adopted a mutual management arrangement. This plan contemplates that each company in the group, including Tri-Continental Corporation, will pay a share of the expenses, based on its proportion of the total assets of the group, for the maintenance of the investment research and administrative staff by Union Service Corporation, a newly organized non-profit management corporation.

Mr. Bailie, when examined as to the economic advantage for the stockholders in the pyramid structure of Tri-Continental Corporation, testified:²⁹⁹

Q. What economic advantages are there, if any, of having a set-up of one trust that owns a substantial block of stock and another trust which owns a substantial block of another stock?

A. That is not quite a fair description, because Tri-Continental owns at the present time directly a block of Selected Industries, Tri-Continental owns directly a block of Capital Administration; Tri-Continental owns directly Broad Street Management, which sells Broad Street Investment as a sales agency; Tri-Continental owns directly a block of Blue Ridge.

Q. But you do have the situation where Tri-Continental owns 25 per cent of Selected Industries, which, in turn, owns 7 per cent of Blue Ridge and 5 per cent of Globe Rutgers,³⁰⁰ is that not so?

A. That is correct.

Q. Is there any economic utility or advantage in having that type of set-up?

A. You are now talking about those last two?

Q. That is right.

A. The only reason that Selected Industries bought Globe Rutgers is because they thought it was a darned good investment. I mean they looked into the possibilities and they had a pyramided structure of a substantial size, and they thought it was going to be a very good investment there, as it had been. Now Selected Industries at times had not gone along with Tri-Continental in special situations. For instance, in our Real Estate Park Properties Selected Industries did not want to go into Real Estate Park Properties, but the Globe Rutgers did. In Blue Ridge they also felt that there was a block of stock they would like to have. Of course, they took much less than Tri-Continental. I personally think this factor would be a slight one, and, from your point of view, more logical if in that picture the Selected Industries did not own a block of Blue Ridge * * *

Q. From the testimony, it seems to me that the result of the structure as it exists today is not a matter of volition, in the sense that you consider the present structure the desirable form, but rather was actually motivated by the fact that the only way to increase the size of the fund was through these various steps—

A. That is right.

²⁹⁹ Id., at 18620-3.

³⁰⁰ A fire insurance company in which Tri-Continental Corporation organized a controlling interest on August 30, 1933, and with which company Tri-Continental Corporation had a service contract. (Derived from supplementary material supplied the Commission by Tri-Continental Corp.)

Mr. Baillie, discussing the desirability of collapsing the entire system, testified:²⁸¹

A. —It seems to me, as the markets go up and as times are what we hope to think are normal, that the structure should be simplified, should be cut down, should be brought together at times when it is fair to the various stockholders concerned. Great damage could be done to them if they were rushed at the wrong time into a merger, but it does seem to me that the process of simplification, until you get the type of capital structure that you have talked about before, where you say the leverage is the same, then it seems to me that the advantages are probably with a single organization.

On November 22, 1938, a modification in the constituent elements of the Tri-Continental Corporation structure was effected. At this time, as has already been indicated, Tri-Continental Corporation held a controlling interest in Selected Industries, Inc., Capital Administration Company, Ltd., and Broad Street Investing Company. In addition Tri-Continental Corporation and Selected Industries, Inc., together held a minority control interest in Blue Ridge Corporation, which they jointly controlled with two of the so-called Harrison Williams companies, which will be described below—Central States Electric Corporation and American Cities Power & Light Corporation.²⁸²

Central States Electric Corporation and American Cities Power & Light Corporation at this time held also an 86.3% interest in Electric Shareholdings Corporation, an investment company of the general management type, which had been organized under the laws of Delaware on March 8, 1929. In November 1938 Electric Shareholdings Corporation had outstanding 90,850 shares of \$6 preferred stock and 1,602,439 shares of common stock, of which Central States Electric Corporation and American Cities Power & Light Corporation together owned 1,385,757 shares. The assets of Electric Shareholdings Corporation at this time were approximately \$17,000,000 of which almost 50% were invested in The North American Company, a public utility holding company registered under the Public Utility Holding Company Act of 1935.

Central States Electric Corporation itself, and through its subsidiary companies American Cities Power & Light Corporation, Electric Shareholdings Corporation, and other of its subsidiary companies, held more than a 10% interest in The North American Company. Central States Electric Corporation either had to register under Section 4 of the Public Utility Holding Company Act of 1935, or divest itself of some of its interest in The North American Company.

The latter alternative was adopted. An arrangement was effected whereby control of Electric Shareholdings Corporation, which held a substantial interest in The North American Company, was transferred to the Tri-Continental Corporation system. Tri-Continental Corporation, which owned 1,436,450 shares of Blue Ridge Corporation, and Selected Industries, Inc., which owned 482,470 shares of Blue Ridge Corporation transferred these shares to Central States Corporation and American Cities Power & Light Corporation. In consideration therefor Tri-Continental Corporation received 957,359

²⁸¹ Id., at 18624-5.

²⁸² The Chicago Corporation also held a minority interest in Blue Ridge Corporation.

shares and Selected Industries, Inc., 285,641 shares of the common stock of Electric Shareholdings Corporation. Central States Electric Corporation and American Cities Power & Light Corporation received respectively 891,648 shares and 972,852 shares of the common stock of Blue Ridge Corporation. As a result, therefore, Electric Shareholdings Corporation, which name was changed to General Shareholdings Corporation, became an affiliated company in the Tri-Continental Corporation system and Blue Ridge Corporation was transferred to the control of Central States Electric Corporation and its subsidiary companies.

C. Operation and Management of Pyramided Systems of Investment Companies; Effect on Stockholders

1. COMPLEXITIES IN STOCKHOLDERS RELATIONSHIPS

The pecuniary advantages to persons who create and operate these holding company systems of investment companies may not be consonant with the interests of the public investors. The pyramided systems created, as has already been shown, by a series of organizations, mergers, consolidations, and shifts in control of investment companies, have not been without effect on the relative rights, interests, and obligations of the stockholders of the respective investment companies subjected to the changing managements. In fact, in the operation and management of these holding company systems the interests of the stockholders of the constituent investment companies were most drastically affected. The lack of beneficial effect of the pyramiding device on the security buying public has been summarized as follows:

It results in the creation and sale to investors of large amounts of unsound senior securities. It produces common stocks of holding companies which are subject to deceptively rapid increases in earning power in favorable years and which are invariably made the vehicle of wild and disastrous public speculation. The possession of control by those who have no such capital investment is inequitable and makes for irresponsible and unsound managerial policies. Finally, the holding company device permits of financial practices which exaggerate the indicated earnings, dividend return, or "book value," during boom times, and thus intensify speculative fervor and facilitate market manipulation.²²

a. Effect on Management Personnel

The modification in the personnel of the management of these companies is the first element which is affected in a holding company structure. The device of the pyramided system, as has become apparent, precludes the existence of independent investment companies controlled by independent managers. It is a medium whereby investment companies are controlled through a chain of other investment companies, which are ultimately controlled by one or more persons who usually have only a minority interest in the top company of the structure. The direct management of the once independent investment company is removed in such a set-up, despite the fact that the

²² Graham, Beul., and Dodd, D. L., *Security Analysis* (1934), p. 566.

public may have invested in these companies, influenced by its estimate of the integrity and responsibility of the initial management group of the company whose investment abilities and qualifications may have been extensively publicized in the original prospectus of the company. This modification in the personnel management was most frequently effected without prior knowledge or consent of the stockholders of these investment companies.

b. Effect on Investment Policies

Concomitantly with the change in the management was the modification in the investment policies of these companies which were often diametrically opposed to the avowed purposes of the organization of the original companies. For example, to conform to the interests of the management group of these pyramided structures, stockholders of diversified investment companies became stockholders of other investment companies; stockholders of companies investing in public utility securities of United States and Europe, became stockholders in companies whose primary activity was the acquisition of real estate properties in and around Boston, Mass.; stockholders of diversified investment companies became stockholders of companies engaged in facilitating the acquisition of control of other investment companies for ultimate consolidation into one single company.

Even the application of a diversified investment policy to investment companies in a pyramided structure is fraught with difficulties and complexities following first, from the fact that the companies in these pyramided structures have individual capital structures which necessitate distinctive investment needs and second, from the problem of equitably allocating the purchases and sales of securities for the various companies under common control. Earle Bailie, president of Tri-Continental Corporation, when examined on these difficulties, testified:²⁶⁴

Q. There are various securities outstanding which, in and of itself, present an investment problem, is that not so?

A. Yes.

Q. In the sense of securing the rights of each type of security?

A. That is right. That is one of the reasons—why that year we pulled down our pyramid by \$20,000,000 by retiring the old Investors Equity debentures, by cutting down the amount of our preferred stocks, gradually pulling down that pyramid, not because we wished to do that, but gradually, over the rising trend of the market, with the idea in our minds that it would be advantageous to our various security holders gradually to simplify the picture.

Q. In addition, to the problems which are inherent in a complicated or diversified security structure, you also have the further complication, do you not, by virtue of the inter-company holdings, is that not so?

A. The only inter-company holdings that I think are complicated arise out of the Blue Ridge block of stock. I do not see any complications from Tri-Continental's Selected Industries, establishing a management contract with Selected Industries. I do not see any complication arising from Tri-Continental owning Broad Street Management stock where the stockholders were apprised of the situation and understood it. Those are downstream holdings,

²⁶⁴ Public Examination, Tri-Continental Corporation, at 18613.

if I may put it that way. That is the distinction I am trying to make. In other words, I do not see the obligations arising out of an investment company which can service more than its own assets. I see no obligation there from this block of stock of the company which they manage.

I do see complications in the Blue Ridge holdings that was the reason why the first step was to get rid of the Chicago Corporation stock, and we are planning as best we can, to further simplify this situation. It is not difficult.

Q. I understand your testimony is that you are continuously confronted with the problem of the allocation of the amount of investment, the type of investment, by virtue of the fact that you have this Selected Industries?

A. That is right.

E. F. Henderson, one of the controlling sponsors of the so-called Henderson group of companies²⁰³ testified:²⁰⁴

Q. Now, it is pretty much universally conceded that—and I want to see if you don't concede it—that any capital structure that has more than one class of security in and of itself creates a conflict of interest in the management, because an investment which may be good for the funded debt may not be good for the preferred or the common, isn't that so?

A. There is that possibility.

Q. The fact of the matter is that Brown Brothers and Harriman testified, that it was by virtue of the existence of their funded debt that in 1932 they thought the best thing to do was to liquidate the portfolio to protect the bond.

A. Yes, sir.

Q. Wasn't that so?

A. Yes, sir.

Q. And many times where you have to make sure that you meet your interest payments on your funded debt, you may have to get into situations which will assure you a return, so that you can meet your funded debt, isn't that so?

A. Yes, sir.

Q. Although you may have other situations which have greater speculative character, and greater chance for ultimate return, but you have to forego those situations because you have your funded debt to meet, isn't that so?

A. That is right.

Q. So that you have this conflict or impulsion with respect to investment policy, in each one of these investment situations by virtue of the complexity of the capital structure of each one of the units, isn't that so?

A. Yes, * * *.

Q. * * * You have situations where one company with a complex structure is superimposed on another company with a complex structure which in turn is superimposed on another complex structure. You say that no conflicts would exist with respect to investments by virtue of that arrangement?

A. There are possibilities of conflict.

The individual stockholder's interests thus are subordinated in an effort to adjust investment policies to conform to the various complex capital structures, to the varied histories and experiences of all the constituent investment companies in such systems.

²⁰³ See *supra* for discussion of the so-called Henderson group of companies.

²⁰⁴ Public Examination, General Investment Corporation, at 15362-64.

To this effect, Louis H. Seagrave testified as follows with respect to the management's problems involved in the former Founders pyramid of investment companies:²⁶⁷

These companies were all companies that had their particular problems. They had different dividend dates. Some of them had made their principal investments in some years and some in others. In some cases it may seem advisable to change them, and in others it may not. I remember times when some of the companies sold securities because they needed cash with which to pay their dividends. I can remember when we found some companies with a little more cash, though perhaps not any more proportionately, than others, and yet a particular investment came along that necessitated, if they participated on the same basis, disposing of something else. Their capital structures were somewhat different. As the result there were times when we believed it highly advisable to keep larger amounts of bonds in some companies than in others, their investments were not identical. So that always there were different problems arising in these companies. It was not a case of a rational happening, it was happening week in and week out, year in and year out.

2. CREATION OF FICTITIOUS ASSET VALUES

a. Effect of Circular Ownership: Control of the Central States Electric Group

Moreover conditions obtain as a result of the complex capital structures of the constituent investment companies in a pyramided system which contribute to complicating the determination of the true asset values of the stockholders' interests in these companies. Where, for example, pyramided structures are created by a series of circular and cross-holdings among the companies a series of fictitious values results which make it practically impossible for the stockholders to ascertain the actual asset values of their respective securities.²⁶⁸ In fact, deter-

²⁶⁷ Public Examination, American General Corporation, et al., at 24099. For detailed discussion of the Founders group of companies see Part Three, Ch. VI.

²⁶⁸ The Report has already described the activities of the so-called Fiscal Management and Northern Fiscal groups in the acquisition and control of investment companies. It was shown that these groups were enabled to acquire and retain control of 7 investment companies with assets of approximately \$15,000,000 without making any personal investment. This was effected by the creation of personal holding companies, which held the controlling blocks of stock of the acquired companies. The acquired investment companies, in turn, held the preferred stocks of the holding companies which held nothing but those control blocks of stock of the acquired investment companies. The resulting structures represented instances of circular ownership.

For example, Fiscal Management Company, Ltd., the personal holding company of the Fiscal Management Group held the control blocks of stock of First Income Trading Corporation, and Continental Securities Corporation. First Income Trading Corporation, in turn held a block of the preferred stock of Fiscal Management Company, Ltd., and a block of the common stock of another investment company known as Reynolds Investing Company, Inc., also acquired by the Fiscal Management Group. Continental Securities Corporation held all the outstanding common stock of Corporate Administration, Inc., which managed and distributed the security of the open-end investment company, Administered Fund Second, Inc., and a large block of the common stock of Reynolds Investing Company, Inc., which together with the stock of that company owned by First Income Trading Corporation constituted a control block of stock of Reynolds Investing Company, Inc.

mination of these values may even be beyond the ken of those in control of the system.

It will be recalled that beginning in 1929 a series of circular ownerships were present in the Central States group. Central States Electric Corporation and Shenandoah Corporation held substantial blocks of each other's common stock. In addition, there was circular ownership between Central States Electric Corporation, Shenandoah Corporation, and Blue Ridge Corporation: Central States Electric Corporation held the common stock of Shenandoah Corporation which, in turn, held common stock of Blue Ridge Corporation which, in turn, held common stock of Central States Electric Corporation. Mr. Stone, president of these companies testified as follows with regard to effect of these relationships, and the problems involved in ascertaining these respective values created as a result of the above-described cross and circular ownership:²⁶⁹

Q. There is no question about the fact that Shenandoah and Blue Ridge complicated the capital structure of the Central States systems is there?

A. Well, the formation of these companies added to the size of the picture and added certain features to the financial structure, looking at it from top to bottom.

Reynolds Investing Company, Inc., held a large block of the preferred stock of Fiscal Management Company, Ltd.

As a result of these cross-holdings, a cycle of artificial valuations were created. To illustrate, an increase in the earnings of the management stock of First Income Trading Corporation held by Fiscal Management Company, Ltd., would presumably increase the value of such management stock. This increase in the value of the management stock would increase the earnings and the value of the assets of Fiscal Management Company, Ltd., and would thus increase the market value of the preferred stock of Fiscal Management Company, Ltd. (Since the preferred stock of Fiscal Management Company, Ltd., had a participating share in the entire earnings of the company, the stock on the basis of its earning power would presumably sell in the market at a price higher than its liquidating preference in assets.) As a consequence, the assets of First Income Trading Corporation would increase in value as the reflection of the increase in value of the shares of preferred stock of Fiscal Management Company, Ltd., which it owned. The resultant augmented value of the assets of First Income Trading Corporation might tend to increase the market value of its management stock since the earning power of such stock might be deemed to have increased because of the increase in the total investible assets of the company. The increased market value of First Income Trading Corporation management stock held by Fiscal Management Company, Ltd., would increase the value of the assets of that company. Thus the cycle of artificial valuations which has been described would be repeated. In fact, however, the underlying values and earning power of the assets of the two companies, other than their circular ownership of each other's stock, would not have been increased in any way.

This same analysis may be applied to an evaluation of the effect of the interownership of the control block of stock of Continental Securities Corporation, Reynolds Investing Company, Inc., and Fiscal Management Company, Ltd., which is further complicated by the intercompany holding between Continental Securities Corporation and Reynolds Investing Company, Inc.

Furthermore, by purposely designating Fiscal Management Company, Ltd., as a leverage company to hold controlling blocks of the equity securities of leverage investment companies the Fiscal Management and Northern Fiscal group acquired not only the leverage advantage of the stocks in the portfolio of the personal holding companies but also acquired the leverage advantage of the common stock of the holding companies which the organizers of these companies owned. (See Part Three, Ch. II, pp. 350-496.)

²⁶⁹ Public Examination, Central States Electric Corporation, at 13263, 13265. For detailed description of the complex capital structure of these companies and the effect thereof on the stockholders see Part Three, Ch. V, pp. 1683-1708.

Q. It complicated it so much that the auditors had a hard time making out a formula, didn't they, to determine the actual value of the cross-holdings in the system?

A. Yes.

Q. You have seen that formula, haven't you?

A. Yes; I have seen the cross-holding formula.

Q. Can you make it out yourself?

A. Can I?

Q. Yes.

A. Well, I don't know that I can.

* * * * *

Q. Wouldn't it be impossible for the average investor to work out the actual value of the respective holdings of Shenandoah and Central States after the formation of Shenandoah, with these cross-holdings?

A. Giving effect to the cross-holding reserve formula?

Q. Yes.

A. I should say it would be difficult for the average person to do it. It would be difficult for me to do it, I should say.

Q. You were president of the company and you said it would be very difficult for you to do it?

A. Difficult in this sense that it is the type of thing that I, as president of the company, did not undertake to do and would not undertake to do.

Harrison Williams, the dominant figure of Central States Electric Corporation, similarly conceded that it was a hard thing to analyze the value of the securities held by the stockholders of these various companies in his system as a result of the pyramiding of the investment companies engaged in by Central States Electric Corporation in 1928 and 1929:²⁷⁰

Q. Well, the fact remains that you have here in Central States a holding company superimposed upon a lot of other holding companies, and from an investment point of view in Central States, you are probably a long ways away from the values in the system, aren't you?

A. You mean a long ways away from the operating company.

Q. Yes. How can you tell what the values are? How can you be so definite and certain with intermixed here so many holding companies so far removed from your ultimate pillars of investment; namely, your operating companies?

A. Well—

Q. You get pyramiding on pyramiding on pyramiding.

A. Well, I admit that was a hard thing to analyze—

Even in those instances where the holdings between companies were only "one-way" the stockholders could not without considerable difficulty ascertain the value of their respective holdings. For example, in discussing in a previous section of the report²⁷¹ the value of the stock of Central States Electric Corporation, the top company of a pyramided system, the complexities involved in this determination were described as follows:

The earnings of the North American common stock, the principal asset of the system, reached the top company, Central States Electric Corporation, in vary-

²⁷⁰ Public Examination, Central States Electric Corporation, at 12341.

²⁷¹ See Part Three, Ch. V, pp. 1700-1.

ing ratios depending on the leverage from the senior securities existing in the particular investment company of the group, in which the block of North American common stock was held. For example, at the end of 1929 approximately 85% of the earnings of this block of North American common stock held by Blue Ridge Corporation would after allowing for dividends to the senior securities of Blue Ridge Corporation, accrue to Shenandoah Corporation. In the case of Shenandoah Corporation, however, after allowing for payments to its senior securities, only 45% of these earnings coming from Blue Ridge Corporation and from Shenandoah Corporation's own holdings of North American common stock would be passed on to Central States. To the earnings of North American common stock which had been received by Central States Electric Corporation from Blue Ridge Corporation and Shenandoah Corporation as above described would be added the earnings received directly from Central States' own holdings of a substantial amount of North American common stock, and its 70% interest (after dividends for senior securities) in the block of North American common stock held by American Cities Power & Light Corporation. Thus the earnings from the major investment of the system would be reflected in the top investment company, Central States Electric Corporation in different percentages and with varying leverage, the determination of which would involve intricate mathematical calculations, even if all the information were available.

It is thus apparent that inherent in the mere operation of pyramided structures of investment is the obscuring of the true asset values of the stockholders' interests.

b. Effect of Valuation of Stocks of Affiliates

(1) REYNOLDS INVESTING COMPANY, INC.

The values of the securities of the constituent companies in a pyramided system, however, have been in some cases further complicated as a result of the management policies of those who control these systems.

Appraisal values may be applied to the underlying securities of affiliated investment companies, which in turn would affect the value of the securities of all the companies in the system. For example, Reynolds Investing Company, Inc., as at December 31, 1931, carried its 198,416 shares of Reybarn Co., Inc., its subsidiary, at \$3 per share or a total value of \$595,248.²⁷² The market value of Reybarn Co., Inc., common stock, at this time was 75¢ per share. Instead of taking the market value of Reybarn Co., Inc., common stock, Reynolds Investing Co., Inc., purported to set forth what it regarded as the real value of the Reybarn Co., Inc., stock which it held. Reynolds Investing Co., Inc., and Reybarn Co., Inc., each held investment in U. S. Foil Co. and Case, Pomeroy & Co., Reybarn Co., Inc., as at May 31, 1931, had appraised its holding of Case, Pomeroy & Co. common stock at \$8.75 per share and its investment in U. S. Foil Co. class B stock at \$4.50 per share.

²⁷² Reply to the Commission's questionnaire for Reynolds Investing Company, Inc., Part III.

²⁷³ Reynolds Investing Co., Inc., had made these evaluations as at December 31, 1931, after there had been a sharp decline of the market between May 31, 1931, and December 31, 1931.

Reynolds Investing Co., Inc., had evaluated its investment in Case, Pomeroy & Co. at \$10 per share, and its holdings in U. S. Foil Co. stock at \$9 per share. Thus in appraising the value of its investment in Reybarn Co., Inc., common stock, Reynolds Investing Co., Inc., placed its own value on investments in U. S. Foil Co. and Case, Pomeroy & Co. held by Reybarn Co., Inc., rather than adhering to the prices fixed for those stocks by Reybarn Co., Inc. The values thus fixed by Reynolds Investing Co., Inc., on the portfolio securities of Reybarn Co., Inc., affected the asset value of the common stock of Reybarn Co., Inc., which in turn affected the asset value of the stock of Reynolds Investing Co., Inc. In other words, therefore, the stockholders' interest in Reynolds Investing Co., Inc., would thus constitute merely a reflection of the appraisal values placed on its subsidiary's investments. This enabled Reynolds Investing Co., Inc., to show a value of its assets sufficient to avoid the "touch-off" clause of the debentures.

(2) CENTRAL STATES ELECTRIC CORPORATION GROUP

Additional factors, not directly attributable to inter-investment company ownership, were present in the Central States Electric Corporation system of companies. The market price of The North American Company common stock, which was the principal holding of the group of companies, was inflated over a period of years by the distribution activities of North American Securities Co., Harrison Williams' personal holding company. Millions of dollars were expended in purchasing shares of North American common stock on the Stock Exchange while these shares were being distributed over-the-counter through security dealers on a commission basis. Likewise, the market price of Central States Electric Corporation common stock was moved upwards, facilitated by the fact that Harrison Williams held over 90% of the total number of shares issued and outstanding. However, in a large measure, due to the inflated market value of the securities of affiliated investment companies held in the portfolio of Central States Electric Corporation, the market value of the total number of issued and outstanding shares of Central States Electric Corporation common stock amounted to \$680,000,000 on September 30, 1929, while the net liquidating asset value of these shares, evaluating portfolio securities of affiliated investment companies at their asset value and other securities at their market value, amounted to only \$260,000,000. The tremendous spread between market value and the net liquidating asset value of Central States Electric Corporation common stock, amounting to \$420,000,000, was to a great extent caused by the excess of market value over asset values of securities of affiliated investment companies held in the Central States Electric Corporation portfolio. The market value of the securities of Blue Ridge Corporation held by Central States Electric Corporation exceeded their asset value by \$43,000,000. Similarly, the market value of the shares of Shenandoah Corporation exceeded its asset value by \$104,000,000; the market value of American Cities Power & Light Corporation shares exceeded asset value by \$39,000,000 and the shares of Electric Shareholdings Corporation exceeded asset value by \$13,000,000. The investor purchasing securities of Central States Electric Corporation or its affiliated investment companies was misled by the

artificial market values created by this vast manipulative scheme, and by the device of carrying the securities of affiliated investment companies in the portfolio of the parent company at their market value as representative of their intrinsic value.

Mr. Williams testified:²⁷⁴

Q. That is a common phenomenon, isn't it, in a holding company set-up; each company at the top goes faster?

A. What?

Q. I say it is a common phenomenon that each company on top goes a little faster than the company underneath? That is a normal instance of pyramiding?

A. Yes; I understand—

Conversely, a decrease in the market value of the stocks of the underlying companies effects a greater decrease in the market value of the stocks of the top company, as a member of the pyramid structure.²⁷⁵

c. Effect of Market Operations in the Stock of Subsidiary Companies

(1) CENTRAL STATES ELECTRIC CORPORATION GROUP

Market operations in the stocks of subsidiary companies creates not only fictitious values for the stock of that company, but also directly inflate the value of the stocks of the top company. The obscuring of the stockholders' interests in all of these companies results therefrom.

The method of distributing and marketing the securities of Central States Electric Corporation and its affiliated investment companies, controlled by Harrison Williams, furnish ample illustration of such practices. In general, the technique employed was to effect purchases on the Stock Exchange of a substantial part of the offerings of a particular equity stock and to distribute all or a part of such stock off the exchange through a country-wide chain of security dealers on a commission basis. In this manner, the preponderance of purchase transactions on the Stock Exchange effected a rise in the market price of the common stock of a subsidiary investment company to a point far in excess of its asset value. The shares of the subsidiary investment company, carried in the portfolio of Central States Electric Corporation at the inflated market value, reflected an artificial value in portfolio of the parent company. In turn, the common stock of Central States Electric Corporation was subject to the same manipulative influences, resulting in a market price with a relatively greater difference between market value and asset value. As a result of these practices, Harrison Williams was enabled to dispose of a large part of his holdings of Central States Electric Corporation common stock at high market prices and at a tremendous profit. The inflated market value gave no true indication to the investor of the intrinsic value of the securities in question.

For example, Central States Electric Corporation sponsored American Cities Power & Light Corporation as a subsidiary investment company in 1923, 400,000 shares of Class A (preferred) stock and

²⁷⁴ Public Examination, Central States Electric Corporation, at 12349.

²⁷⁵ *Id.*, at 12412-15. For a more detailed discussion of the problem see Pt. Three, Ch. V, pp. 1628-1699.

400,000 shares of Class B (voting) stock were distributed to the public, and 1,600,000 shares of Class B (voting) stock were acquired by Central States Electric Corporation. By virtue of its ownership of 80% of the issued and outstanding shares of Class B stock, Central States Electric Corporation could, by increasing or decreasing its holdings, cause sharp fluctuations in the market price established for the stock. Trading in the 400,000 shares of Class B stock outstanding in the hands of the public was more susceptible to market operations than would have been the case if the total 2,000,000 shares of Class B stock had been outstanding in the hands of the public and subject to sale on the market. In fact, North American Securities Co., Harrison Williams' personal holding company, conducted a trading account in the Class B stock of American Cities Power and Light Corporation and caused the market price of the stock to rise rapidly to a point substantially in excess of the liquidating asset value. With respect to the market value of the 1,600,000 shares of American Cities Power & Light Corporation Class B stock held by Central States Electric Corporation, L. E. Kilmarx testified as follows:²⁷⁶

A. The market value may have been \$44,000,000, because it had advanced in value marketwise during that time.

Q. What was it carried on the books at, original cost?

A. At original cost, \$16,150,000.

Mr. JOHNSON. It was carried at market value.

Q. All right, so that then within these two months your original investment of \$16,000,000 in 80 percent of the common stock of American Cities had gone up to \$44,000,000?

A. Based upon the market value, that is correct.

Q. Or a profit within that period, a paper profit, of \$28,000,000?

A. Well, that is an advance in market.

When Electric Shareholdings Corporation was organized as an investment company in March 1929, Central States Electric Corporation and Hydro-Electric Securities Corporation, as joint sponsors, each acquired 50% of the originally issued and outstanding shares of common stock. The preferred stock of the new company was sold to the public. A short time after the organization of Electric Shareholdings Corporation, the joint sponsors distributed approximately 14% of the originally issued and outstanding shares of common stock to the public through the medium of a joint trading account. In this instance, the market price for the common stock was entirely artificial. At the time when trading in the common stock was instituted, the only stock available for sale was held by the joint sponsors. In addition, a trading account was conducted in shares of the preferred stock. Concerning the effect of the trading account on the market value of Electric Shareholdings Corporation common stock, Harrison Williams testified:²⁷⁷

Q. 625,000 shares of the common stock, being 50 percent of the common stock which was owned by Central States, of Electric Shareholdings cost Central States \$12,500,000, is that correct?

A. I think that is correct.

²⁷⁶ Public Examination, Central States Electric Corporation, at 12755-6.

²⁷⁷ Id., at 12966-8.

Q. And the value of that at the market as of March 31, 1929, was \$17,200,000, approximately?

A. Was it?

Mr. KILMARRY: That is correct.

Q. That is, in eleven days that value had gone up, on market value, about \$5,000,000?

A. Correct.

Q. That is about the same speed all of them seem to have gone up.

A. When was that?

Q. March 31, 1929, and the corporation was formed March 20?

A. Yes.

Q. And, as we have seen, all common stock, 1,250,000 shares was owned by the two sponsors to start with, and out of that they took 178,500 shares for the trading account. There was no other stock outstanding, was there?

A. No.

Q. And the same common stock had a value as of July 31, 1929, of \$39,700,000?

A. When was that?

Q. July 31, 1929.

A. That was again the peak of the market.

Q. That is right, in the peak.

A. The peak of the boom.

Q. Yes. It multiplies three times within a period of four or five months. Isn't that right?

A. Yes.

Q. So that you had a paper profit then, within eleven days, of \$5,300,000, and within four months of \$27,200,000?

A. Approximately.

When Shenandoah Corporation was organized in July 1929, Central States Electric Corporation and The Goldman Sachs Trading Corporation, joint sponsors, each acquired 2,000,000 shares (totalling 80%) of the originally issued and outstanding shares of common stock. The public purchased 1,000,000 shares of common stock and 1,000,000 shares of preference stock. The 1,000,000 shares of common stock outstanding in the hands of the public, representing the entire floating supply, were insufficient to satisfy the public demand. As a result, when trading opened in the common stock, the market price was almost twice the public offering price. In addition, trading accounts were conducted in Shenandoah Corporation common and preference stock, resulting in a further inflation of the market prices.

Again in the case of Blue Ridge Corporation, organized in August 1929 by Central States Electric Corporation and The Goldman Sachs Trading Corporation as a subsidiary investment company of Shenandoah Corporation, the expedient of distributing to the public only 20% of the total number of issued and outstanding shares of common stock was adopted. Shenandoah Corporation acquired 6,250,000 shares of Blue Ridge Corporation common stock, and the public purchased 1,000,000 shares of common stock and 1,000,000 shares of preference stock. The public demand for the securities vis-a-vis the floating supply immediately raised the market price above the offering price. Trading accounts in the Blue Ridge Corporation common and preference stock stimulated the inflation.

In each of the above instances, the floating supply of common stock was limited to 20% or less of the total number of shares issued and outstanding, and with the restricted supply against a strong demand inevitably raised the market price. Had the new capital, obtained from the public by these affiliated investment companies, been raised by means of the public offering of Central States Electric Corporation securities, thereby avoiding the ownership of one investment company by another, this type of artificial increase in market price would not have been possible.

(2) NATIONAL INVESTORS GROUP

The tremendous inflation possible in the market prices of the common stocks through operations in the stock of constituent investment companies of a pyramided system are illustrated by experiences of the National Investors Corporation group of investment companies. This system of companies, organized between June 1927 and August 1929, consisted of National Investors Corporation, the top company of the structure, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation.²⁷⁸ National Investors Corporation and Second National Investors Corporation were both leverage investment companies, their capital structures consisting of common and preferred stocks and option warrants for the purchase of common stock. Third National Investors Corporation and Fourth National Investors Corporation had only common stock and option warrants. Control of the system was vested in the common stockholders of National Investors Corporation which had invested its entire capital funds in its affiliated companies as follows:

	Number of shares	Percent of total	Number of warrants	Percent of total
Second National Investors Corp.....	100,000 (com.)..	33%	200,000	100
Third National Investors Corp.....	20,000 (com.)..	10	102,000	77
Fourth National Investors Corp.....			750,000	75

In the management of this pyramided structure the sponsors operated trading accounts in the common stocks of Second, Third, and Fourth National Investors Corporation. The effect of these trading accounts was to increase the market value of the common stock of the affiliated companies. Concomitantly with the rise in the value of the common stocks was a corresponding rise in the market value of the warrants. This rise in the market value of the warrants, in turn affected an increase in the asset value of the common stock of National Investors Corporation which had most of its funds invested in these affiliated companies. Accordingly, the market value of the option warrants of National Investors Corporation, was likewise increased.

By September 15, 1929, the assets of National Investors Corporation had risen from an initial investment of \$4,400,000 to approximately

²⁷⁸ For a detailed discussion of the organization of these companies see Part Three, Chapter IV, 1460-80.

\$27,000,000 due to the increase in the market prices of the securities of affiliates held by National Investors Corporation. The market value of the option warrants of National Investors Corporation had risen to \$360½ per warrant.²⁷⁹ The asset value of the common stocks reached approximately \$265 per share.

It must be noted that as rapid as may be the ascent, under favorable circumstances, of the market prices of equity stocks in a pyramided structure where the constituent investment companies have complex capitalization, at least as rapid will be the descent of these equity stocks, when the purchasing public reaches the end of its optimism. Subsequent to 1929, the common stock of National Investors Corporation experienced a precipitous decline in its assets and market values. From the end of 1930 to the close of 1934, the common stock had no asset value whatsoever.²⁸⁰ As of December 31, 1935, its asset value was nominal, amounting to but 21 cents per share.²⁸¹ By December 31, 1932, the market value of this stock was \$3¾ per share. The year-ends of 1933, 1934, and 1935 disclosed even further declines in market price, to wit, \$2½, \$1¼, and \$2 per share, respectively.²⁸² The warrants, the majority of which had been given to the insiders free of any cost and which had experienced so phenomenal a rise in 1929, followed the market decline of the common stock. These warrants sold as low as \$¾ in 1932 and \$1¾ at the end of 1935.²⁸³

Mr. Presley, president of National Investors Corporation, testified:²⁸⁴

Q. While that type of structure, assuming that I am right that it contributed to a large extent in permitting a comparatively small investment, because no matter how large Guardian's investment was in National Investors, it was very small compared to the total investment that the public made in the four companies—

A. That is right.

Q. While there may have been certain advantages in that type of corporate structure, from the standpoint of the organizing group, looking toward retention of control, have you or have you not found that there are certain weaknesses in that situation, perhaps from the standpoint of somebody else getting that same control?

A. A very great weakness.

Q. Why do you say that, Mr. Presley?

A. The weakness is inherent in almost any holding company, whether it is in the investment trust field, or in the utility field, or industrial field, of control of a large amount of money, or numerous companies, through the so-called "B-stock set-up" so that a small amount of money initially is capable of controlling a tremendous amount of money through subsidiaries in the case of investment trusts

²⁷⁹ Public Examination, National Investors Corporation, at 4347.

²⁸⁰ Reply to the Commission's questionnaire for National Investors Corporation, Pt. IV (item 28).

²⁸¹ *Ibid.*

²⁸² *Ibid.* Due to a common stock split-up of 6-for-1 in October 1929, the price of the common stock on the basis for the old would therefore be 15, 7½, and 12, respectively.

²⁸³ In October 1929, when the common stock was split 6-for-1, the warrants formerly exercisable to purchase one and one-half shares of common stock became exercisable to purchase nine shares of new common stock only. (Reply to Commission's questionnaire for National Investors Corporation, Pt. V, Item 54a, Table 16.)

²⁸⁴ Public Examination, National Investors Corporation, at 4513-14.

or acquisitions. But the greatest danger lies in the collapse of shares of that Type B type control stock in periods of depression, and where, as in the case of Guardian Detroit Company's position, a large block became available, at a very low price in relation to the value of the assets of the affiliated companies.

d. Effect on Rights and Duties of Security Holders

The following are examples of two investment companies which were transferred from one pyramided structure to another, with a discussion of the ensuing effect on the rights, interests and obligations of the stockholders of the respective companies as their funds were subjected to varying types of management.

(1) GENERAL INVESTMENT CORPORATION (FORMERLY KNOWN AS PUBLIC HOLDING CORPORATION OF AMERICA)

It will be recalled that General Investment Corporation was organized in 1929 by United Founders Corporation, an investment company of the management type, and the investment banking firm The Harris Forbes Corporation, and had as its alleged purpose the acquisition of interest in the equity securities of public utility companies in United States and Europe.²⁶⁵ From 1929 to 1933, United Founders Corporation relied for the management of General Investment Corporation on The Harris Forbes Corporation which caused the assets of the investment company to be used to expand the resources of the utility systems for which The Harris Forbes Corporation was the banker, and to take over the financing obligations of the sponsors. In 1933 United Founders Corporation took over the management of General Investment Corporation and thereafter that company became a constituent element of the so-called Founders system of investment companies.²⁶⁶

By July 15, 1933, however, The Equity Corporation, an investment company controlled by David Milton and Ellery C. Huntington, acquired control of United Founders Corporation and its subsidiaries among which was included its interest in General Investment Corporation. On November 23, 1935, The Equity Corporation caused United Founders Corporation and its subsidiaries, exclusive of General Investment Corporation, to be consolidated to form American General Corporation and 39% of its voting stock was held by The Equity Corporation. Thereafter the American General Corporation increased its interest in General Investment Corporation to 40% voting control. As a result General Investment Corporation was controlled by American General Corporation which was in turn controlled by The Equity Corporation.

During this entire period 1933 to 1935, while General Investment Corporation was first under the control of United Founders Corporation and thereafter American General Corporation, which The Equity Corporation controlled, the activities of General Investment Corporation were primarily confined to the liquidation of a portfolio of public

²⁶⁵ For detailed history of General Investment Corporation see Part Three, Ch. II, pp. 497-623.

²⁶⁶ For detailed discussion of the Founders system of investment companies see Pt. Three, Ch. VI, Sec. II.

utility securities. The funds thus derived were used by General Investment Corporation to repurchase its own outstanding preferred stock at substantial discount from asset value. This investment policy was counter to the original avowed investment policy of the company. Furthermore, the stockholder who may have invested in the company, relying on the management facilities available to them by an investment banking firm, was now being managed by another investment company, whose controlling personnel were lawyers.

In 1936 there was effected a further change in the management of General Investment Corporation when that company was transferred to another pyramid system. American General Corporation sold control of the General Investment Corporation to International Equities Corporation, an investment company of the general management type which was controlled by Ernest B. Warriner. Under Mr. Warriner's management of General Investment Corporation its assets were invested primarily in specialized situations which included, among other things, a controlling interest in Standard Investing Corporation, another investment company of the general management type, and a 26% interest in Utility Equity Corporation, an investment company of the general management type.

As a result, a new chain of investment companies was created, consisting of International Equities Corporation, General Investment Corporation, Standard Investing Corporation, and Utility Equities Corporation. This system was controlled by Ernest B. Warriner, who had had no association with investment companies except through his relationship with Wallace Groves during his acquisition of control of investment companies.²⁸⁷ The funds of General Investment Corporation were thus under the management of a new enterprise who pursued an investment policy for the company, which conformed to the interests of Mr. Groves.

In 1937 General Investment Corporation was transferred to a new controlling management and became a constituent element of a fourth pyramided system of investment companies, controlled, as has already been described above, by Henderson Brothers of Boston. In this system the relation of General Investment Corporation to its subsidiary, Standard Investing Corporation, was completely altered. Under the Henderson management Standard Investing Corporation, control of which was first acquired by Henderson Brothers from Mr. Warriner, itself acquired control of International Equities Corporation, which controlled General Investment Corporation and which still retained its 26% interest in Utility Equities Corporation. Accordingly the one-time subsidiary of General Investment Corporation became its parent.

It will be recalled that Standard Investing Corporation was a leverage investment company so that the stockholders of General Investment Corporation, when it controlled Standard Investing Corporation, obtained the leverage advantage of the common stock of Standard Investing Corporation. As a result of the transfer of the common stock of Standard Investing Corporation held by General Investment Corporation to investment companies controlled by Henderson Brothers, the stockholders of General Investment Corporation were deprived

²⁸⁷ See Part Three, Ch. II, pp. 585-6.

of the leverage advantage of its previous ownership of the common stock of Standard Investing Corporation. A further effect of this change in the management of General Investment Corporation was a modification of its investment policies from that of being invested in specialized situations in which Wallace Groves was interested to the investment in real-estate properties in which Henderson Brothers were interested.

In July 1939, as was seen above, control of General Investment Corporation was transferred back to American General Corporation, which is still controlled by The Equity Corporation, which David Milton and Ellery Huntington still control.

All the transfers were effected without prior consent of the company's security holders. Their interests were then subjected to constant changes making it impossible for them at any time to determine the value of their interests in this company, the character of the management, the investment policy of their company, or their relationship to other investment companies which may have been shifted around with them from system to system. The pyramided system proved a convenient vehicle for these transfers of companies, inasmuch as this controlling group was enabled, as has been stated, to purchase control of these companies with little personal investment, but with the use of the funds of the companies already in the system.

(2) AMERICAN, BRITISH & CONTINENTAL CORPORATION

The changes to which the stockholders of American, British & Continental Corporation were subjected as a result of being transferred from one holding company system of companies to another is another instance of the extent to which their rights were materially altered in order to supplement the expansion programs of sponsors of pyramided systems of investment companies. American, British & Continental Corporation was incorporated as an investment company of the general management type under the laws of Delaware on November 18, 1926, and was sponsored by the investment banking firms of Blyth, Witter & Co.²⁸⁸ and J. Henry Schroder Banking Corporation. Associated with them in the original operation of the company were ten European banks²⁸⁹ who participated in effecting the primary purpose of the organization of the company,²⁹⁰ the selection of a diversified portfolio of both domestic and foreign securities.

²⁸⁸ Now known as Blyth & Co.

²⁸⁹ Public Examination, American, British & Continental Corporation, Commission's Exhibit No. 447.

²⁹⁰ *Id.*, at 4634-5. The policy of the company was defined as follows in the prospectus of American, British & Continental Corporation:

Following the practice of the successful British Investment Trust Companies, the Board will invest in loans and securities diversified both as to type and geographical location. Included in the investments, which the corporation proposes to make will be the bonds of, or loans and credits to Governments, Municipalities, and other political subdivisions, and railways, public utilities, and commercial, financial, and industrial institutions in foreign countries and in the United States: also in such preferred and common stock of any companies or corporations as appear to offer opportunities for safe and profitable investment. The corporation may participate in the underwriting of foreign and domestic issues, and a portion of the Corporation funds may be reserved for investment within the United States in approved loans and securities. *Id.*, Commission's Exhibit No. 447.

²⁹¹ *Id.*, at 4726.

The net capital contribution to the company was \$19,672,721.87.²⁹¹ Of this sum, \$14,200,000 was contributed by the public, who purchased 5% gold debentures in the principal amount of \$5,000,000,²⁹² 100,000 shares of \$6.00 cumulative preferred stock and 300,000 shares of common stock,²⁹³ and \$4,000,000 was contributed by the sponsors, including the various European banks who participated in the operation of the company, with their purchase of 300,000 shares of common stock and 40,000 shares of \$6.00 second preferred stock.²⁹⁴ By December 31, 1931, just prior to the sale of control of American, British & Continental Corporation to Atlas Corporation, the first change in the management of this company the assets of the American British company were \$6,771,986.94,²⁹⁵ a shrinkage of approximately 66%²⁹⁶ from the net capital contributed to the company. American, British & Continental Corporation "had not developed from the management standpoint" according to the expectation of the sponsors. However, the sponsors, instead of giving "any serious thought"²⁹⁷ to the liquidation of the company, which would have given them "no chance to come back at all,"²⁹⁸ commenced negotiation for the sale of their control block of stock to Atlas Corporation.

Atlas Corporation, it will be recalled,²⁹⁹ was organized as an investment company of the general management type on July 11, 1929.³⁰⁰ Although originally, as it has been shown, the investments of the company were primarily concentrated in the common stocks of utility operating and holding companies,³⁰¹ in 1930 this policy was changed to absorbing other investment companies.³⁰² At this time the stocks of investment companies generally were selling at about 35% discount. The market value of these securities was about 35% less than their asset value.³⁰³ Mr. Odum, recognizing the opportunity of acquiring portfolios of other investment companies at a total price less than their asset value, began a program of acquisition of other investment companies. By December 1931, just prior to acquiring its interest in American, British & Continental Corporation, Atlas Corporation controlled directly and indirectly various investment companies.³⁰⁴

²⁹¹ *Id.*, at 4626, Commission's Exhibits Nos. 450, 451.

²⁹² *Id.*, at 4633, Commission's Exhibits Nos. 441, 444. For a detailed discussion of the distribution of the stock of American, British & Continental Corporation see Part Three, Ch. III, pp. 945-50.

²⁹³ *Id.*, at 4725. This figure does not take into account the \$1,485,550.74 returned to the stockholders in the form of dividends.

²⁹⁴ *Id.*, at 4725.

²⁹⁵ *Ibid.*

²⁹⁶ *Id.*, at 4751.

²⁹⁷ *Ibid.*

²⁹⁸ See Part Three, Ch. IV, for a detailed description of Atlas Corporation.

²⁹⁹ Public Examination, Atlas Corporation, Commission's Exhibit No. 1942.

³⁰⁰ *Id.*, at 17719.

³⁰¹ *Id.*, at 17719-21.

³⁰² *Ibid.*

³⁰³ These companies were Atlas Utilities & Investors Co., Ltd., All American General Corporation, Allied Atlas Corporation (formerly known as Exide Securities Corporation), Power & Light Securities Trust, Selected Stocks, Inc., Financial Corporation (formerly known as Ungerleider Financial Corporation), Iroquois Share Corporation, Federated Capital Corporation, General Empire Corporation, Jackson & Curtis Investment Associates, Sterling Securities Corporation, Securities Allied Corporation (formerly known as Chatham Phoenix Allied Corporation), Chain Store Stocks, Inc., National Securities Investment Co., and Aviation Securities Corporation. (*Id.*, Commission's Exhibit No. 2001.)

On December 24, 1931, after substantial negotiation³⁰⁵ with Atlas Corporation, the sponsors of American, British & Continental Corporation accepted an offer from I. R. Boyd, at this time an officer of Atlas Corporation, to purchase up to 380,000 shares of the common stock at \$1.75 per share of American, British & Continental Corporation, which was owned by the sponsors, and up to 27,000 shares of the common stock owned by investors of J. Henry Schroder Banking Corporation.³⁰⁶ The terms of the contract were to be effected between January 1, 1932, and January 6, 1932, and delivery and payment by Atlas Corporation was to be made at the offices of Manufacturers Trust Company of New York.³⁰⁷ Mr. Boyd had been, until December 1931 an officer of J. Henry Schroder Banking Corporation. He resigned from this position to become affiliated with Atlas Corporation in its negotiation for control of American, British & Continental Corporation.

Although the stockholders of American, British & Continental Corporation were thus to be transferred to the Atlas Corporation system, whose business was far removed from the announced investment policy of American, British & Continental Corporation, the stockholders were not consulted with regard to this transfer.³⁰⁸ The annual report of American, British & Continental Corporation as at December 31, 1931, merely announced that the control of the company was sold to a New York group.³⁰⁹ Actually, the undisclosed principal for whom Mr. Boyd effected this control was National Securities Investment Company,³¹⁰ 68% of whose common stock was held by Securities Allied Corporation, a wholly controlled subsidiary of Atlas Corporation.³¹¹ No attempt, furthermore, was made to describe to the stockholders of American, British & Continental Corporation that their assets would now figure in the expansion program of Atlas Corporation.

Between 1932 and May 1935 National Securities Investment Co. acquired the following securities of American, British & Continental Corporation: \$2,068,500 principal amount debentures (49.37% of total outstanding), 59,417 shares of preferred stock (64.98% of total outstanding), and 461,562 shares of common stock (76.92% of total outstanding). Some of these securities were acquired directly from the investment company itself; others were acquired from other subsidiaries in the Atlas Corporation system; and still others were acquired from Atlas Corporation who had originally received these securities in exchange for Atlas Corporation securities.³¹² As a result, by virtue of its transfer to the Atlas Corporation, a pyramided system, the stockholders of American, British & Continental Corporation were subjected to a new management by Atlas Corporation which was merely engaged in the purchase and sale of control of investment companies.

On May 27, 1935, Atlas Corporation, as part of its program of dealing in these securities of investment companies, had National Securi-

³⁰⁵ Public Examination, American, British & Continental Corporation, at 4753.

³⁰⁶ Public Examination, Atlas Corporation, Commission's Exhibit No. 2000.

³⁰⁷ *Ibid.*

³⁰⁸ Public Examination, American, British & Continental Corporation, at 4753.

³⁰⁹ Public Examination, Atlas Corporation, Commission's Exhibit No. 2001.

³¹⁰ *Ibid.*

³¹¹ *Ibid.*

³¹² Public Examination, Allied General Corporation, at 5296, and Commission's Exhibits Nos. 495 and 496.

ties Investment Co. sell its stock in American, British & Continental Corporation to The Equity Corporation. The Equity Corporation, it will be recalled, was organized on December 7, 1932,³¹² with the avowed purpose of acquiring by the legal processes of dissolution, mergers, or consolidation the units of its subsidiaries and of other investment companies.³¹³ At this time, however, The Equity Corporation was in the process of creating a pyramided system of investment companies and controlled already Interstate Equities Corporation, Chain & General Equities Corporation, Yosemite Holding Corporation, Reliance International Corporation, Eastern Shares Corporation, five insurance companies including Majestic Fire Insurance Company, Colonial States Fire Insurance Company, American Merchant Marine Insurance Company, American Colony Insurance Company, and North State Insurance Company,³¹⁴ the so-called United Founders group of investment companies.³¹⁵ The effect of this transfer was to put the stockholders of American, British & Continental Corporation into a new pyramided system under the control of persons whose ultimate purpose as indicated above was to merge its subsidiary companies into The Equity Corporation. The funds to purchase control of American, British & Continental Corporation were supplied by a subsidiary of The Equity Corporation, namely, Reliance International Corporation.³¹⁷

American, British & Continental Corporation thus became a constituent element of the Equity Corporation System. Thereafter, The Equity Corporation made a series of exchange offers of The Equity Corporation stock for the stock of American, British & Continental Corporation. Finally, on September 6, 1936, American, British & Continental Corporation was merged into The Equity Corporation and the stockholders of American, British & Continental Corporation became stockholders of The Equity Corporation, and as such were subjected to an investment policy of investing in diversified securities and insurance companies.

D. Intercompany Transactions

Implicit in the management of holding company systems of investment companies is the possibility of intercompany transactions which

³¹² See Pt. Three, Ch. II, pp. 218-221 for a detailed discussion of the organization of The Equity Corporation.

³¹³ Public Examination, Allied General Corporation, at 5296, and Commission's Exhibits Nos. 495 and 496.

³¹⁴ Part VII. See the Report of the Commission on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VII, p. 119 et seq.

³¹⁵ Public Examination, Atlas Corporation, Commission's Exhibit No. 2001.

³¹⁷ Reliance International Corporation was also an investment company originally organized as a subsidiary of Reliance Management Corporation, another investment company of the general management type. From 1929, the date of the organization of Reliance International Corporation, to 1932 Reliance International Corporation was maintained as a subsidiary of Reliance Management Corporation. In 1932 Reliance Management Corporation was absorbed into its subsidiary, Reliance International Corporation. Thereafter between 1932 and December 1934, Atlas Corporation and its subsidiary, National Securities Investment Company, had acquired in the open market and by exchange offers 38,268 shares of preferred stocks, 23% of the total preferred stock outstanding, and 300,193^{3/4}% shares of the Class A common stock. On December 10, 1934, Atlas Corporation and National Securities Investment Company sold their interest in Reliance International Corporation to The Equity Corporation, and it became a constituent element of The Equity Corporation system.

may be effected between the constituent elements of such organizations. Ernest F. Henderson, who controlled such a system, already hereinbefore described, conceded the potentiality of such abuse, in the following testimony:³¹⁸

A. There has been a great deal of criticism of improper intercompany transaction, and we were anxious to be free from that criticism.

Q. But at least you were, in a position where you may be subject to that criticism; isn't that so?

A. We might be criticized for it; yes. But I would like to state that we don't think that we could be properly criticized for it.

Q. And also you are in a position are you not where if you effect a transaction you have to keep in mind the respective interests of the stockholders of all of these investment trusts.

A. Absolutely.

Q. You also are in a position that not only must you have in mind the respective interests of the stockholders of each of these investment trusts, but you have your own personal interests involved in each one of these transactions; isn't that so?

A. Yes, but our primary interest goes hand in hand with the interests of the stockholder.

Significantly, the intercompany security transactions between investment companies and affiliated interests were, it will be recalled, the means for the creation of some of the structures of circular ownership and pyramided structures of investment companies.³¹⁹ Securities issued as a result of such intercompany transactions accounted for slightly more than \$1,200,000,000 during the period 1927-1935.³²⁰ This is equivalent to approximately 50% of the value of all the sales of securities of closed-end management investment companies proper and management investment holding companies.³²¹

Intercompany transactions may be categorized into four types: (a) sale of securities for cash to other investment companies including sponsor, affiliate, or subsidiary companies; (b) exchanges of securities by one investment company occupying a position as sponsor, subsidiary, or affiliate; and (c) exchange of securities by one investment company in connection with a plan of merger or consolidation; (d) sales of other than investment company securities to investment companies or their affiliates. Sales of investment company securities to other investment companies for cash amounted to about \$202,000,000, and exchanges for the securities of affiliated companies totaled \$145,000,000.³²² Other than investment-company securities sold to investment companies, which constitute the fourth category of intercompany dealings, accounted for approximately \$220,000,000.

In an earlier section of this report³²³ it was indicated that the largest proportion of intercompany transactions of the first two types

³¹⁸ See Part Three, Ch. II, Sec. X.

³¹⁹ See *supra* for discussion of creation of Central States Electric group.

³²⁰ This figure does not include transactions made in connection with the consolidation of several companies formed by one sponsor (e. g., The Chicago Corporation, December 1930 and December 1932; General American Investors Company, Inc., September 1929; Tri-Continental Corporation, December 1929) or reclassification of securities. See Part Two, Chapter III, pp. 196-197.

³²¹ The total value of the sales of securities was \$1,088,653,000. Of this amount \$2,800,186,000 constituted the securities sold by public sale (Part Two, Ch. III, Table 62).

³²² *Ibid.*

³²³ See *supra*.

was effected by The Goldman Sachs Trading Corporation-Central States group of companies, which, it will be recalled,³²⁴ included Central States Electric Corporation, Shenandoah Corporation, Blue Ridge Corporation, and The Goldman Sachs Trading Corporation. The intercompany transactions connected with the formation and expansion of these companies involved \$135,000,000 in the form of cash sales to other investment companies (representing 67% of the total of securities issued in all transactions of that type) and \$121,165,000 of exchanges with affiliated companies (or 84% of the total of all such exchanges).³²⁵

With respect to the third classification of intercompany transactions, it has been shown that \$873,000,000 of securities were issued in exchanges connected with mergers and consolidation. Atlas Corporation and The Equity Corporation and the companies affiliated with them accounted for about \$529,000,000, or 61% of total securities issued by such exchanges. After 1929 exchanges in connection with mergers and consolidation were particularly important. Securities issued in this fashion amounted to more than 50% of the total securities sold and issued in intercompany transactions by the closed-end management companies proper and investment-holding companies in every year from 1930 to 1935.

In the pyramided or group systems of investment companies transactions were effected between the holding companies to create fictitious profits and earnings. A striking example is the United Founders Corporation Group of companies.

Each company at different times was the source of such "profits" to the others, and itself was in turn the recipient of similar profits from others. The basic pattern was simple: Founders Company A would bring out an issue of 90,000 shares of no par common stock. Founders Companies B, C, and D would each purchase 30,000 shares from A, paying it \$10 a share. Founders Companies B, C, and D would, after a period varying from several days to several months, resell the stock to the public at \$20 a share through the medium of Founders General Corporation, the distributing agency of the group. Result: the public would have paid \$1,800,000 for the 90,000 shares of stock; Company A would have received \$900,000 of capital; Companies B, C, and D would have recorded \$900,000 in "profits."

These "profits," which frequently exceeded 100% on cost, were euphemistically termed by former officers of the Founders System "underwriting profits," but were reported tersely to stockholders in the companies' financial reports as "profits on investments." Thus the purchasers of the stock of Company A were unaware that only a portion of the capital contributed by them had reached their company; and the stockholders of Companies B, C, and D were unaware that a substantial part of the "earnings" reported by their companies represented diverted capital of affiliated companies.³²⁶

³²⁴ See Part Two, Ch. III, p. 209, and Part Three, Ch. IV.

³²⁵ *Id.* Two, Ch. III, p. 200.

³²⁶ For a detailed discussion of this technique, see Part Three, Ch. VI, Section III.

For other examples of intercompany transactions see story on formation of Blue Ridge Corporation by The Goldman Sachs Trading Corporation, *supra*, Investment Trusts and Investment Companies Controlled by Donald P. Kenyon, Part Three, Ch. II, page 309 et seq.; Eastern Utilities Investing Corporation, Part Three, Ch. II, page 624 et seq.

Appendix W—Supplementary material in connection with Hayden, Stone & Co.

1. OFFICES AND DIRECTORSHIPS IN INVESTMENT COMPANIES HELD BY PARTNERS OF HAYDEN, STONE & CO.

Investment company	Member of Hayden, Stone & Co.	Position	Date	
			From	To
The Adams Express Company.	Charles Hayden *	Chairman of Board of Managers.	Jan. 1, 1927	Dec. 31, 1935
The Adams Express Company.	Charles Hayden..	Chairman of Executive Committee. ^b	Apr. 19, 1928	Dec. 31, 1935
The Adams Express Company.	Steele Mitchell....	Manager.....	Oct. 13, 1927	Apr. 19, 1928
The Adams Express Company.	Steele Mitchell....	Manager.....	Apr. 1, 1929	Dec. 21, 1935
The Adams Express Company.	Steele Mitchell....	Vice-Pres.....	Feb. 20, 1933	Dec. 31, 1935
The Adams Express Company.	Steele Mitchell....	Member of Executive Committee.*	Oct. 27, 1927 May 15, 1933	Apr. 19, 1928 Dec. 31, 1935
The Adams Express Company.	Richard F. Hoyt..	Manager.....	Apr. 1, 1929	Mar. 7, 1935
Haygart Corporation.....	Charles Hayden..	Chairman of Board of Directors.	Nov. 12, 1928	Jan. 7, 1930
Haygart Corporation.....	Charles Hayden..	Director.....	Nov. 10, 1928	Jan. 7, 1930
Haygart Corporation.....	Richard F. Hoyt..	Vice-Pres.....	Nov. 12, 1928	Dec. 27, 1929
Haygart Corporation.....	Richard F. Hoyt..	Director.....	Nov. 12, 1928	Dec. 27, 1929
Haygart Corporation.....	John R. Dillon....	Director and Vice-Pres.	Dec. 27, 1929	Jan. 7, 1930
Sterling Securities Corporation. ^c	Charles Hayden..	Director and Member of Financing Committee.	June —, 1929	Dec. 31, 1935
Sterling Securities Corporation.	Steele Mitchell....	Director and Member of Executive and Finance Committees.	June —, 1929	1931
Petroleum Corporation.....	Charles Hayden..	Director.....	Jan. —, 1929	Dec. 31, 1935
Petroleum Corporation.....	Charles Hayden..	Member of Executive Committee.	Jan. —, 1929	Dec. 31, 1935
Aviation Securities Corporation of New England.	Charles Hayden..	Director.....	Apr. —, 1934	Mar. —, 1935
Aviation Securities Corporation of New England.	Lester Watson....	Vice-Pres.....	Mar. —, 1929	Apr. —, 1934

* Charles Hayden died January 8, 1937. On January 14, 1937, Mr. Robert G. Stone, partner in Hayden, Stone & Co., was elected a member of the Board of Managers and of the Executive Committee of The Adams Express Company to take the place of Charles Hayden. On that day Mr. Steele Mitchell, former vice-president, was elected president. Robert G. Stone took the place of Charles Hayden as a director and member of the Executive Committee of American International Corporation. (Reply to Commission's questionnaire for The Adams Express Company, supplemental information.)

^b On October 27, 1927 the Executive Committee was created by resolution of the Board of Managers. (Id., supplemental information.)

^c Mr. Mitchell was elected as a substitute for Charles Hayden, during the latter's absence from Oct. 1927 to April 1928. Mr. Mitchell served as Secretary of the Executive Committee from April 16, 1928, to December 31, 1935. (Id., supplemental information.)

^d Reply to Commission's questionnaire for Sterling Securities Corporation, Pt. I; Public Examination, Sterling Securities Corporation, Commission's Exhibits Nos. 1498-1499.

Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

Investment company	Member of Hayden, Stone & Co.	Position	Date	
			From	To
Aviation Securities Corporation of New England.	Lester Watson....	Director.....	Mar. —, 1929	Apr. —, 1934
Aviation Securities Corporation of New England.	Robert G. Stone..	Director.....	July —, 1935	Dec. —, 1935
Aviation Securities Corporation of New England.	John R. Dillon....	Vice-Pres.....	Mar. —, 1935	Dec. —, 1935
Aviation Securities Corporation of New England.	John R. Dillon....	Director.....	Apr. —, 1933	Dec. —, 1935
Aviation Securities Corporation of New England.	Richard F. Hoyt..	President.....	Apr. —, 1933	Mar. —, 1935
Aviation Securities Corporation of New England.	Richard F. Hoyt..	Director.....	Mar. —, 1929	Mar. —, 1935
Aviation Securities Corporation of New England.	Clarkson Potter...	Director.....	Apr. —, 1935	Dec. —, 1935
Mayflower Associates, Inc....	Charles Hayden...	Director.....	Feb. 15, 1935	Dec. 31, 1935
U. S. & International Securities Corporation.	Charles Hayden...	Member of Finance Committee.	Oct. 29, 1928	Dec. 31, 1935
U. S. & International Securities Corporation.	Charles Hayden...	Director.....	Oct. 29, 1928	Dec. 31, 1935
American International Corporation.	Charles Hayden...	Director.....	Nov. —, 1933	Dec. 31, 1935
American International Corporation.	Charles Hayden...	Member of Executive Committee.	Nov. —, 1933	Dec. 31, 1935
American International Corporation.	Steele Mitchell....	Director.....	Dec. —, 1933	Dec. 31, 1935

2. LIST OF PARTICIPATIONS BY HAYDEN, STONE & CO. DURING THE PERIOD FROM THE END OF 1928 TO THE END OF 1929 IN SELLING, BANKING, AND PURCHASE GROUPS IN THE SECURITIES OF INVESTMENT COMPANIES OTHER THAN HAYGART CORPORATION, THE ADAMS EXPRESS COMPANY, STERLING SECURITIES CORPORATION, PETROLEUM CORPORATION OF AMERICA, AND AVIATION SECURITIES CORPORATION OF NEW ENGLAND

Date	Issue	Investment Company Securities	Participation		
			Selling group	Banking group	Purchase group
Sept. 16, 1929	600,000 Shs....	All American Gen'l. Corp. Cap. Stk.	200 Shs....		
Nov. 1, 1928	125,000 Shs....	Amer. British & Cont'l Corp. Common.	300 Shs....		
Aug. 16, 1929	600,000 Shs....	American Equities Co. Common.	950 Shs....		
Jan. 21, 1929	\$25,000,000....	Amer. Int'l Corp. Conv. Deb. 5½s, 1949.	\$100,000....		
Aug. 20, 1929	1,000,000 Shs..	Blue Ridge Corp. 6% Conv. Pref. Stock.	3,000 Shs....		

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Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

Date	Issue	Investment Company Securities	Participation		
			Selling group	Banking group	Purchase group
Aug. 20, 1929	1,000,000 Shs.	Blue Ridge Corp. Common.....	3,000 Shs.		
Dec. 7, 1928	300,000 Shs.	Chain Stores Stock, Inc., Cap. Stk.	200 Shs.	200 Shs.	
Oct. 24, 1928	60,000 Units.	Capital Administration Co., Ltd.	100 Units.		
Sept. 30, 1929	1,900,000 Shs.	Chatham Phenix Allied Corp. Common.	23,240 Shs.	100,000 Shs.	
July 24, 1929	240,000 Shs.	Continental Shares, Inc., 6% Cum. Conv. Pref.	400 Shs.	400 Shs.	
Aug. 27, 1929	500,000 Shs.	Fourth National Investors Corp. Common.	75 Shs.		
Jan. 29, 1929	300,000 Shs.	Gen'l Realty & Utilities Corp. Pfd. Stk.	15,000 Shs.	39,640 Shs.	
Mar. 18, 1929	500,000 Shs.	Globe Underwriters Exchange, Inc., Cap. Stk.	2,000 Shs.	2,000 Shs.	
Dec. 7, 1928	100,000 Shs.	The Goldman Sachs Trading Corp. Cap. Stk.	3,500 Shs.		
May 3, 1929	300,000 Shs.	Graymur Corporation Cap. Stk.	2,000 Shs.		
Mar. 13, 1929	750,000 Shs.	Insuranshares Corp. of Del. Class A Common.	1,000 Shs.		
Aug. 2, 1929	250,000 Units.	Interstate Equities Corp.	1,000 Units.		
Sept. 16, 1929	1,000,000 Shs.	The Lehman Corp. Cap. Stk.	2,250 Shs.		
Feb. 6, 1929	200,000 Units.	National Sec. Invest. Co. 6% Cum. Pref. Stk.	100 Units.		
Jan. 23, 1929	200,000 Shs.	New York Investors, Inc., Common.	2,000 Shs.		
Oct. 9, 1929	3,025,000 Shs.	Pennroad Corp. Common VTC.	12,000 Shs.		20,000 Shs.
Sept. 5, 1929	328,000 Units.	Prince & Whitely Trading Corp.	800 Units.		
Jan. 31, 1929	200,000 Shs.	Reliance Management Corp. Common.	650 Shs.		
Dec. 18, 1928	700,000 Units.	Selected Industries, Inc.	1,050 Units.	500 Units.	
Oct. 17, 1928	100,000 Shs.	Second Gen'l Amer. Inv. Co., Inc., 6% Cum. Pfd.	500 Shs.		
July 26, 1929	1,000,000 Shs.	Shenandoah Corp. Conv. Pfd.	1,600 Shs.	2,500 Shs.	
July 26, 1929	1,000,000 Shs.	Shenandoah Corp. Common	1,400 Shs.	2,500 Shs.	
Aug. 21, 1929	250,000 Shs.	Solvay Amer. Inv. Corp. 5½% Cum. Pfd.	500 Shs.	1,000 Shs.	
Jan. 21, 1929	1,000,000 Shs.	Tri-Continental Corp. Common.	2,000 Shs.		
Jan. 21, 1929	250,000 Shs.	Tri-Continental Corp. 6% Conv. Pref. Stk.	2,000 Shs.		
Aug. 19, 1929	500,000 Units.	Tri-Continental Allied Co., Inc.	1,500 Units.	1,500 Units.	1,500 Units
Sept. 27, 1929	200,000 Shs.	United Securities Trust Associates Com.	2,000 Shs.		
Jan. 25, 1928	140,000 Units.	U. S. & British Int'l Co., Ltd.	150 Units.		
Oct. 30, 1928	500,000 Shs.	U. S. & Int'l Sec. Corp. 1st Cum. \$5 Pref. Allot. Certs.	14,600 Shs.	12,500 Shs.	
Sept. 13, 1929	600,000 Shs.	U. S. & Overseas Corp. Common.	850 Shs.		
Nov. 27, 1928	165,000 Units.	Utility Equities Corp.	4,000 Units.	4,000 Units.	
Feb. 14, 1929	700,000 Shs.	Utility & Industrial Corp. Conv. Pfd.	2,000 Shs.		
Feb. 14, 1929	1,000,000 Shs.	Utility & Industrial Corp. Common.	2,000 Shs.		

Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

3. PORTFOLIO SECURITIES OF THE ADAMS EXPRESS COMPANY AND AFFILIATION OF HAYDEN, STONE & CO. THEREWITH, DECEMBER 31, 1929

Portfolio company	Number of shares or principal amount of bonds	Original cost to investment company	Members of Hayden, Stone & Co. on the Board *
Allis-Chalmers Manufacturing Company.	7,500	\$354,716.07	Charles Hayden, Director.
Atlantic Gulf & West Indies Steamship Line:			Richard F. Hoyt, 1st V.-P.; Member of Executive Committee; Director.
Common.....	20,000	1,485,000.00	Robert G. Stone, Director. Charles Hayden, Member of Executive Committee.
Preferred.....	5,000	305,000.00	
Aviation Corporation of The Americas..	10,000	226,250.00	Richard F. Hoyt, Chairman of Board. John R. Dillon, Treasurer.
Aviation Credit Corporation.....	4,705	57,636.25	Richard F. Hoyt, Chairman of Board.
Aviation Securities Corporation of New England.	10,088	61,284.60	Lester Watson, Member of Executive Committee, Director. Richard F. Hoyt, Director.
Brooklyn-Manhattan Transit Corporation:			Charles Hayden, Member of Executive & Finance Committees, Director.
Common.....	18,000	1,132,100.00	Albert H. Wiggin, Chairman of Finance Committee, Director.
Preferred.....	1,900	165,680.00	
Bonds.....	\$777,000	750,390.25	
Brooklyn-Queens Transit Corporation:			Charles Hayden, Director.
Common.....	6,275	57,988.60	
Preferred.....	5,310	291,407.08	
Commercial Credit Company:			No directors.
Common.....	4,800	108,000.00	
Class A.....	2,000	64,000.00	
Continental Diamond Fibre Company..	10,300	350,882.50	John R. Dillon, Director.
Curtiss-Wright Corporation:			Richard F. Hoyt, Chairman of Board.
Common.....	23,903	158,925.80	Charles Hayden, Richard F. Hoyt, Members of Committee to Exchange Stock
Class A.....	2,174	28,896.38	
Cuba Cane Sugar Corporation:			Charles Hayden, Chairman of Executive Committee and Board.
Conv. deb. 8's 1930.....	\$1,300,000	144,816.00	
Conv. deb. 7's 1930.....	\$1,195,000	102,385.75	Richard F. Hoyt, Director.
Eastern Steamship Lines, Inc.....	43,200	1,222,700.00	Robert G. Stone, Director. Charles Hayden, Chairman of Executive Committee. Jere A. Downs, V.-P. and Director.
General Realty & Utilities Corporation: Preferred.	9,500	674,500.00	Charles Hayden, Director. [Maurice Newton (of Hallgarten & Company)]
Hotel Waldorf-Astoria Corp.: First Mortgage 7's 1954	(*)	(*)	Charles Hayden, Director.
International Cement Corporation.....	27,000	1,514,975.00	Charles Hayden, Director. Robert G. Stone, Director. John R. Dillon, Comptroller, Director. Richard R. Hoyt, V.-P., Member of Executive Committee and Director.

* Name without designation of the office indicates that individual was a partner or associate of Hayden, Stone & Co., and a member of the board of directors of the portfolio company. Name enclosed in brackets signifies that the individual was not a member of Hayden, Stone & Co., but was a director of The Adams Express Company and a director of the portfolio company.

* Syndicate participation.

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Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

Portfolio company	Number of shares or principal amount of bonds	Original cost to investment company	Members of Hayden, Stone & Co. on the Board *
International Nickel Co. of Canada (Ltd.).	4,000	\$126,600.00	Charles Hayden, Chairman of Executive Committee and Board.
International Paper and Power Co.: Preferred.	4,000	356,800.00	[Albert H. Wiggin] Member of Executive and Finance Committees, Director.
Johnson Motors Co.....	1,000	32,000.00	Richard F. Hoyt, Director.
Kennecott Copper Corporation.....	4,600	258,175.00	Charles Hayden, Chairman of Finance Committee, Director. [W. H. Smith], Director.
Mack Truck, Inc.....	24,400	1,653,100.00	Charles Hayden, Member of Executive Committee, Director. [T. L. Chadbourne], Director. [Albert H. Wiggin] Director. Richard F. Hoyt, Director.
Madison Square Garden Corporation...	5,000	61,875.00	Richard F. Hoyt, Chairman of Board, Member of Executive Committee, Voting Trustee. John R. Dillon Secretary.
Mathieson Alkali Works (Inc.).....	7,300	289,657.50	Charles Hayden, Director. Robert G. Stone, Director. Richard F. Hoyt, Member of Executive Committee, Director.
Maytag Company: preferred w/w.....	4,000	160,600.00	No directors.
Otis Elevator Co.....	6,900	1,861,020.00	Charles Hayden, Member of Executive Committee. [Albert H. Wiggin] Director. [T. L. Chadbourne] Director.
Petroleum Corporation of America.....	16,300	322,087.50	Charles Hayden, Member of Executive Committee. [T. L. Chadbourne] Director. [C. I. Stralem] Director. Supra.
Prairie Oil & Gas Company.....	5,000	258,750.00	Supra.
Prairie Pipe Line Company.....	3,000	178,500.00	Supra.
Punta Alegre Sugar Company: Bonds..	\$150,000	124,565.00	Richard F. Hoyt, Member of Executive Committee and Director.
Sterling Securities Corporation: class A.	33,800	481,042.50	Charles Hayden, Steele Mitchell, Supra.
Thompson-Starrett Co. Inc.:			Charles Hayden, Director. Richard F. Hoyt, Director. [C. I. Stralem] Director. [Maurice Newton] Director.
Common.....	16,600	215,800.00	
Preferred.....	6,600	269,775.00	
Underwood Elliott Fisher Company....	10,200	933,778.00	Charles Hayden, Chairman of Finance Committee and Director. [Albert H. Wiggin] Director.
United Dry Docks, Inc.....	5,000	39,375.00	Richard F. Hoyt, Director.
Warner Quinlan Company: conv. deb.	\$364,000	337,828.00	Member of Hayden, Stone & Co. on Board.

Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

4. SECURITIES OF CORPORATIONS AFFILIATED WITH HAYDEN, STONE & CO. IN THE PORTFOLIOS OF RAILWAY & EXPRESS CO. AND HAYGART CORPORATION, 1929 ^a

	Railway & Express Company		Haygart Corporation	
	Shares	Market value (Nov. 27, 1929)	Shares	Market value (Dec. 31, 1929)
Allis-Chalmers Manufacturing Company.....	5,300	\$241,150.00	10,502	\$538,227.50
Atlantic Gulf and West Indies Steamship Line:				
Common.....	None	None	20,000	1,505,000.00
Preferred.....	None	None	5,000	300,000.00
Brooklyn, Manhattan Transit Corporation:				
Common.....	13,000	760,500.00	5,000	322,500.00
Preferred.....	1,900	169,125.00	None	None
Bonds.....		432,660.00		100,000.00
Brooklyn, Queens Transit Corporation:				
Common.....	None	None	1,275	13,387.50
Preferred.....	None	None	1,410	73,320.00
Commercial Credit Company.....	None	None	4,800	112,800.00
Commercial Credit Company: Class A.....	None	None	2,000	65,000.00
Continental Diamond Fibre Company.....	4,300	113,950.00	6,000	187,500.00
Curtiss-Wright (A).....	725		2,174	31,794.75
Curtiss-Wright.....	2,579	70,000.00	23,903	179,272.50
Cuba Cane Sugar 7's and 8's.....		120,721.25		196,000.00
Eastern Steamship Lines, Inc.....	10,000	830,000.00	13,200	343,200.00
General Realty & Utilities Corporation:				
Preferred.....	5,000	400,000.00	9,500	655,500.00
Common.....	None	None	337½	4,218.75
Hotel Waldorf-Astoria 7% gold bonds w/w.....	None	None		237,000.00
Hotel Waldorf-Astoria common stock.....	None	None	4,250	
International Cement Co.....	15,500	945,500.00	27,000	1,545,750.00
International Paper & Power: preferred.....	4,000	326,000.00	None	None
Johnson Motors.....	None	None	1,000	32,000.00
Kennecott Copper Corporation.....	4,000	229,000.00	4,600	269,100.00
Mack Truck, Inc.....	15,000	1,050,000.00	19,400	1,358,000.00
Mathieson Alkali Works.....	7,300	289,262.50	None	None
Maytag Company: preferred w/w.....	4,000	120,000.00	None	None
Otis Elevator Co.....	1,500	346,500.00	5,200	1,430,000.00
Petroleum Corporation of America.....	None	None	10,000	200,000.00
Prairie Oil & Gas.....	None	None	5,249	270,323.50
Prairie Pipe Line.....	None	None	3,000	178,125.00
Punta Alegre Sugar Co.:				
Bonds.....	None	None		137,500.00
Common.....	None	None	1,380	8,280.00
Thompson-Starrett Co., Inc.:				
Preferred.....	None	None	6,600	262,350.00
Common.....	None	None	16,600	149,400.00
Underwood Elliott Fisher Company.....	7,800	787,800.00	None	None
United Dry Docks, Inc.....	None	None	5,000	40,000.00
United Dry Docks option warrants.....	None	None	1,250	
Warner Quinlan conv. debentures.....		222,500.00		100,000.00

^a Figures derived from supplementary information supplied the Commission for The Adams Express Company, except market value of shares of Haygart Corporation.

^b Par value.

*Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued***5. SECURITIES OF CORPORATIONS AFFILIATED WITH
HAYDEN, STONE & CO. IN THE PORTFOLIO OF UNITED
STATES & INTERNATIONAL SECURITIES CORPORATION**

	Shares	Balance sheet value (average cost)
Dec. 31, 1929: General Realty & Utilities Corporation.....	20,000	\$300,000.00
Dec. 31, 1930:		
Kennecott Copper Corporation.....	10,000	290,950.00
General Realty & Utilities Corporation.....	13,564	135,640.00
Dec. 31, 1931:		
Kennecott Copper Corporation.....	22,000	487,200.00
Mack Trucks, Inc.....	2,500	45,312.50
General Realty & Utilities Corporation.....	13,564	135,640.00
Dec. 31, 1932:		
General Realty & Utilities Corporation.....	13,564	135,640.00
Kennecott Copper Corporation.....	22,000	487,200.00
Mack Trucks, Inc.....	2,500	45,312.50
Dec. 31, 1933:		
General Realty & Utilities Corporation.....	13,564	135,640.00
International Nickel Company of Canada (Ltd.).....	3,200	72,912.50
Kennecott Copper Corporation.....	20,000	409,007.00
Mack Trucks, Inc.....	5,000	102,330.00
Dec. 31, 1934:		
International Paper & Power Company, 7% cum. pfd.....	2,500	47,387.50
Kennecott Copper Corporation.....	20,000	409,007.00
General Realty & Utilities Corporation.....	13,564	135,640.00
Mack Trucks, Inc.....	5,000	107,983.50
International Nickel Company of Canada (Ltd.), conv.....	3,200	72,912.50
Dec. 31, 1935:		
International Paper & Power Company, 7% cum. pfd.....	2,500	47,387.50
International Nickel Company of Canada (Ltd.), com.....	3,200	72,912.50
General Realty & Utilities Corp., com.....	13,564	135,640.00
Kennecott Copper Corporation.....	18,000	369,772.00

Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

6. PORTFOLIO SECURITIES OF AMERICAN INTERNATIONAL CORPORATION SHOWING AFFILIATION WITH HAYDEN, STONE & CO.

Portfolio company	As of Dec. 31, 1935		As of Dec. 31, 1936		Affiliation of Hayden, Stone & Co.
	Shares	Cost	Shares	Cost	
Allis-Chalmers Manufacturing Company.			5,000	\$251,505.00	Underwriting: * November 1935, \$15,000,000; conv. deb. 4's, Nov. 1, 1945.
Anaconda Copper Mining Co.	10,000	\$163,356.50	12,000	348,805.12	Underwriting: † October 1935, \$55,000,000; 4½'s deb., Oct. 1, 1950.
Continental Oil Co. (Del.)....	10,000	175,850.00	10,000	175,850.00	None.
International Harvester Co....	5,000	203,103.56	5,000	411,212.50	None.
International Nickel Co. of Canada, Ltd.	8,500	188,211.25	9,000	294,637.35	Supra.
Kennecott Copper Corporation.	10,000	227,012.50	10,000	346,969.58	Supra.
National Supply Co. of Delaware.			5,000	281,202.50	Underwriting: * December 1922, 75,000 shs. common; January 1923, \$1,000,000 7% cum. pref. cap. stock.
Pullman, Incorporated.....			9,000	424,375.00	None.
Paramount Pictures, Inc., 2nd pfd.			10,000	132,959.56	[Maurice Newton, of Hallgarten & Company, Executive Committee and Director.] ‡
Southern Railway Co.....	7,000	185,737.50	10,000	262,017.50	None.
Twentieth Century-Fox Film Corp. \$1.50 cum. pfd.	7,000	182,445.11	20,000	509,909.92	John R. Dillon, director. * Underwriting: † Subsidiary, Fox Film Corp. April 1931, \$30,000,000 6's Apr. 1, 1936.
Youngstown Sheet & Tube Co.			10,000	573,330.00	Underwriting: * April 1926, \$30,000,000; conv. 3½%, Feb. 1, 1951.

* American Underwriting Houses and Their Issues, 1935, p. 59.

† Ibid.

‡ Moody's Industrials, 1935, p. 1171.

§ Poor's Industrials, 1936, p. 2228.

• Poor's Industrials, 1935, p. 2886.

† American Underwriting Houses and Their Issues, 1931, p. 55.

• Poor's Industrials, 1936, p. 358.

Appendix W—Supplementary material in connection with Hayden, Stone & Co.—Continued

7. PORTFOLIO SECURITIES OF THE ADAMS EXPRESS COMPANY IN 1935 AND 1936 (AND NOT IN 1929) SHOWING AFFILIATION WITH HAYDEN, STONE & CO.

Portfolio company	As of Dec. 31, 1935		As of Dec. 31, 1936		Affiliation of Hayden, Stone & Co.
	Shares	Cost	Shares	Cost	
American International Corporation.	60,000	\$454,530.00	98,000	\$949,665.00	Charles Hayden, director; * Steele Mitchell, director; * Supra, pp.
American Locomotive Co.	7,600	498,681.70	-----	-----	Charles Hayden, director.*
Cleveland-Cliffs Iron Co.: preferred.	8,000	200,000.00	8,000	380,787.50	Underwriting: † December 1935, \$16,500,000; 1st 4¼'s Nov. 1, 1950. Steele Mitchell, director.*
Cliffs Corporation V. T. C.	11,000	201,583.50	5,000	103,611.01	Company holds entire stock of Cleveland-Cliffs Iron Works, Co.; Steele Mitchell, director.*
Granite City Steel Co.: common.	750	19,948.75	12,000	314,373.25	Charles Hayden, director.*
Granite City Steel Co.: part paid.	11,250	177,775.00	-----	-----	
Marlin Rockwell Company....	2,000	64,612.50	-----	-----	[T. L. Chadbourne] director.†
Mayflower Associates, Inc.	4,000	154,000.00	4,700	82,250.00 (Market value)	Member of Hayden, Stone on Board.†
Twentieth Century-Fox Film: preferred.	10,000	220,921.14	20,000	547,450.00	John R. Dillon, director.*
United States & International Securities Corp.: 1st pfd. w/w.	11,300	558,117.68	17,000	1,201,822.80	Charles Hayden, director, member of Executive Committee.†
Best & Co.	12,000	485,493.00	10,000	401,118.00	C. M. Connell, director; * Richard F. Hoyt, director; * financed by Hayden, Stone & Co. in June 1927.*
Anaconda Copper Mining Co.*	20,000	835,250.00	22,500	990,562.50	Supra,

* Poor's Directory of Directors, 1935, p. 418.

† Id., at 418.

* Id., at 196.

* American Underwriting Houses and Their Issues, 1935, p. 59.

* Public Examination, The Adams Express Company, at 6946.

† Poor's Industrials, 1936, p. 1989.

* Public Examination, The Adams Express Company, at 6946.

* Id., at 6958.

* Poor's Directory of Directors, 1935, p. 174. Poor's Industrials, 1935, p. 1218. Public Examination, The Adams Express Company, p. 6959.

† Id., at 6959.

* Poor's Industrials, 1935, p. 286.

† Poor's Directory of Directors, 1935, p. 1636.

* Poor's Industrials, 1935, p. 910.

* Poor's Directory of Directors, 1935, p. 207. Poor's Industrials, 1935, p. 910.

* Since underwriting of this company by Hayden, Stone & Co. took place in 1935 it is included herein, although the 1929 portfolio of The Adams Express Company contained 2,000 shares.