73D CONGRESS }
2d Session }
SENATE
{ REPORT
{ No. 1455

STOCK EXCHANGE PRACTICES

REPORT

OF THE

COMMITTEE ON BANKING AND CURRENCY

PURSUANT TO

S.Res. 84

(72d CONGRESS)

A RESOLUTION TO INVESTIGATE PRACTICES OF STOCK EXCHANGES WITH RESPECT TO THE BUYING AND SELLING AND THE BORROWING AND LENDING OF LISTED SECURITIES

AND

S.Res. 56 and S.Res. 97

(73d CONGRESS)

RESOLUTIONS TO INVESTIGATE THE MATTER OF BANKING OPERATIONS AND PRACTICES, TRANSACTIONS RELATING TO ANY SALE, EXCHANGE, PURCHASE, ACQUISITION, BORROWING, LENDING, FINANCING, ISSUING, DISTRIBUTING, OR OTHER DISPOSITION OF, OR DEALING IN, SECURITIES OR CREDIT BY ANY PERSON OR FIRM, PARTNERSHIP, COMPANY, ASSOCIATION, CORPORATION, OR OTHER ENTITY, WITH A VIEW TO RECOMMENDING NECESSARY LEGISLATION, UNDER THE TAXING POWER OR OTHER FEDERAL POWERS

SUBMITTED BY MR. FLETCHER

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73D CONGRESS } SENATE { REPORT
2d Session } { No. 1455

STOCK EXCHANGE PRACTICES

JUNE 6 (calendar day, JUNE 16), 1934—Ordered to be printed

Mr. FLETCHER, from the Committee on Banking and Currency, submitted the following

REPORT

[Pursuant to S.Res. 84, 72d Cong.; S.Res. 56 and S.Res. 97, 73d Cong.]

The Committee on Banking and Currency, authorized by Senate Resolutions 84, 239, and 371 of the Seventy-second Congress, and continued in effect by Senate Resolutions 56 and 97 of the Seventy-third Congress, to investigate security dealings, banking practices and effects of same, submits the accompanying introductory statement and report:

INTRODUCTORY STATEMENT

On March 2, 1932, the Senate Committee on Banking and Currency, or any duly authorized subcommittee thereof, was authorized and directed by Senate Resolution No. 84 of the Seventy-second Congress to make a thorough and complete investigation of the practices with respect to the buying and selling and the borrowing and lending of listed securities upon the various stock exchanges, the values of such securities, and the effect of such practices upon interstate and foreign commerce, upon the operation of the national banking system and the Federal Reserve System, and upon the market for securities of the United States Government, and the desirability of the exercise of the taxing power of the United States with respect to any such securities.

Pursuant to the resolution, an exhaustive investigation into stock-exchange practices was conducted by a duly authorized subcommittee of the Committee on Banking and Currency. Public hearings were held on April 11 and 12, 1932, with Claude Branch, Esq., acting as counsel to the subcommittee; and hearings were continued on April

18, 21, 23, 26, May 19, 20, 21, and June 3, 4, 10, 11, 14, 16, 17, 18, and 23, 1932, with William A. Gray, Esq., acting as counsel. The scope of these hearings was limited to stock-exchange practices.

On January 11 and 12, 1933, the subcommittee heard testimony regarding the flotation and distribution of securities issued by Krueger & Toll Co., with John Marrinan, Esq., conducting the examination.

On January 24, 1933, Ferdinand Pecora, Esq., was retained as counsel to the subcommittee and thenceforth the inquiry proceeded under his guidance.

On February 15, 16, and 17, 1933, evidence was presented relating to the Insull failure.

Between February 21 and March 2, 1933, hearings were held with regard to the National City Bank and its securities affiliate the National City Co.; and on March 1, 1933, testimony was also heard concerning practices on the New York Stock Exchange.

The scope of the inquiry was materially expanded when Senate Resolution No. 56 of the Seventy-third Congress was agreed to on April 4, 1933. The resolution provided:

Resolved, That the Committee on Banking and Currency, or any duly authorized subcommittee thereof, in addition to the authority granted under Senate Resolution 84, Seventy-second Congress, agreed to March 4, 1932, and continued in force by Senate Resolution 239, Seventy-second Congress, agreed to June 21, 1932, and further continued by Senate Resolution 371, Seventy-second Congress, agreed to February 28, 1933, shall have authority and hereby is directed—

(1) To make a thorough and complete investigation of the operation by any person, firm, copartnership, company, association, corporation, or other entity, of the business of banking, financing, and extending credit; and of the business of issuing, offering, or selling securities;

(2) To make a thorough and complete investigation of the business conduct and practices of security exchanges and of the members thereof;

(3) To make a thorough and complete investigation of the practices with respect to the buying and selling and the borrowing and lending of securities which are traded in upon the various security exchanges, or on the over-the-counter market, or on any other market; and of the values of such securities; and

(4) To make a thorough and complete investigation of the effect of all such business operations and practices upon interstate and foreign commerce, upon the industrial and commercial credit structure of the United States, upon the operation of the national banking system and the Federal Reserve System, and upon the market for securities of the United States Government, and the desirability of the exercise of the taxing power of the United States with respect to any such business and any such securities, and the desirability of limiting or prohibiting the use of the mails, the telegraph, the telephone, the radio, and any other facilities of interstate commerce or communication with respect to any such operations and practices deemed fraudulent or contrary to the public interest.

The authority of the investigating committee was further supplemented by Senate Resolution No. 97, of the Seventy-third Congress, agreed to on June 8, 1933, which provided as follows:

Resolved, That the Committee on Banking and Currency, or any duly authorized subcommittee thereof, in addition to and supplementing the authority granted under Senate Resolution 84, Seventy-second Congress, agreed to March 4, 1932, and continued and supplemented by Senate Resolution 239, Seventy-second Congress, agreed to June 21, 1932, Senate Resolution 371, Seventy-second Congress, agreed to February 28, 1933, and Senate Resolution 56, Seventy-third Congress, agreed to April 4, 1933, shall have authority to investigate any transactions or activities relating to any sale, exchange, purchase, acquisition, borrowing, lending, financing, issuing, distributing, or other disposition of, or dealing in, securities or credit by any person, firm, partnership, company, association, corporation, or other entity, and/or any other acts or operations of any one or more of them or of agents, affiliates, or subsidiaries of any one or more of them or of any entity (corporate or otherwise) directly or indirectly controlled or influenced by any one or more of them, which may affect or bear upon, either directly or indirectly, any of the foregoing transactions or activities. Such investigation shall be made with a view to recommending necessary legislation, under the taxing power or other Federal powers.[1]

Between May 23 and June 9, 1933, public hearings were conducted with regard to the business operations and practices of J. P. Morgan & Co.

Between June 27 and July 6, 1933, public hearings were conducted with regard to the business operations and practices of Kuhn, Loeb & Co.

Between October 3 and October 13, 1933, public hearings were conducted with regard to the business operations and practices of Dillon, Read & Co.

Between October 17 and December 7, 1933, the subcommittee heard evidence relating to the Chase National Bank and its securities affiliate, the Chase Securities Corporation.

Between December 19, 1933, and February 9, 1934, a public inquiry was conducted into the closed banks in Detroit and evidence was received relating to the Guardian Detroit Union Group, Inc., and the Detroit Bankers Co.

Between February 14 and February 26, 1934, the subcommittee heard evidence as to manipulative activities in the so-called "repeal stocks" on the New York Stock Exchange.

Between February 26 and April 5, 1934, the full Committee on Banking and Currency conducted hearings on the Securities Exchange Act of 1934.

On April 18, 1934, the committee received for the record, a report prepared by its staff on the trading activity in the stocks of certain aviation corporations between December 1, 1933, and February 9, 1934.

On May 1, 1934, the subcommittee received in evidence the returns filed by stock exchanges, stock-exchange members and member firms, banks, and corporations in response to questionnaires submitted to them respectively by the subcommittee.

On May 3 and 4, 1934, the hearings were devoted to the introduction into evidence of the reports prepared by the investigating staff of the subcommittee on the Guardian Trust Co., Cleveland, and the Union Trust Co., Cleveland.

In the course of the investigation thus far conducted by the subcommittee a record of more than 12,000 printed pages has been compiled and more than 1,000 exhibits received in evidence. The subcommittee has endeavored to investigate thoroughly and impartially some of the complex and manifold ramifications of the business of issuing, offering, and selling securities and the business of banking and extending credit. It has endeavored to expose banking operations and practices deemed detrimental to the public welfare; to

[1] It should be noted that the above Resolution No. 97 had for its primary purpose the bestowal of increased power upon the Committee or any duly authorized subcommittee thereof to investigate any particular transaction or transactions as well as "practices" as had been incorporated in previous resolutions, in order that the Committee might not have its hands tied while going into income-tax transactions of firms or individuals. See pt. 2, Lamont, Thomas S., pp. 558, 779–780.

reveal unsavory and unethical methods employed in the flotation and sale of securities; and to disclose devices whereby income-tax liability is avoided or evaded. Its purpose throughout has been to lay the foundation for remedial legislation in the fields explored and in some measure that purpose has already been achieved. During the progress of this investigation, Congress enacted the Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, and several amendments to the revenue act calculated to eliminate methods of tax avoidance described before the subcommittee.

The cost of the investigation has been approximately $250,000. The expenditures, however, have been justified many fold by the incalculable benefits flowing to the American people from the hearings in the form of enlightment as to practices which have cost them so dearly in the past and in the form of remedial measures designed to prevent such practices for all time in the future. The Federal Government has been or will be reimbursed many times over by the receipt of additional income taxes and penalties imposed on the basis of testimony developed at the hearings. To date assessments for deficiencies and penalties have been levied by the Bureau of Internal Revenue in a sum exceeding $2,000,000 as a direct result of the revelations before the subcommittee. No estimates are available concerning the extent to which the Treasury has been or will be further enriched as an indirect result of those revelations, but it is certain that a great many returns have been voluntarily amended and additional payments made since the public hearings were held.

CHAPTER I. SECURITIES EXCHANGE PRACTICES

1. Extent and Importance of Transactions on Exchanges

Transactions in securities on organized exchanges and over-the-counter markets are affected with a national public interest. Directly or indirectly the influence of such transactions permeates our national economy in all its phases. The business conducted on securities exchanges has attained such magnitude and has become so closely interwoven with the economic welfare of the country, that it has been deemed an appropriate subject of governmental regulation.[1]

In former years transactions in securities were carried on by a relatively small portion of the American people. During the last decade, however, due largely to development of the means of communication—the expanding network of telephone, telegraph, ticker, radio, and newspaper facilities—the entire Nation has become acutely sensitive to the activities on securities exchanges. While only a fraction of the multitude who now own securities can be regarded as actively trading on the exchanges, the operations of these few profoundly affect the holdings of all. Moreover, the currently realizable value of securities held by banks, trust companies, insurance companies, endowed institutions, and the like, is dependent upon market quotations and consequently the welfare of countless individuals who have a financial interest in such institutions is directly affected by activities on the exchanges.

Operations on organized exchanges have assumed extraordinary proportions. On 34 organized exchanges throughout the country, 1,525,018,217 shares were traded in during the year 1928, 1,849,454,014 during the year 1929, and 561,729,033 during the year 1932. As of July 31, 1933, there were listed on those exchanges 6,057 common and preferred stock issues with a total market value of $95,051,876,295; and 3,798 bond issues with a total market value of $49,080,819,993.[2]

It is evident that a business of such stature not only entails the use of the mails and other instrumentalities of interstate commerce, but itself constitutes an important part of the current of interstate commerce. Neither can it be doubted that the credit mechanism of the Nation is interlocked with transactions on exchanges, or that such transactions exert tremendous influence upon industry and trade. In retrospect, the fact emerges with increasing clarity that the excessive and unrestrained speculation which dominated the securities markets in recent years, has disrupted the flow of credit, dislocated industry and trade, impeded the flow of interstate commerce, and brought in its train social consequences inimical to the public welfare.

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[1] Securities Exchange Act of 1934, Securities Act of 1934, and Banking Act of 1933.
[2] Pt. 17, p. 7855, and New York Stock Exchange Year Book, 1932–33, pp. 117, 122.

2. Cost of Transactions on Exchanges

The cost to the American public of maintaining the securities markets has been staggering. Through the medium of questionnaires, the subcommittee has accumulated figures heretofore unavailable, which, upon recapitulation, reflect the sums received by members of the various exchanges for commissions and interest, and the gross income and net profits derived from their business.

The following table sets forth the net commissions received by member firms and individual members of 29 organized exchanges for the period between January 1, 1928, and August 31, 1933:

	Commissions
New York Stock Exchange	[3] $1,561,649,477
New York Curb Exchange	[4] 46,029,588
27 miscellaneous exchanges	[5] 41,989,626
Combined total commissions	1,649,668,691

The next table sets forth the net interest received by member firms of the same exchanges for the period between January 1, 1928, and August 31, 1933:

	Interest
New York Stock Exchange	[6] $320,040,673
New York Curb Exchange	[7] 1,358,731
27 miscellaneous exchanges	[8] 4,054,568
Combined total interest	325,453,972

The combined total commissions and the combined total interest received by members of those 29 exchanges aggregate $1,975,112,663, which figure represents the amount paid by the public for effecting transactions through such members.

In the following table are shown the total income and the net income of member firms and individual members of the same exchanges for the period between January 1, 1928, and August 31, 1933:

	Total income [1]	Net income [2]
New York Stock Exchange	[3] $2,245,912,402	[4] $906,053,147
New York Curb Exchange	[5] 110,368,088	[5] 70,739,100
27 miscellaneous exchanges	[6] 84,000,907	[6] 22,636,691
Combined totals	2,440,311,397	999,428,938

[1] Includes net commissions, net interest, profits on trading, and miscellaneous income, but excludes profits realized on their own trading by partners of member firms.

[2] Excludes profits realized on their own trading by partners of member firms.

[3] Excludes total income of 6 odd-lot firms. Pt. 17, pp. 7869, 7875.

[4] Includes net income of 6 odd-lot firms. Pt. 17, pp. 7869, 7875.

[5] Pt. 17, pp. 7881, 7885.

[6] Pt. 17, pp. 7899, 7921.

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[3] Pt. 17, pp. 7869, 7875.

[4] Pt. 17, pp. 7881, 7885.

[5] Baltimore Stock, Boston Stock, Boston Curb, Buffalo Stock, Cincinnati Stock, Cleveland Stock, Chicago Curb, Chicago Stock, Detroit Stock, Hartford Stock, Los Angeles Curb, Los Angeles Stock, Minneapolis-St. Paul Stock, New York Produce, New York Mining, New Orleans Stock, Philadelphia Stock, Pittsburgh Stock, Richmond Stock, San Francisco Curb, San Francisco Mining, San Francisco Stock, Salt Lake Stock, Seattle Stock, St. Louis Stock, Standard Stock of Spokane, and Washington (D.C.) Stock. Pt. 17, pp. 7899, 7921.

[6] Pt. 17, p. 7869.

[7] Pt. 17, p. 7881.

[8] Pt. 17, p. 7899.

The combined total income of member firms and individual members of those 29 exchanges for the period was $2,440,311,397; and their combined net income was $999,428,938.

The sums derived by members of the exchanges for effecting transactions on behalf of the public represent only a fragment of the cost to the public of speculation on the exchanges. The shrinkage in the value of securities following the illusory boom which culminated in October 1929 involved losses on an unprecedented scale. On September 1, 1929, the total market value of stocks listed on the New York Stock Exchange reached an all-time high of $89,-668,276,854. By November 1, 1929, this total had dropped to $71,759,485,710, a decrease of approximately 18 billion dollars; and on July 1, 1932, the figure sank to the low point of $15,633,479,577, a decrease of 74 billion dollars from the high.[9] Bonds listed on the New York Stock Exchange diminished in value from a high of $49,293,758,598 on September 1, 1930, to a low of $30,554,431,090 on April 1, 1933, a decrease of over 18 billion dollars.[10] The annals of finance present no counterpart to this enormous decline in security prices.

The economic cost of this down-swing in security values cannot be accurately gauged. The wholesale closing of banks and other financial institutions; the loss of deposits and savings; the drastic curtailment of credit; the inability of debtors to meet their obligations; the growth of unemployment; the diminution of the purchasing power of the people to the point where industry and commerce were prostrated; and the increase in bankruptcy, poverty, and distress—all these conditions must be considered in some measure when the ultimate cost to the American public of speculating on the securities exchanges is computed.

3. Comparative Activities on Organized Exchanges

Comprehensive questionnaires were prepared by the subcommittee, designed to elicit information concerning the activities of the organized securities exchanges throughout the country.[11] They were submitted to the following 34 exchanges: Baltimore Stock Exchange, Boston Stock Exchange, Boston Curb Exchange, Buffalo Stock Exchange, Cincinnati Stock Exchange, Cleveland Stock Exhange, Colorado Springs Stock Exchange, Chicago Board of Trade, Chicago Curb Exchange, Chicago Stock Exchange, Denver Stock Exchange, Detroit Stock Exchange, Hartford Stock Exchange, Los Angeles Curb Exchange, Los Angeles Stock Exchange, Milwaukee Grain and Stock Exchange, Minneapolis-St. Paul Stock Exchange, New York Curb Exchange, New York Mining Exchange, New York Produce Exchange, New York Stock Exchange, New York Real Estate Securities Exchange, Inc., New Orleans Stock Exchange, Philadelphia Stock Exchange, Pittsburgh Stock Exchange, Richmond Stock Exchange, San Franciso Curb Exchange, San Francisco Stock Exchange, San Francisco Mining Exchange, Salt Lake Stock Exchange, Seattle Stock Exchange, St. Louis Stock Exchange, Standard Stock

[9] New Work Stock Exchange Year Book, 1932-33, pp. 112, 113.

[10] New York Stock Exchange Year Book, 1932-33, pp. 120, 122.

[11] The New York Stock Exchange questionnaire appears at p. 7340, and the Miscellaneous Exchange questionnaire at p. 7848, of pt. 17.

Exchange of Spokane, and Washington (D.C.) Stock Exchange. A comparison of the returns filed by these exchanges establishes that the New York Stock Exchange dominates the securities business in every respect.

(*a*) *Membership and attendance.*—The total membership, regular and associate, on all exchanges is 6,404. The members of the New York Stock Exchange number 1,375, and they hold 960 memberships on other exchanges, giving them a total of 2,335, or 36.4 percent of the membership on all exchanges. The New York Curb Exchange has 550 regular members and 426 associate members. The membership on other exchanges ranges between 12 members on the Richmond Stock Exchange and 1,549 members on the Chicago Board of Trade.[12]

The combined average daily attendance on all exchanges is 2,858 members, of whom an average of 1,000 appear daily on the New York Stock Exchange and an average of 344 on the New York Curb Exchange. On 22 of the remaining exchanges the average daily attendance is less than 25 members, and on 28 exchanges it is less than 50 members.[13]

(*b*) *Members carrying margin accounts.*—On the New York Stock Exchange 447 member firms carry margin accounts, and upon the other exchanges 550 member firms and 63 individual members carry such accounts. The total number of memberships held by all firms carrying margin accounts is 1,337, of which 615 are owned by member firms of the New York Stock Exchange. Member firms of the New York Stock Exchange constitute over 42 percent of all member firms carrying margin accounts throughout the country.[14]

(*c*) *Volume of trading.*—In 1928 the combined trading on all exchanges aggregated 1,525,018,217 shares, of which 920,550,032, or 60 percent of the total, were traded in on the New York Stock Exchange; in 1929 the combined trading on all exchanges aggregated 1,849,454,014 shares, of which 1,124,608,910 shares, or 61 percent of the total, were accounted for by the New York Stock Exchange; and in 1932 the combined trading on all exchanges aggregated 561,729,-033 shares, of which 425,234,294 shares, or 76 percent of the total, were the portion of the New York Stock Exchange. The volume of trading on the New York Stock Exchange for the month of July 1933 was upward of 120,000,000 shares, which exceeded the trading for the years 1928, 1929, and 1932 combined on any other exchange except the New York Curb Exchange, the San Francisco Mining Exchange, and the Chicago Stock Exchange.[15]

(*d*) *Number and value of securities listed.*—As of July 31, 1933, 4,851 stock issues, common and preferred, and 2,249 bond issues were listed on all exchanges exclusive of the New York Stock Exchange.[16] On the New York Stock Exchange, as of that date, 1,207 common and preferred stock issues and approximately 1,549 bond issues were listed.[17]

On July 31, 1933, the total market value of all common and preferred stocks listed on all exchanges, except the New York Stock

[12] Pt. 17, pp. 7849, 7852.
[13] Pt. 17, pp. 7849, 7852.
[14] Pt. 17, p. 7849.
[15] Pt. 17, p. 7854.
[16] Pt. 17, p. 7855.
[17] New York Stock Exchange Year Book, 1932–33, pp. 109, 117.

Exchange, was $62,289,668,303.59.[18] On that date the total market value of all common and preferred stocks listed on the New York Stock Exchange was $32,762,207,992.[19]

The total market value of bonds listed on all exchanges, except the New York Stock Exchange, on July 31, 1933, was $14,622,997,711.05.[20] On the same date the total market value of bonds listed on the New York Stock Exchange was $34,457,822,282.[21]

4. Margin Purchasing

(*a*) *The nature of margin purchasing.*—Margin purchasing is speculation in securities with borrowed money. The credit facilities for the purchase of securities on margin in this country are unequaled anywhere. In the past the sole prerequisite to the establishment of a margin account was the deposit with a broker of a comparatively small portion of the purchase price of the securities. The balance was supplied by the broker, who in turn had easy access to the credit reservoirs of the country through the medium of loans from banks, private corporations, and other brokers.

The financial and moral responsibility of the customer was beside the point. The broker, confidently relying upon the mechanism of the exchange to aid him in swiftly liquidating the collateral when necessary, did not hesitate to lend his credit to all comers.

The celerity with which margin transactions were arranged and the absence of any scrutiny by the broker of the personal credit of the borrower, encouraged persons in all walks of life to embark upon speculative ventures in which they were doomed by their lack of skill and experience to certain loss. Excited by the vision of quick profits, they assumed margin positions which they had no adequate resources to protect, and when the storm broke they stood helplessly by while securities and savings were washed away in a flood of liquidation.

(*b*) *Number of margin accounts.*—During the year 1929 the total number of customers of member firms of 29 exchanges [22] was 1,548,707. The transactions of 949,470, or 61.31 percent of the total number of customers, were of a cash character and the transactions of 599,237, or 38.69 percent, were of a margin character.

The member firms of the New York Stock Exchange had 1,371,920 customers out of the total. The New York Stock Exchange member firms reported that the transactions of 811,986, or 59.19 percent, of their customers were of a cash character and the transactions of 559,934, or 40.81 percent, of their customers were of a margin character.[23] The member firms of the New York Curb Exchange

[18] Pt. 17, p. 7855.
[19] New York Stock Exchange Year Book, 1932–33, p. 117.
[20] Pt. 17, p. 7855.
[21] New York Stock Exchange Year Book, 1932–33, p. 122.
[22] New York Stock, New York Curb, Baltimore Stock, Boston Stock, Boston Curb, Buffalo Stock, Cincinnati Stock, Cleveland Stock, Chicago Curb, Chicago Stock, Detroit Stock, Hartford Stock, Los Angeles Curb, Los Angeles Stock, Minneapolis-St. Paul Stock, New York Produce, New York Mining, New Orleans Stock, Philadelphia Stock, Pittsburgh Stock, Richmond Stock, San Francisco Curb, San Francisco Mining, San Francisco Stock, Salt Lake Stock, Seattle Stock, St. Louis Stock, Standard Stock of Spokane, and Washington (D.C.) Stock.
[23] Pt. 17, p. 7802.

had 44,952 customers out of the total, who were estimated by the members to include 35,011, or 77.88 percent, cash customers and 9,941, or 22.12 percent, margin customers.[24] The members of the 27 other exchanges divided the balance of 131,835 customers and estimated that 102,473, or 77.72 percent, were cash customers and 29,362, or 22.28 percent, were margin customers.[25]

In the period between January 1 and September 1, 1933, the total number of customers of member firms of the same 29 exchanges was 1,148,180, of which 689,090, or 60.02 percent, were of a cash character, and 459,090, or 39.38 percent, were of a margin character. The member firms of the New York Stock Exchange had 1,028,491 customers out of the total who were approximated by the members to comprise 596,376, or 57.99 percent, cash customers and 432,115, or 42.01 percent, margin customers.[26] The member firms of the New York Curb Exchange had 23,050 customers out of the total who were estimated by the members to include 17,520, or 76.01 percent, cash customers and 5,530, or 23.99 percent, margin customers.[27] The members of the 27 other exchanges divided the balance of 96,639 customers and estimated that 75,194, or 77.81 percent, were cash customers and 21,445, or 22.19 percent, were margin customers.[28]

The subcommittee has ascertained the number of accounts with debit balances on the books of the member firms of these 29 exchanges for divers dates. Accounts with debit balances are accounts for which securities have been purchased with funds borrowed by the customers from the brokers. The following table shows the number of accounts with debit balances carried by member firms of the New York Stock Exchange, New York Curb Exchange, and 27 other exchanges on the dates indicated:

Accounts with debit balances

Date	New York Stock Exchange [1]	New York Curb Exchange [2]	27 other exchanges [3]	Total
Dec. 31, 1928	292,631	7,220	17,641	317,501
July 31, 1929	340,019	8,638	20,436	369,093
Dec. 31, 1929	319,789	8,014	20,027	347,830
Dec. 31, 1930	258,385	6,425	15,173	279,983
Dec. 31, 1931	227,366	5,316	12,862	245,544
Dec. 31, 1932	203,450	5,489	11,709	220,618
June 30, 1933	269,915	6,203	14,580	290,698

[1] P. 17, p. 7862. [2] P. 17, p. 7880. [3] P. 17, p. 7889.

The table indicates a substantial increase of 51,592 margin accounts during the speculative period between December 31, 1928, and July 31, 1929. During the first 6 months of 1933, when speculation again was rampant, the number of margin accounts increased by 70,050.

As compared with the multitude of persons and corporations holding securities throughout the country, the number of margin cus-

[24] Pt. 17, p. 7879.
[25] Pt. 17, p. 7889.
[26] Pt. 17, p. 7862.
[27] Pt. 17, p. 7879.
[28] Pt. 17, p. 7889

tomers on the organized exchanges was not large, even during the boom years. Yet these margin purchasers, while their speculations were uncontrolled, affected the national economy in a measure immensely disproportionate to their numbers. Their activities resulted in wide fluctuations in the price of securities, which ultimately imperiled the holdings of bona fide investors of every type. This disproportion between the number of persons trading on margin and their overshadowing position on the financial scene furnished one of the most cogent arguments for remedial legislation with respect to margins.

(*c*) *Regulation of margin purchasing.*—The Securities Exchange Act of 1934 subjects all speculative credit to the central control of the Federal Reserve Board as the most experienced and best-equipped credit agency of the Government. In order to prevent the excessive use of credit for the purchase or carrying of securities, the Board is directed to prescribe rules and regulations with respect to the amount of credit which may be initially extended and subsequently maintained on any security registered on a national securities exchange. While no rigid statutory limitations are placed upon the power of the Board to raise or lower margin requirements, the judgment of Congress is expressed with regard to the standard which should be adopted by the Board for the initial extension of credit, viz: 55 percent of the current market price of the security offered as collateral or 100 percent of the lowest market price of the security during the preceding 3 years (but not more than 75 percent of the current market price), whichever is greater. The rules and regulations prescribed by the Federal Reserve Board must be adhered to by brokers, dealers, banks, and all other persons and corporations who extend or maintain credit for the purpose of purchasing or carrying any security registered on a national securities exchange, with certain exceptions, of which the chief are that the rules and regulations shall not apply to loans not made in the ordinary course of business or to loans made by banks on securities other than equity securities.[29]

These provisions are intended to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin, and to vest the Government credit agency with power to reduce the aggregate amount of the Nation's credit resources which can be directed by speculation into the stock market and away from commerce and industry. Other provisions imposing restrictions upon the borrowings of brokers and dealers will be discussed in the next section of this chapter in connection with brokers' loans and banking credits for securities transactions.

5. Brokers' Loans and Banking Credits for Security Transactions

(*a*) *Nature of brokers' loans.*—Brokers' loans are loans on security collateral made to brokers or dealers in securities. The rates charged for such loans are those in effect on the New York call and

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[29] Securities Exchange Act of 1934, sec. 7.

time money markets. Such loans possess a high degree of liquidity for the reason that they may be called for payment on the same day when payment is expected. There is no personal equation in this type of loan and no obligation to tide the borrower over a difficult situation.

When a customer purchases stock on margin, the broker is required to increase his borrowings in order to finance the transaction, and thereupon a broker's loan arises. Brokers' loans tend to increase whenever there is an increase in the number of margin buyers, an increase in the number of shares bought on margin, an increase in the average price of stocks bought on margin either because of a rising market or a shift of trading into higher-priced groups of stocks, or a decrease in the customers' credit balances or in the resources of brokers. All these circumstances are aspects of a rising market and reflect the rise in speculative fervor.

(*b*) *Dangers in excessive credit for speculation.*—Brokers obtain funds to finance their own and their customers' margin transactions chiefly by borrowing from banking institutions. Banks, in turn, make these loans on their own behalf or act as agents in lending the funds of nonbanking corporations, individuals, and investment trusts, commonly designated as "others." Brokers also borrow in large volume from nonbanking corporations having available cash, without the intervention of banks.[30]

When the volume of brokers' loans piles up to the heights reached in recent years, the situation is fraught with peril. In the event of unfavorable developments in the financial world, such loans are promptly called, the borrowers are forced to sell securities on a vast scale, and a decline in security values is precipitated. With the drop in market prices, margin accounts become undermargined, resulting in further involuntary liquidation, which accelerates the decline. The shrinkage in security prices not only demoralizes the margin trader, but impairs the security of collateral loans made by the banks and the value of securities held in their own portfolios. Thus, the lending institutions suffer loss because of the decline in security values occasioned by swift contraction of the volume of brokers' loans.

Another danger resulting from an undue volume of brokers' loans is the tremendous burden imposed on the banking system when funds loaned by private corporations and individuals are unexpectedly withdrawn. In such event the banks must take over those loans and in endeavoring to fill the breach their resources may be strained beyond the point of safety. The potential seriousness of this condition may be judged when the huge volume of loans emanating from nonbanking sources is considered.

Other evils flow from excessive brokers' loans. A plentiful supply of funds for brokers' loans when a speculative boom is in progress, tends to encourage further speculation in securities and may lead to

[30] The effect of the Banking Act of 1933 and the Securities Exchange Act of 1934 on these practices will be discussed below in the subsection entitled "Regulation of Brokers' Loans."

speculation in commodities. A rapid rise in stock prices, facilitated by brokers' borrowings tends to make industry overoptimistic, to overstimulate production and to encourage the issuance of new and unnecessary securities. Loans by nonbanking lenders tend to decrease bank deposits and reduce the lending power of banks to commerce and industry; and the fact that such loans increase the cost of credit to legitimate business.

(*c*) *Volume of brokers' loans.*—Brokers' loans rose from a maximum of $1,926,800,000 in the year 1922 to a peak of $8,549,338,979 in the month of October 1929.[31] Accompanying this tremendous expansion of borrowings by brokers, the average price of stocks, based on Standard Statistics' Index, rose from $60 in 1922 to $212 in 1929. Following the stock-market collapse on October 24, 1929, brokers' loans declined $3,000,000,000 in 10 days and over $8,000,000,000 in 3 years, reaching a low of $241,599,943 on August 1, 1932.[32] Concurrently, the average price of stocks declined from $212 to $35.[33]

The insatiable demand for credit during the boom years drove the rate of interest on call loans up to 15 percent to 20 percent per annum. Attracted by this unprecedented interest return, banking and nonbanking lenders poured into the securities markets billions of dollars for speculative purposes.

An official of the Standard Oil Co., Inc., of New Jersey, testified as follows:

Mr. PECORA. Can you tell the committee, Mr. Resor, the factors and circumstances that led to such very heavy borrowings by brokers in the year 1929 or at least up to the end of October of that year?

Mr. RESOR. I can tell you why we loaned so much money; because there was a demand for it at excessively high rates, over and above what we could get from what we would normally invest in, which are Government securities, municipals, and things of that sort.

Mr. PECORA. What caused that great demand?

Mr. RESOR. Speculation in the stock market, of course.

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Mr. PECORA. Could that excessive speculation have been maintained without the credits extended to brokers, represented by call loans?

Mr. RESOR. No; I doubt it. The point I wanted to make is that I believe if the demand is there the money will be forthcoming. The money was not there first, to make the demand.[34]

Charles E. Mitchell, former chairman of the National City Bank of New York, testified to the same effect.[35]

The great demand for call-loan money for speculative purposes and the high interest rates paid on such money, led a number of industrial corporations to issue securities at a time when they did not require all the additional capital for their regular business. On this point a vice president of the Cities Service Co., a public-utility holding corporation, testified as follows:

Senator TOWNSEND. Mr. Johnston, how was this surplus of money which Cities Service was loaning in the Street obtained? Was it a profit on their business, or how was it obtained?

Mr. JOHNSTON. Partly from the earnings of the operating companies and partly from the sale of securities.

Senator TOWNSEND. Sale of securities—what do you mean by that?

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[31] The New York Stock Exchange Year Book, 1932–33, p. 98, 99.
[32] New York Stock Exchange Year Book, 1932–33, p. 99.
[33] E. A. Goldenweiser, Feb. 26, 1934, pt. 15, p. 6437.
[34] R. P. Resor, Feb. 23, 1934, pt. 14, p. 6337.
[35] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, p. 1817.

Mr. JOHNSTON. Cities Service Co. and its subsidiaries.

The CHAIRMAN. Issuing stock and selling stock?

Mr. JOHNSTON. Different kinds of securities were issued. There was stock issued; yes, sir.[36]

The consequence of such financial operations was the creation of a vicious cycle which hastened the financial collapse of October 1929. On the one hand, the financial structure was strained by the superfluous corporate financing. On the other hand, surplus corporate funds thus created were thrown back into the speculative market in the form of call loans, stimulating an increased volume of speculation.

(*d*) *Loans by nonbanking corporations.*—Not only did nonbanking corporations make brokers' loans through the medium of banking institutions, but in many instances such corporations made loans directly to brokers. These loans were entirely uncontrolled by any banking institution or governmental authority. The decline in security values which commenced in October 1929 was rapidly accelerated by the sudden withdrawal of these funds from the call-money market, forcing a drastic liquidation of securities. As pointed out by Charles E. Mitchell, these withdrawals placed a terrific strain upon banking institutions.

Senator FLETCHER. Well, as I understand about that time brokers' loans mounted to something like 6 to 8 billion dollars, and call loans were paying somewhere near 20 percent at the peak.

Mr. MITCHELL. Yes.

Senator FLETCHER. You recognized that as an unhealthy situation, didn't you?

Mr. MITCHELL. Most decidedly.

Senator FLETCHER. Could you briefly state what you did to stop it?

Mr. MITCHELL. One of the greatest difficulties was, of course, loans for account of others, which very materially swelled the credit structure, and that was the very source from which came those large brokers' loans. Bankers, in other words, did not have control of the money situation. It was in the control of the so-called "others." And we did everything in our power to find a correction of that fundamental fault. * * *

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Senator BROOKHART. Didn't you increase your brokers' loans during this very speculative period?

Mr. MITCHELL. No, sir. Our brokers' loans were increased only as the demand of industry and commerce subsided. And, of course, after the break, and then all those people who had been lending on call for their own account and not through the banks, rushed and took their money out; and then every bank in New York was obliged to make up that deficiency and was forced to go to the Federal Reserve bank for borrowing. So that following the period of the collapse the record will show that all New York banks leaned heavily on the Federal Reserve credit, and that was the only thing that saved the situation at that time. But prior to that time and while this speculation was going on we did not lean on the Federal Reserve bank credits at all, or for only a day or two here and there, to even our position up.[38]

In January 1929 a confidential letter on economic conditions was addressed to the executive committee of Henry L. Doherty & Co., an affiliate of Cities Service Co., by an economic advisor, in which attention was called to the unusual expansion of credit for use in securities markets through loans made to brokers by corporations and individuals. The communication stated:

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[36] Ernest H. Johnston, Feb. 23, 1934, pt. 14, p. 6318.

[37] E. A. Goldenweiser, Feb. 26, 1934, pt. 15, pp. 6446–6447.

[38] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, pp. 1814–1815.

* * * Money was most plentiful, and corporations took advantage of this and of the great demand for securities to float large amounts of new securities, which were used to build up cash reserves after bank loans were paid off, working capital increased, and some plant expansion taken care of. These cash reserves found employment in the call-money market. This condition, in general, then, accounts for the source from which money is pouring into the security markets in the form of brokers' loans not originating in the banks themselves.

The above chart shows the astounding rate at which brokers' loans for the account of others (labeled "Uncontrolled") have advanced during 1928, a year when the United States credit base of gold was narrowed by approximately $500,000,000 from a total of approximately four and five-tenths billions. This outside credit has been termed "uncontrolled" because bank reserves need not be kept against such loans and because such transactions are practically as free and unregulated as a personal loan from one individual to another. The other curve on the chart showing the division of brokers' loans is labeled "controlled" and shows the relatively small increase in brokers' loans supplied by the banks themselves.

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The great importance of the present huge amount of brokers' loans from outside sources lies in the fact that while the banks are not now directly concerned with loans from others, these loans do represent a potential call on bank credit. Any sudden withdrawal of money from the security markets by individuals, corporations, or through foreign accounts, must be met by the banks if chaos and disrupting gyrations in call money and in the stock market are to be avoided. This is quite clear when the close relationship between brokers' loans and stock prices is observed in the chart on the preceding page.[39]

In another confidential letter addressed to the executive committee of Henry L. Doherty & Co. in February 1929 it was further stated:

The importance of the volume of brokers' loans in the present credit and general business situations warrant periodic checking-up of the course of these figures.

In the January issue of this letter it was stated that the great importance of the present huge amount of brokers' loans from outside sources lies in the fact that, while banks are not directly concerned with loans from others, these loans do represent a potential call on bank credit. In the first week of the new year this fact was clearly demonstrated. Brokers' loans from outside sources showed a sharp drop at the year end, due to the usual withdrawals made at this time for year-end settlements and requirements. These transactions left a void in brokers' loans of approximately $375,000,000 which the New York banks promptly filled. Since then loans for others have returned in greater volume and the reporting member banks have withdrawn their relief fund.

The brief January drop in the stock market caused almost no liquidation of total brokers' loans. The more severe break in February did force a drop of about $100,000,000 in a total of over 5.5 billion dollars. At the end of February the stock market has fully recovered to a new high and figures for brokers' loans of the last week in February advanced $30,000,000, indicating that liquidation has about run its course for the present movement at least.

Thus we have the picture: Greater speculation, more and more uncontrolled money in brokers' loans, and continuation of the trend toward higher money which has been in process for over a year and a half. The situation is not comforting, from the business point of view.[40]

Yet Henry L. Doherty & Co., acting as fiscal agents for the Cities Service Co., continued to make loans on call directly to brokers, without the interposition of any bank, at rates of interest ranging between

[39] Committee exhibit no. 84, Feb. 23, 1934, pt. 14, pp. 6312–6313.
[40] Committee exhibit no. 85, Feb. 23, 1934, pt. 14, p. 6314.

5 percent and 15 percent per annum. During 1929, the Cities Service Co. made 912 loans in the call-money market of New York City, in the cumulative amount of $285,325,092.21. The peak amount reached on any one day was $41,900,000 outstanding on September 25, 1929, 1 month before the market crash. Following the break, there was a rapid decrease in the call loans of Cities Service Co., and by the end of the year the company had no call loans outstanding.[41]

Standard Oil Co. of New Jersey likewise made call loans directly to brokers. During 1929, the cumulative number of loans made by the company and its subsidiaries was 20,466, and their cumulative amount (computed by multiplying the daily average of such loans by the number of days on which the loans were outstanding) was $17,662,520,000. The peak amount reached on any one day was $97,824,000 outstanding on September 9, 1929. In 1928 the daily average of loans made by Standard Oil Co. of New Jersey and its subsidiaries was between $30,000,000 and $35,000,000, and in 1929 the daily average rose to approximately $69,304,000. The total net interest received by the company and its subsidiaries on call loans for the year 1929 was $4,945,217.65, which did not include one-quarter of 1 percent interest received by the brokers who placed the loans for the company.[42]

Electric Bond & Share Co. and its subsidiaries, during the year 1929, made 1,663 loans in the call-money market for a cumulative total of $867,295,000. The peak amount reached on any one day was $187,900,000 outstanding on August 27, 1929, and the daily average was $100,727,010. The interest on such loans ranged from 5 to 15 percent per annum. After the break in October 1929 Electric Bond & Share Co. sharply reduced the amount of its call loans.[43]

Sinclair Consolidated Oil Corporation and its affiliated and subsidiary corporations made call loans during 1929 in the cumulative amount of $211,000,000, with a peak amount for any one day of $17,600,000, reached on October 9, 1929. The daily average of its loans was $12,595,636.[44]

A compilation of the number and amount of street loans made by 20 private corporations[45] in the call-money market of New York City appears in part 14, at page 6370, of the record of the hearings.

(*e*) *Loans by banks.*—The statistics submitted by 33 banks throughout the country[46] in response to the subcommittee's questionnaire,

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[41] Ernest H. Johnston, Feb. 23, 1934, pt. 14, pp. 6315–6316.

[42] R. P. Resor, Feb. 23, 1934, pt. 14, pp. 6334–6336.

[43] C. E. Groesbeck, Feb. 23, 1934, pt. 14, pp. 6324–6326.

[44] Harry F. Sinclair, Feb. 23, 1934, pt. 14, p. 6330.

[45] American Founders Corporation and subsidiaries; American & Foreign Power Co., Inc., and subsidiaries; American Can Co.; Anaconda Copper Mining Co.; Auburn Automobile Co.; Bethlehem Steel Corporation and subsidiaries; Chrysler Corporation; Cities Service Co.; Consolidated Oil Corporation; Electric Bond & Share Co. and subsidiaries; General Foods Corporation; General Motors Corporation; International Nickel Co., Inc.; Pan-American Petroleum & Transport Co.; Radio Corporation of America and subsidiaries; Radio-Keith-Orpheum Corporation; Standard Oil Co. of New Jersey and subsidiaries; Tri-Continental Corporation and affiliated corporations; The United Corporation; The United Gas & Improvement Co. and subsidiaries.

[46] Bankers Trust, Bank of The Manhattan Co., Central Hanover Bank & Trust, Chemical Bank & Trust, First National Bank, Guaranty Trust, Irving Trust, National City Bank, New York; Continental Illinois, First Union Trust and Savings Bank, First National, The Northern Trust of Chicago; First Wisconsin National, of Milwaukee; American Trust, Bank of American National Trust, The San Francisco Bank, Wells Fargo and Union Trust, of San Francisco; Security First National, of Los Angeles; First National Bank, National Shawmut Bank, Merchants National Bank, of Boston; Industrial Trust, Rhode Island Hospital Trust, of Providence; Philadelphia National Bank, Girard Trust, Fidelity-Philadelphia Trust, First National Bank, of Philadelphia; Cleveland Trust, Central United National, of Cleveland; Mellon National, Union Trust, First National Bank, of Pittsburgh; and New York Trust, of New York.

disclose that as of July 31, 1929, they had outstanding street loans in the aggregate sum of $4,700,145,650, of which $2,016,788,700 were for the account of nonbanking corporations, copartnerships, or individuals. Day loans outstanding on that date amounted to $265,958,000.[47]

Several arguments have been advanced in defense of these loans by "others." It has been contended that such loans serve a necessary function by furnishing credit which the banks would otherwise be called upon to supply. The argument assumes that this credit should be furnished by someone—that it is desirable and connected with a sound condition. The progress of events has shown that the diversion of enormous credit reserves into speculation is economically unsound and constitutes a menace to the Nation's credit system.

It is also argued that these loans by "others" are part of the mechanism whereby corporations are enabled to raise capital for plant expansion. The record shows that this claim is weak in two respects. Such expansion in exaggerated form may itself be undesirable and uneconomic.[48] Moreover, as has already been noted, proceeds of these loans were by no means used entirely for industry, but in part were used to finance the speculative purchase of stocks or to supply issuers with funds which they proceeded to relend on call. Thus, loans for others constituted another link in the endless chain of inflationary activity—a cause as well as a result of stock-market speculation.

In addition to the vast sums poured by banks and corporations into the call money market, billions of dollars were loaned by banks on stock-market collateral. The subcommittee has ascertained from the 33 banks above referred to the amount of their secured loans outstanding, aside from street loans, as of July 31 of each year from 1929 to 1933, inclusive. The following table shows the totals of such loans, together with the portions secured by the various types of collateral designated.[1]

Date [1]	Loans secured by collateral such as stocks and bonds, exclusive of U.S. Government bonds	Loans secured by U.S. Government bonds	Loans secured by real-estate mortgages, life insurance, and similar collateral	Total collateral loans
July 31, 1929	$2,216,846,850	$50,095,100	$782,477,400	$3,049,419,350
July 31, 1930	2,388,576,400	43,609,450	790,681,550	3,222,867,400
July 31, 1931	2,178,556,900	45,960,200	923,348,650	3,147,865,750
July 31, 1932	1,791,956,000	44,602,550	878,046,650	2,714,605,200
July 31, 1933	1,308,494,400	53,858,650	905,846,300	2,268,199,350

[1] Pt. 17, p. 7924.

Banks also made substantial loans for the financing of syndicate or pool operations in stocks. In 1929 the 33 reporting banks made 34 loans to finance syndicate or pool operations, totaling $76,459,550; in 1930 they made 45 such loans, totaling $34,922,750; in 1931 they made 34 such loans, totaling $24,166,300; in 1932 they made 10 such

[47] Pt. 17, p. 7923.
[48] E. A. Goldenweiser, Feb. 26, 1934, pt. 15, p. 6442.

loans, totaling $3,832,600; and in 1933 they made 2 such loans, totaling $950,000. During 1929 some or all of these 33 banks participated in 434 stock syndicate or pool accounts; during 1930 in 352 stock syndicate or pool accounts; during 1931 in 191 stock syndicate or pool accounts; during 1932 in 44 stock syndicate or pool accounts; and from January 1 to September 15, 1933, in 30 stock syndicate or pool accounts. The foregoing syndicate and pool accounts were formed to trade in 118 different stocks. Syndicates formed to trade in bonds are not taken into account.[49]

(*f*) *Regulation of brokers' loans.*—The Banking Act of 1933 contains several effective curbs upon the volume of credit which may be made available to brokers. By the act, member banks of the Federal Reserve System are prohibited from making loans as agents for nonbanking corporations.

No member bank shall act as the medium or agent of any nonbanking corporation, partnership, association, business trust, or individual in making loans on the security of stocks, bonds, and other investment securities to brokers or dealers in stocks, bonds, and other investment securities. * * *[50]

The act also provides that member banks shall pay no interest on demand deposits.

No member bank shall, directly or indirectly by any device whatsoever, pay any interest on any deposit which is payable on demand. * * *[51]

The purpose of this provision is to discourage interior banks from dumping their surplus funds into the financial centers for speculative purposes.

In order to prevent a repetition of the incident in March 1929, when, despite the express warning of the Federal Reserve Board to the contrary, the National City Bank poured $25,000,000 into the call-loan market, the Banking Act of 1933 fortifies the Board with power to call in immediately all advances made to any member bank which disregards a warning against increasing its stock market loans.

* * * If any member bank to which any such advance has been made shall, during the life or continuance of such advance, and despite an official warning of the reserve bank of the district or of the Federal Reserve Board to the contrary, increase its outstanding loans secured by collateral in the form of stocks, bonds, debentures, or other such obligations, or loans made to members of any organized stock exchange, investment house, or dealer in securities, upon any obligation, note, or bill, secured or unsecured, for the purpose of purchasing and/or carrying stocks, bonds, or other investment securities (except obligations of the United States) such advance shall be deemed immediately due and payable, and such member bank shall be ineligible as a borrower at the reserve bank of the district under the provisions of this paragraph for such period as the Federal Reserve Board shall determine. * * *[52]

The Securities Exchange Act of 1934 attacks the problem from another angle. That act makes it unlawful for any member of a national securities exchange, or any broker or dealer who transacts business through any such member, from borrowing on any security regis-

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[49] Pt. 17, pp. 7024–7025, 7029–7031.
[50] Banking Act of 1933, sec. 11 (a).
[51] Banking Act of 1933, sec. 11 (b).
[52] Banking Act of 1933, sec. 9.

tered on a national securities exchange except (1) from or through a member bank of the Federal Reserve System, (2) from any nonmember bank which has agreed to comply with all provisions of the act, of the Banking Act of 1933, and of the Federal Reserve Act, relating to the use of credit to finance security transactions, or (3) in accordance with the rules and regulations of the Federal Reserve Board permitting loans between members, brokers, and dealers. Restrictions are also placed upon the amount which brokers may borrow in relation to their capital and upon their power to hypothecate their customers' securities for loans.[53] Since the Federal Reserve Board is also authorized to limit the amount which banks may loan on stocks,[54] an effective, flexible, and unified control is established over the amount of the Nation's credit which may be directed into stock-exchange activities.

6. Trading by Members and Segregation of Functions of Brokers and Dealers

(a) *Extent of trading by members for their own account.*—The investigation conducted by the subcommittee for the first time disclosed the extent of trading by members of organized exchanges for their own account. Statistical data on the subject were compiled for the month of July 1933, one of the most active months in the history of organized exchanges. The volume of trading on the New York Stock Exchange for that month was 120,271,243 shares.[55] Since every trade involves a purchase and a sale the figure indicates that 120,271,243 shares were bought and 120,271,243 shares were sold, making a total of 240,542,486 shares bought and sold. A summary follows showing the number of shares purchased and the number of shares sold on the New York Stock Exchange for the account of member firms, partners of member firms, and individual members of the New York Stock Exchange during the month of July 1933:

	Shares bought	Shares sold	Total bought and sold
Member firms [1]	16,013,032	16,835,620	32,848,652
Partners of member firms [1]	10,404,652	10,816,696	21,221,348
Individual members [2]	5,360,262	5,546,348	10,906,610
Total	31,777,946	33,198,664	64,976,610

[1] Pt. 17, p. 7862. [2] Pt. 17, p. 7874.

Thus, it appears that 64,976,610 shares or 27.0125 percent of the shares bought and sold on the New York Stock Exchange during one of the most active months of its existence were bought and sold for the personal account of the member firms, partners of member firms, and individual members of the New York Stock Exchange.

Member firms and partners thereof who conduct a commission business act as agents for their customers. When they trade for their own account, they act as principals. A broker may occupy the dual position of agent and principal in a single transaction, and

[53] Securities Exchange Act of 1934, sec. 8.
[54] Securities Exchange Act of 1934, sec. 7 (d).
[55] Pt. 17, p. 7874.

in such case his personal interest necessarily clashes with that of his customer. The New York Stock Exchange has adopted a rule prohibiting a member, when acting as a broker, from buying or selling for his own account or that of a partner or for any account in which he or a partner is interested, securities, the order for the sale or purchase of which has been accepted by him or his firm or a partner for execution, except under the conditions specified in the rule.[56] However assiduous the exchange authorities may be in protecting the rights of the customer, the conflict between the broker's self-interest and his duty to his customer is present, and the customer's welfare is thereby endangered.

When purchases and sales for the account of member firms, partners thereof, and individual members are reported on the ticker tape or in the press, there is, of course, no disclosure of the nature of those transactions. The public, in July 1933, had no means of knowing that approximately 27 percent of all transactions were executed for the account of members of the New York Stock Exchange. A volume of trading which might readily have been construed to reflect a widespread public participation in the market and a genuine revival of confidence in securities, represented to the extent of 27 percent the activities of members themselves. Unfortunately, there is no way of measuring the extent to which the remaining 73 percent of trading was fomented, encouraged, or directly caused by the trading activities of members. The fact that the total number of shares bought by members of the New York Stock Exchange during the month approximates the total number sold by them, evidences that their transactions were of the in-and-out variety, speculative in nature and devoid of investment quality.

A similar situation existed on other exchanges. The volume of trading on the New York Curb Exchange for the month of July 1933, was 21,102,896 shares,[57] a total of 42,205,792 shares bought and sold. The following summary shows the number of shares purchased and the number of shares sold on the New York Curb Exchange for the account of member firms, partners of member firms and individual members of the New York Curb Exchange during the month of July 1933:

	Shares bought	Shares sold	Total bought and sold
Member firms [1]	2, 110, 896	2, 537, 838	4, 648, 734
Partners of member firms [2]	542, 508	541, 280	1, 083, 788
Individual members [3]	2, 920, 049	2, 946, 181	5, 866, 230
Total	5, 573, 453	6, 025, 299	11, 608, 752

[1] Pt. 17, p. 7879. [2] Pt. 17, p. 7880. [3] Pt. 17, p. 7884.

Member firms, partners of member firms, and individual members of the New York Curb Exchange bought and sold for their own account during the month 27.48 percent of the total number of shares bought and sold on the exchange.

[56] Rules of the New York Stock Exchange, ch. XI, sec. 1, as amended June 14, 1932.
[57] Pt. 17, pp. 7880, 7884.

The combined trading volume of 27 other exchanges[58] for the month of July 1933, was 19,882,028 shares, a total of 39,764,056 shares bought and sold. Of that number, 4,913,271 shares were bought and sold by member firms, partners of member firms, and individual members of such exchanges, representing 12.36 percent of the total number of shares bought and sold.[59]

The total number of shares purchased and sold on all exchanges during the month of July 1933, was 322,512,334. Member firms, partners of member firms, and individual members of all exchanges purchased and sold for their own account on the respective exchanges of which they were members, a total of 81,488,633 shares, or a percentage of 25.26 percent of the total.

(b) *Members' profits on trading for their own account.*—The extent of the transactions carried on by stock-exchange firms and individual members for their own account is reflected in the following figures showing the net profits derived from such trading:

New York Stock Exchange

Period	Member firms [1]	Individual members [2]	Total profits
1928	$123,931,612	$16,987,332	$140,918,944
1929	87,200,048	8,844,639	96,045,587
1930	[3] 7,745,412	[3] 3,354,445	[3] 11,099,857
1931	[3] 7,326,336	[3] 3,300,400	[3] 10,626,736
1932	13,333,231	[3] 3,119,184	10,214,047
1933 (Jan. 1-Aug. 31)	28,563,213	6,243,958	34,807,171
Total	237,957,256	22,301,900	260,259,156

[1] Pt. 17, p. 7869. [2] Pt. 17, p. 7875. [3] Loss.

New York Curb Exchange

Period	Member firms [1]	Individual members [2]	Total profits
1928	$8,915,472	$11,057,558	$19,973,030
1929	14,200,621	12,326,513	26,527,134
1930	2,772,021	461,813	3,233,834
1931	1,333,097	[3] 188,410	1,144,687
1932	1,710,410	[3] 51,208	1,659,202
1933 (Jan. 1-Aug. 31)	1,987,923	3,003,121	4,991,044
Total	30,919,544	26,609,387	57,528,931

[1] Pt. 17, p. 7881. [2] Pt. 17, p. 7885. [3] Loss.

Twenty-seven other exchanges

Period	Member firms [1]	Individual members [2]	Total profits
1928	$10,217,544	$1,747,796	$11,965,340
1929	9,609,798	[3] 32,467	9,577,331
1930	3,033,338	[3] 1,070,767	1,962,571
1931	1,379,515	[3] 923,013	456,502
1932	1,704,011	[3] 172,854	1,531,157
1933 (Jan. 1-Aug. 31)	4,474,632	645,272	5,119,904
Total	30,418,838	193,967	30,612,805

[1] Pt. 17, p. 7899. [2] Pt. 17, p. 7921. [3] Loss.

[58] Baltimore Stock Exchange, Boston Stock, Boston Curb, Buffalo Stock, Cincinnati Stock, Cleveland Stock, Chicago Stock, Chicago Curb, Detroit Stock, Hartford Stock, Los Angeles Curb, Los Angeles Stock, Minneapolis-St. Paul Stock, New York Produce, New York Mining, New Orleans Stock, Philadelphia Stock, Pittsburgh Stock, Richmond Stock, San Francisco Stock, San Francisco Curb, San Francisco Mining, Salt Lake Stock, Seattle Stock, St. Louis Stock, Standard Stock Exchange of Spokane, Washington, D.C., Stock (pt. 17, p. 7804).

[59] Pt. 17, p. 7804.

The combined net trading profits of the member firms and individual members of all exchanges from January 1, 1928, to August 31, 1933, was $348,400,892. This figure does not include profits from the personal trading of partners of stock-exchange firms who greatly outnumber those individual members whose profits are included.

The figures likewise do not include purchases made against odd lots by such firms or individuals.[60] On the New York Stock Exchange 6 firms are engaged in the odd-lot business, 3 exclusively, and 3 partially. For the year 1929 these firms purchased 142,623,682 shares and sold 158,238,659 shares, a total of 300,862,341 shares bought and sold. During the period from April 1 to July 1, 1933, they purchased 56,895,451 shares and sold 55,800,825 shares, a total of 112,696,276 shares bought and sold. The combined net profits of the 6 firms (including only that portion of the net profits of the 3 firms partially engaged in the odd-lot business which they have allocated to their odd-lot business) for 1928 aggregated $16,278,670; for 1929, $12,980,126; for 1930, $3,095,949; for 1931, $2,090,443; for 1932, $2,165,283; for the period from January 1 to August 31, 1933, $8,234,452, making their combined total profits from January 1, 1928, to August 31, 1933, $44,794,923.[60] These profits were chiefly derived at the expense of small investors who purchased a few shares at a time.

(*c*) *Participation by brokers in selling syndicates.*—Members of organized exchanges have frequently participated in the public offering and distribution of securities. Just as the banking affiliates found a fertile field for the distribution of their securities among customers of the banks, so brokers interested in selling syndicates resort to their customers as an outlet for the securities they had to sell.

On the New York Stock Exchange during the year 1929, 137 member firms underwrote or participated in the underwriting of securities which were subsequently offered for public sale; in 1930 there were 127 such firms; in 1931 there were 107; in 1932 there were 82; and in the period from January 1 to August 31, 1933, inclusive, there were 82. During 1929, 63 member firms made public offerings of securities or participated with others in public offerings; in 1930 there were 58 such firms; in 1931 there were 68; in 1932 there were 57; and in the period from January 1 to August 31, 1933, inclusive, there were 43.[61] A similar condition prevailed on other exchanges.[62]

(*d*) *Classification of functions.*—In the performance of their functions members of exchanges generally fall into one or more of the following classifications:

Bond brokers, who buy and sell bonds for the account of others.

Floor brokers, who execute orders upon the floor of the exchange either (1) as the floor members of commission houses or (2) as sub-brokers (colloquially designated as "two dollar brokers") for other members of the exchange.

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[60] Pt. 17, pp. 7863, 7869. (For a discussion of odd lot trading, see subsection below, "Odd lot dealers.")
[61] Pt. 17, p. 7863.
[62] Pt. 17, p. 7890.

Specialists, who are floor brokers of the second type, but confine their activities to certain specified securities.

Floor traders, who are free-lance dealers trading for their own account.

Odd-lot dealers, who specialize in buying and selling in amounts less than the unit of trading.

The activities of a member are not limited by his exchange to any single function. He may be—and frequently is—a floor broker and floor trader or a floor trader and specialist or a floor broker, floor trader, and specialist.

Based on a census taken by the New York Stock Exchange as of August 25, 1933, the estimated number of members acting primarily as traders for their own account was 86. According to the returns filed to the questionnaires, as of September 30, 1933, 61 member partners of 43 firms acted primarily as floor traders, and 112 individual members acted primarily as floor traders. The New York Stock Exchange estimated the number of members acting primarily as floor brokers, as of August 25, 1933, at 289. According to the returns, as of September 30, 1933, 467 member partners of 341 firms acted primarily as floor brokers, and 146 individual members acted primarily as floor brokers. As of July 1, 1933, 230 member partners of 129 firms acted primarily as specialists, and 97 individual members acted primarily as specialists.[63]

(e) *Specialists.*—Specialists commonly act as sub-brokers executing orders for the account of other brokers in particular stocks, and also act as principals dealing in securities for their own account. Every stock listed on the New York Stock Exchange has a specialist; some stocks have more than one specialist; and some specialists have more than one stock. The exchange makes no assignment of specialists, and a member is free to become a specialist in any stock.[64]

Specialists are not restricted by the rules of the exchange as to the kind of orders they may execute. Hence, they fill market orders, limited orders, and stop orders. A market order to buy is an order to buy at the best price immediately obtainable; a market order to sell is an order to sell at the best price immediately obtainable. A limited order to buy is an order which fixes the maximum price at which the customer will buy; a limited order to sell is an order which fixes the minimum price at which the customer will sell. By a limited order the specialist is vested with authority to buy at a lower price than the maximum or to sell at a higher price than the minimum fixed by the customer. A buy stop order is an order to buy at the market after the stock has reached a minimum fixed price. A sell stop order, which is generally a protective order to limit loss, is an order to sell at the market after the stock has reached a maximum fixed price. As soon as there is a completed transaction at the price where an order is stopped, the stop order becomes a market order.[65]

Representatives of the exchanges have denied that a substantial percentage of the trades in any particular security clear through the

[63] Pt. 17, pp. 7862, 7874.
[64] Richard Whitney, Mar. 2, 1934, pt. 15, p. 6780.
[65] Raymond Sprague, Mar. 2, 1934, pt. 15, pp. 6782–6784.

specialist and have asserted that his activities are confined chiefly to carrying out limited orders.[66]

Senator BROOKHART. He gets a great many or most of the orders for both buying and selling from the brokers that are designating him as their specialist, does he not?

Mr. WHITNEY. What he gets, I believe, Senator, mostly are the buying and selling orders, the selling orders above the market and the buying orders below the market, what are called "limited orders." He usually has those given him for the day, for the week, for the month.[67]

Raymond Sprague, a specialist on the New York Stock Exchange, likewise testified that by far the greater percentage of the orders executed by specialists were limited orders and not market orders; and that on various dates selected by him at random, the volume of market orders placed with him was very slight.[68]

On the other hand, a study made by the Senate subcommittee of the day-by-day trading of specialists in 23 securities listed on the New York Stock Exchange during the month of July 1933 supports the conclusion that specialists were responsible for a very large percentage of the transactions in those securities, by virtue of transactions either for the account of others or for their own account. The following figures tabulate the total sales made on the New York Stock Exchange during the month of July 1933, in each of the 23 securities under examination, the number of shares bought and sold by specialists for the account of others, the number of shares bought and sold by specialists for their own account, the percentage of trades of specialists for their own account, and the percentage of all trades cleared through specialists:

Trading by specialists for own account and for account of others for month of July 1933 [1]

	Total sales on the New York Stock Exchange	Total bought and sold for account of others	Total bought and sold for own account	Percent of trades of specialists for own account	Percent of all trades cleared through specialists
Allied Chemical, common	212,400	130,400	91,200	21.5	52.2
American Can Co.	369,000	206,000	131,600	17.8	45.8
American Tobacco "A"	30,800	16,800	18,500	30.0	56.8
American Tobacco "B"	141,600	100,319	70,700	25.1	60.4
Auburn Automobile Co.	410,700	280,000	207,200	25.2	59.3
Celanese Corporation	739,000	557,100	274,300	18.6	56.3
Chrysler Corporation	1,395,800	674,400	415,500	14.9	39.0
E. I. du Pont de Nemours	813,300	406,000	189,000	11.7	42.2
General Electric	1,561,600	1,083,600	414,700	13.3	48.0
Goodyear Tire & Rubber Co.	441,800	257,900	258,500	29.3	58.4
General Motors	2,562,100	1,402,958	506,800	9.9	38.4
Industrial Rayon	194,200	130,300	91,400	23.5	57.1
International Nickel	1,509,000	783,500	246,700	8.2	34.1
Montgomery Ward	972,100	816,600	91,300	4.7	46.7
National Distillers	1,071,400	532,700	278,600	13.0	37.9
Owens-Illinois Glass	210,000	112,400	124,100	29.6	56.3
Radio Corporation, common	2,687,000	2,067,300	369,500	6.9	45.2
Standard Brands	3,397,000	834,000	223,400	3.3	15.6
Underwood-Elliott-Fisher	21,900	19,900			45.4
United Corporation, common	1,183,900	1,056,200	302,800	12.8	57.4
United States Industrial Alcohol	641,900	183,700	105,200	8.2	22.5
United States Steel, common	1,140,300	999,400	201,600	8.8	52.7
Western Union	443,200	268,000	208,900	23.6	53.8

[1] Pt. 17, p. 7954.

[66] Raymond Sprague, supra, p. 6784.
[67] Richard Whitney, Apr. 21, 1932, pt. 1, p. 255.
[68] Raymond Sprague, Mar. 2, 1934, pt. 15, pp. 6784–6785.

The figures show that in many instances more than 40 percent of the total volume of trading cleared through the specialists. On some days it was proven that the specialists accounted for practically all the trading in certain stocks. For example, on July 6, 1933, a total of 1,800 shares of American Tobacco "A" were traded in, of which the specialists bought and sold for their own account 1,500 shares; on July 7, 2,000 shares were traded in, of which the specialists bought and sold for their own account 1,800 shares; on July 21, 3,200 shares were traded in, of which the specialists bought and sold for their own account 2,400 shares.[69]

In the month of July 1933 one firm of specialists on the New York Stock Exchange bought 906,385 shares and sold 908,381 shares, or a total of 1,814,766 shares bought and sold, which represents approximately 1 percent of all the trading on the New York Stock Exchange during one of the most active trading months in its history.[70]

Specialists contend that their purpose in trading for their own account is to maintain a close market for the securities in which they specialize, in order to retain the good will of their broker customers and thereby increase their commissions. A glance at the profits earned by specialists, however, raises the question as to whether the profits derived from trading for their own account are not the primary concern of the specialists. The trading profits of one firm of specialists from January 1 to September 1, 1933, were $1,147,841, as compared with commissions of $298,810. In 1932 its trading profits were $535,420.29 and its net commissions $206,-637.08. In 1931 its trading profits were $528,611.60 and its net commissions $266,276.64. In 1930 (the only year in which commissions exceeded trading profits) its trading profits aggregated $481,-222.92, and its commissions $748,923.09. In 1929 it made a profit of $1,863,197.70 on its trading, and earned net commissions of $780,-593.72. From June to December 1928 its trading profits amounted to $690,795.20 and its net commissions to $410,315.55.[70] Eight of the specialist firms studied, for the period from January 1, 1928, to September 1, 1933, realized trading profits in the sum of $24,976,622, as compared with net commissions in the sum of $9,987,572.

When a specialist receives a limited order he records it in his "book." Since a substantial percentage of all the trading in a particular security clears through the specialist, it appears evident that the "book" reflects with a fair degree of accuracy the condition and tendency of the market and invests the specialist with superior knowledge. Despite the limited restrictions imposed upon his trading by the exchanges, the specialist trading for his own account has a tremendous advantage over the general public. This obvious fact has been denied by representatives of stock exchanges who have insisted on the one hand that the specialist's knowledge is no advantage to him in his own trading, and on the other that he does not use the information derived from his "book." When questioned on this point by counsel for the subcommittee, however, specialists have admitted that their knowledge of the "book" and the condition of the market is advantageous.

Mr. PECORA. It is an advantage to one trading in the market to know what the trend of the market is likely to be, is it not?

[69] Return filed by Adler Coleman & Co. to questionnaire.
[70] Charles C. Wright, Feb. 20, 1934, pt. 13, pp. 6109–6110.

Mr. WRIGHT. It certainly is.
Mr. PECORA. That is always an advantage, is it not?
Mr. WRIGHT. Yes.
Mr. PECORA. You always have that advantage from the knowledge you have as a specialist, do you not?
Mr. WRIGHT. If I always had that knowledge, I would not ever lose money; and I very frequently lose money.
Mr. PECORA. It might not be an advantage which conclusively would enable you to make money every time on a trade, but it is always an advantage, is it not, to have that knowledge?
Mr. WRIGHT. Yes, sir; if you have it.
Mr. PECORA. And the specialist has got it?
Mr. WRIGHT. At times.
Mr. PECORA. Has he not always got it?
Mr. WRIGHT. No, sir. Lots of times your books will be bare and you don't have bids and offers on the stock. What advantage is the book then?
Mr. PECORA. Then he probably would not trade; is not that so?
Mr. WRIGHT. Yes.[70]

The chief argument advanced in favor of permitting the specialist to trade for his own account is that such trading enables the specialist to maintain a close and orderly market. There is, however, no obligation upon him to do so.[71] In extremely active stocks, such as United States Steel and General Motors, where bids and offers are always present, the market is automatically made and the specialist does not make the market. Paul Adler, a specialist on the New York Stock Exchange, stated that the specialist's trading in an active stock neither hindered nor helped the situation.[72] In the inactive stocks, since the specialist is under no obligation to make a market, he is not likely to do so unless it appears probable that he can dispose of the security at a profit. This was graphically demonstrated by Harry H. Moore, a member of the New York Stock Exchange. Moore had received an order to buy 1,000 shares of an inactive stock at 80. The previous sale on the same day was at 73. The specialist's book recorded for sale 100 shares at 76, 100 at 79, and 100 at 80. Although Moore requested the specialist to trade in the security, the latter refused to do so, and 2 days were required to fill the order. The bulk of the stock was bought at 80. After the order was filled, the book bid was 70—$10 below the last purchase.

The CHAIRMAN. What service did the specialist render that was of any particular value there?
Mr. MOORE. None, Senator, in this case. I am saying that this is a case where I did not have the benefit of his services by his trading being injected.
Mr. PECORA. He did not trade simply as a matter of personal disposition?
Mr. MOORE. Correct. It was certainly harrowing to me as I reflected that each one point of increased cost to my customer was $1,000, and I verily believe that had I met a trading specialist I would have saved my customer at least $5,000. It was also distressing to realize that I must leave the book with a bid 10 points below my last purchase.[73]

The specialist's trading for his own account is motivated less by any altruistic desire to supply a market for his customer than by the prospect of making a profit on the trade, according to the record.
Mr. PECORA. But, Mr. Moore, it is your candid belief that if specialists were placed under the compulsion of supporting the market they would be so eager to trade for their own account in any and all circumstances?

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[70] Charles C. Wright, Feb. 20, 1934, pt. 13, pp. 6109–6110.
[71] Richard Whitney, Mar. 1, 1934, pt. 15, p. 6661.
[72] Paul Adler, Mar. 2, 1934, pt. 15, p. 6811.
[73] Harry H. Moore, Mar. 2, 1934, pt. 15, p. 6798.

Mr. MOORE. I am unable to say that. That is a voluntary matter, and I presume it would be decided by each individual according to his capital and his inclination.

Mr. PECORA. And according to his interests?

Mr. MOORE. And according to his interests.

Mr. PECORA. His self-interest?

Mr. MOORE. His self-interest. A specialist trades as a matter of profit.

Mr. PECORA. Exactly.

Mr. MOORE. There is no question about that. We claim that his trading is done as a matter of profit.[74]

The claim made by specialists, that in trading for their own account for the purpose of making a market they incur large risks, is grossly exaggerated. For example, Charles Wright, a specialist in American Commercial Alcohol, in attempting to demonstrate the benefit to the public from the specialist's trading in the stock, emphasized the risk he assumed in establishing the market.

The CHAIRMAN. You say the public were not buying or dealing in this stock at all in July?

Mr. WRIGHT. Yes; they were buying it and selling. They d—n near ruined me, I know. [Laughter.] That thing got to be a nightmare with me.

The CHAIRMAN. How did it affect you? Were you in the stock?

Mr. WRIGHT. No, sir; I was the specialist in that stock, and I was held responsible for every stop order, for the execution of every order in that stock. And I want to say that there was never any complaint filed with the New York Stock Exchange as to my handling of that particular stock. I was only the specialist who stood by and took all the stop orders during the terrific break in liquor stocks.

The CHAIRMAN. Well, as I understand, you did not have any money at stake. You were either making commissions or not making commissions.

Mr. WRIGHT. Well, one day it cost me between $45,000 and $50,000, and I wouldn't like to tell you what it cost me on other days in making the market and keeping it, and keeping on with it. I was the specialist, and the only man to come to for the market.

The CHAIRMAN. But you did not have anything at stake. You were simply the specialist in the stock, as I understand you.

Mr. WRIGHT. I was the specialist in the stock, and it was also my privilege to trade in the stock.

The CHAIRMAN. Then you lost money trading in the stock and not as a specialist but as a trader. A specialist, as I understand, executes orders for other people, while a trader executes his own orders.

Mr. WRIGHT. Well, Senator Fletcher, there were times in that stock when there wasn't even a single bid for it, when the break came, at a time, as I remember distinctly, that I bought 11,000 shares of the stock at a price some 11 points down from the last sale in an effort to make a market in that stock. And then it broke 30 points more. Yes; it was a nightmare to me. And in these fluctuations in stocks the specialist suffers a nightmare, because he is the one held responsible for the execution of every stop order and has charge of every order brought in to the post.[75]

It ultimately appeared that during May, June, and July 1933, the period of most active trading in American Commercial Alcohol, Wright realized a profit of $138,000 on his trading in the stock.

Mr. PECORA. Did you trade actively for your own account or for your firm's account in American Commercial Alcohol during the months of May, June, and July of last year?

Mr. WRIGHT. Yes, sir.

Mr. PECORA. And at the end of July did your trades show a net profit or a loss for the 3 months' period from May to July?

Mr. WRIGHT. A profit.

Mr. PECORA. It showed a profit, do you say?

Mr. WRIGHT. Yes sir. It showed a profit of $138,000.

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[74] Harry H. Moore, supra, p. 6800.

[75] Charles C. Wright, Feb. 20, 1934, pt. 13, pp. 6088-6089.

Mr. PECORA. So that when the nightmare was over it was not so bad after all?

Mr. WRIGHT. Yes, sir; it was very bad.

Mr. PECORA. Well, how much would you have to make in order to avoid a nightmare? [Laughter.]

The CHAIRMAN. Mr. Wright, you spoke about your losses a while ago. It seems that the ultimate result was fairly good for you, wasn't it?

Mr. WRIGHT. It was fairly good, but I had some very severe days.

Senator ADAMS. Well, if we might speak of a fellow who was murdered, you were a pretty live corpse.

Mr. WRIGHT. Well, that is my business.

Mr. PECORA. And it is fair to say that you know your business.[76]

The trading of the specialist in American Commercial Alcohol for his own account during the months of May, June, and July 1933 consisted of 247,700 shares bought and 247,300 shares sold. The total trading in the stock on the New York Stock Exchange between May 15 and July 22, 1933, was 1,145,100 shares. Hence, the specialist handled for his own account more than one-fifth of all shares bought and sold. There were 200,000 shares of American Commercial Alcohol outstanding prior to June 1933, when the outstanding stock was increased to 265,000 shares. During the months of May, June, and July 1933, therefore, the specialist bought and sold an amount substantially equivalent to the entire outstanding capital stock of the corporation.[77]

It is in the semiactive stocks that the specialist claims to perform an important service—that of narrowing the quotations so that there may be a closer and more liquid market. Examples of the specialist's discharge of this function were placed upon the record.[78] It was conceded, however, that this type of trading was not unprofitable, one specialist stating that his firm made money 3 out of 5 days on trading for its own account.[79]

Another consideration must be noted in connection with the specialist's claim that by virtue of his trading in semiactive stocks, a narrower market is created. The seller in a particular transaction receives a little more and the buyer pays a little less than might be the case if the specialist did not trade. On the other hand, excessive trading by the specialist creates the impression of an active market, which induces and encourages outsiders to trade, and this extra impetus accelerates the rise or decline in the price of the stock. Whereas, by virtue of the specialist's trading, the customer may save a fraction of a point on the particular trade, the general price level of the security may have been substantially lifted as a result of the specialist's trading and the customer may pay considerably more than if there had been no such trading.

The organized exchanges have to some degree attempted to eliminate the conflict of duty and interest on the part of the specialist by regulations imposed upon his trading for his own account. Yet the opportunity and temptation to follow the dictates of self-interest rather than duty are ever present, and the vigilance of exchanges has not been sufficient to prevent many infractions by specialists. The record shows how frequently specialists have violated their duty.[80]

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[76] Charles C. Wright, supra, p. 6100.
[77] Charles C. Wright, supra, pp. 6101–6102.
[78] Paul Adler, Mar. 2, 1934, pt. 15, pp. 6811–6812.
[79] Paul Adler, supra, p. 6817.
[80] Pt. 15, pp. 7345–7354.

(*f*) *Floor traders.*—The floor trader plays no part in the mechanics of executing orders for customers. He trades exclusively for his own account, executing his own orders and thereby avoiding payment of commissions. His activities are not restricted to a fixed post, nor to a limited number of securities. By virtue of his access to the floor of the exchange, the floor trader has the advantage of instant information concerning the technical position of the market.[81] His policy is to follow the trend whether up or down, and his trading greatly accelerates the trend and accentuates market fluctuations. The contention that the floor trader assists in the maintenance of a narrow and liquid market is deprived of much of its force by his adherence to this policy. All the arguments against excessive trading by the specialist for his own account are applicable with increased force to trading by the floor trader.

(*g*) *Odd-lot dealers.*—Transactions upon organized exchanges are effected either in round lots or odd lots. A " round " lot is the unit of trading on the floor of the exchange; an " odd " lot is any number of shares less than the unit of trading on the floor. To fill orders involving odd lots, the odd-lot dealer purchases round lots for his own account. The odd-lot dealer is not a broker charging a commission but a dealer whose compensation is the difference between the price at which he sells and the price at which he purchases. He deals not with the public but with the commission broker. The unit employed for regular trading on the New York Stock Exchange is 100 shares in the active stocks. The unit is different in the inactive stocks and also varies on other exchanges.

On all exchanges there are 2,626 members handling odd-lot transactions. On the New York Stock Exchange, as heretofore stated, 6 firms are engaged in odd-lot business, 3 exclusively and 3 partially. On the New York Curb Exchange, 236 members handle odd-lot transactions. On 17 other exchanges all members handle odd-lot transactions.[82]

(*h*) *Effect of the Securities Exchange Act of 1934 upon trading and functions of members, brokers, and dealers.*—By the Securities Exchange Act of 1934, the problem of the segregation and limitation of the functions of members, brokers, and dealers is placed under the control of the Securities and Exchange Commission. The Commission is empowered to regulate or prevent floor trading by members, directly or indirectly, for their own account or for discretionary accounts, and to prevent such excessive trading on the exchange, but off the floor, by members, directly or indirectly, for their own account, as the Commission may deem detrimental to the maintenance of a fair and orderly market.[83]

National securities exchanges are authorized to adopt rules not in contravention of the regulations of the Commission, to permit the registration of members as odd-lot dealers or specialists, or both. Registered odd-lot dealers may buy and sell for their own account so far as may be reasonably necessary to fulfill their particular func-

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[81] Petition on behalf of the floor traders of the New York Stock Exchange, pt. 16, p. 7750.
[82] Pt. 17, p. 7852.
[83] Securities Exchange Act of 1934, sec. 11 (a).

tion. Specialists, when permitted to act as dealers, are limited to such transactions for their own account as may be reasonably necessary to permit them to maintain a fair and orderly market. Specialists are forbidden to reveal information in respect to orders placed with them to favored persons, unless such information is available to all members of the exchange. They are likewise prohibited from executing purely discretionary orders, as distinct from market or limited price orders.[84]

The act forbids any person who is both a broker and a dealer to use an exchange, the mails, or the instrumentalities of interstate commerce, to effect any transaction involving the sale on margin of a security in the distribution of which he has participated during the preceding 6 months. This provision is directed at the temptation on the part of a broker-dealer who is assisting in the distribution of a new issue, to induce customers to invest in it by the offer of credit. In cases which do not fall under this prohibition the broker-dealer is required to disclose in writing to his customer whether he is acting as a dealer for his own account, as a broker for such customer, or as a broker for some other person, the object of this provision being to enlighten the customer regarding factors which are likely to color the broker's advice.[85]

The Commission is further directed to make a study of the feasibility and advisability of the complete segregation of the functions of dealer and broker, and to report the results of its study and its recommendations to the Congress on or before January 3, 1936.[86]

7. Manipulative Devices

The true function of an exchange is to maintain an open market for securities, where supply and demand may freely meet at prices uninfluenced by manipulation and control. In the past this function has been fulfilled most imperfectly. The exposure of the extent and effect of manipulative practices upon organized exchanges was one of the most salutary and important accomplishments of the investigation. Stock exchange representatives have consistently minimized the extent of manipulative activities upon exchanges and, provided there were no technical wash sales or matched orders, they have not regarded manipulative devices in general use as pernicious or violative of the principles of fair, free, and open trading. The tendency has been to belittle reports of manipulative activities as unfounded rumors, unworthy of serious attention. The evidence adduced before the subcommittee has thoroughly discredited this attitude.

(*a*) *Pools*—(1) *The nature and extent of pool operations.*—Pool operations did not conflict with the rules of the exchanges or violate the standard of ethics established for trading on exchanges.

Senator Brookhart. Are pools against the rules of the exchange?
Mr. Whitney. No, sir.
Mr. Pecora. You say pools are not against the rules of the exchange?
Mr. Whitney. They are not, Mr. Pecora.[87]

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[84] Securities Exchange Act of 1934, sec. 11 (b).
[85] Securities Exchange Act of 1934, sec. 11 (d).
[86] Securities Exchange Act of 1934, sec. 11 (e).
[87] Richard Whitney, Mar. 1, 1933, National City, pt. 6, p. 2219.

A pool, according to stock exchange officials, is an agreement between several people, usually more than three, to actively trade in a single security.[88] The investigation has shown that the purpose of a pool generally is to raise the price of a security by concerted activity on the part of the pool members, and thereby to enable them to unload their holdings at a profit upon the public attracted by the activity or by information disseminated about the stock. Pool operations for such a purpose are incompatible with the maintenance of a free and uncontrolled market.

Mr. PECORA. That is the point I am trying to make. The general purpose of pools is to distribute securities at a profit to the members; is that not so?

Mr. WHITNEY. Yes, sir.

Mr. PECORA. And in order to distribute at a profit they have to sell at a higher price than that at which they purchased?

Mr. WHITNEY. Yes, sir.

Mr. PECORA. Pool operations then are often maintained in a fashion calculated to bring higher prices for the stock accumulated? Is that correct?

Mr. WHITNEY. May that be repeated?

(Mr. Pecora's last question was thereupon read as above recorded.)

Mr. WHITNEY. I do not understand, Mr. Pecora, what you have in mind by the use of the word "maintained."

Mr. PECORA. Would you be good enough to read that question to the witness?

(The question by Mr. Pecora was again read by the shorthand reporter, as above recorded.)

Mr. PECORA. Well, "maintained" there is used as a verb synonymous, we will say, with "conducted."

Mr. WHITNEY. I think that is a fair statement; yes.

Mr. PECORA. And it then becomes the definite object and purpose of the members of the pool to conduct such market operations in the stock as will enable them to dispose of it at a profit? Does it not?

Mr. WHITNEY. If it can be disposed of at a profit.

Mr. PECORA. If it can be disposed of. And it is natural to assume, is it not, that the pool members will do whatever is calculated to bring such a result about?

Mr. WHITNEY. If in connection with members of the New York Stock Exchange so that they do not transgress our rules.

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Mr. PECORA. It is the desire of the authorities of the exchange to maintain a free and open market?

Mr. WHITNEY. Yes, sir.

Mr. PECORA. Through the medium of the exchange for the purchase and sale of securities?

Mr. WHITNEY. Yes, sir.

Mr. PECORA. And by a free and open market you do not mean a controlled market, do you?

Mr. WHITNEY. What is a controlled market?

Mr. PECORA. Well, Mr. Whitney, I am trying to use words that are simple in their meaning, but if I am using words that you do not understand I will try to change them.

Mr. WHITNEY. I understand the word "controlled" completely, Mr. Pecora. But the mere fact that a pool may buy large quantities of a stock, if they do not buy them from themselves there is no nefarious transaction, and that, as I see it, is not controlled.

Mr. PECORA. You know what is meant by a controlled market, do you not?

Mr. WHITNEY. I do—what you mean I think I know, but I do not know specifically of controlled markets. If you will give me an example of what you have in mind I will try to answer it.

Mr. PECORA. Well, where the bids and offerings virtually come from the same party or group or groups.

[88] Roland L. Redmond, Oct. 20, 1933, Chase Securities Corp., pt. 5, p. 2492.

Mr. WHITNEY. But there is nothing to prevent other persons interested in that stock from selling large quantities of that stock or from buying it.

Mr. PECORA. But it is possible under the operation of the exchange for a group so to operate in the market as to more or less control prices for the time being?

Mr. WHITNEY. If their stock and if their money holds out; yes.

Mr. PECORA. And it is that sort of thing which the exchange does not like to have done, is it not?

Mr. WHITNEY. If there are no improper transactions connected with such an operation my answer is that the exchange does not object. The exchange has no objection to a man or a pool bidding 40 for 5,000 shares and offering 5,000 shares at 40⅛. None whatsoever.

Mr. PECORA. Is it easily possible for a group operating through the medium of a pool to exercise temporarily, at least, or for the purpose of the operation, a control of the market price?

Mr. WHITNEY. I will answer yes, sir; on the conditions——

Mr. PECORA. The market price of a given security?

Mr. WHITNEY. As long as the stock and their money holds out; yes.

Mr. PECORA. Yes; and to that extent those persons are enabled to exercise a control, are they not?

Mr. WHITNEY. By bidding and offering; yes.

Mr. PECORA. By bidding and offering. Now, what steps, if any, does the exchange take to prevent that kind of control?

Mr. WHITNEY. I do not know of any, Mr. Pecora.[89]

This testimony typified the conception of stock-exchange authorities as to what constitutes free and uncontrolled trading. The testimony before the Senate subcommittee again and again demonstrated that the activity fomented by a pool creates a false and deceptive appearance of genuine demand for the security on the part of the purchasing public and attracts persons relying upon this misleading appearance to make purchases. By this means the pool is enabled to unload its holdings upon an unsuspecting public.

Attempts have been made to differentiate between "beneficent" pools and "nefarious" pools. It is claimed that pools operated for the purpose of stabilizing market prices during periods of secondary distribution, or while liquidating blocks of stock held by estates or creditors are "beneficent" pools; whereas pools operated merely for the purpose of raising the price of securities so that the participants might unload their holdings at increased prices have been characterized as "nefarious" pools. From the viewpoint of the purchaser outside the pool circle, there is no substantial or ethical difference in these two types of pools. Although the purpose may be different, the means employed are identical. In all cases fictitious activity is intentionally created, and the purchaser is deceived by an appearance of genuine demand for the security. Motive furnishes no justification for the employment of manipulative devices.

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The number of pools in which members of the exchanges participated and of which they were managers indicates how popular this device has been with stock-market firms and operators. During the year 1929, 105 stock issues listed on the New York Stock Exchange were subject to one or more syndicate, pool, and/or joint accounts which member firms or partners thereof managed, and in the profits

[89] Richard Whitney, Mar. 1, 1933, National City, pt. 6, pp. 2222–2224.

or losses of which they participated.[90] In addition, two issues were subject to one or more syndicate, pool, and/or joint accounts which individual members of the exchange managed and in the profits or losses of which they participated.[91]

In 1930, 31 stock issues listed on the New York Stock Exchange were subject to one or more syndicate, pool, and/or joint accounts which member firms or partners thereof managed and in the profits or losses of which they had an interest.[92] There were also four issues subject to one or more syndicate, pool, and/or joint accounts which individual members of the exchange managed and in the profits or losses of which they had an interest.[93]

In 1931, six issues listed on the New York Stock Exchange were subject to one or more syndicate, pool, and/or joint accounts in which the member firms or partners thereof shared profits or losses and which they managed.[94]

In 1932, two issues listed on the New York Stock Exchange were subject to one or more syndicate, pool, and/or joint accounts in which the member firms or partners thereof had an interest and which they managed.[95]

In 1933, 13 issues listed on the New York Stock Exchange were subject to one or more syndicate, pool, and/or joint accounts in which the member firms or partners thereof had an interest and

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[90] Alleghany Corporation; Alleghany Corporation preferred; American Commercial Alcohol; American Ice; American Sugar Refining Co.; American Tobacco; Archer Daniels Midland Corporation; Aviation Corporation; Beatrice Creamery; Bendix Aviation; Bethlehem Steel; Borden Co.; Bullard Co.; Bush Terminal; Campbell Wyant Foundry Co.; Celotex Co.; Chicago, Milwaukee & St. Paul R.R. preferred; Cerro de Pasco; Childs & Co.; Chrysler Co.; Clark Equipment Co.; Cluett Peabody Co.; Columbian Carbon Co.; Commonwealth & Southern Congress Cigar Co.; Consolidated Cigar; Consolidated Gas Co.; Continental Can Co.; Continental Motors Co.; Cream of Wheat Corporation; Crosley Radio; Curtis Aeorplane Co.; Curtiss-Wright Co.; Eastern Rolling Mills; Eitington Schild, Firestone Tire common; General American Tank Car Co.; General Cable; General Cigar Co.; General Refractories; Gimbel Bros.; Gold Dust; Goodrich & Co.; Gotham Silk Hose; Grand Union Co.; Columbia Graphophone Co.; Indian Refining Co.; International Match preferred; International Telephone & Telegraph Co.; Kreuger & Toll; Kroger Grocery; Lehn & Fink Poducts; R. H. Macy & Co.; May Department Stores; Marmon Motor Co.; McGraw-Hill; McKesson & Robbins; Mengel Co.; Mexican Seaboard Oil; Miami Copper; Michigan Steel Corporation; Mid-Continental Petroleum Co.; Minneapolis Moline common; Minneapolis Moline preferred; Missouri, Kansas. Texas R.R. common; Monsanto Chemical; Montgomery Ward & Co.; Munsingwear, Murray Corporation of America; National Cash Register Co.; National Dairy Co.; North German Lloyd; Oppenheim-Collins Co.; Packard Motor Co.; Phelps Dodge Co.; Pillsbury Flour Mills; Pittsburgh & W.Va. R. R.; Purity Bakeries; Radio Corporation; Radio Corporation "A"; R. J. Reynolds Tobacco Co.; Safeway Stores, Inc.; Servel, Inc.; Sharon Steel Hoop; Simms Petroleum; Southern Puerto Rico Sugar; A. G. Spalding & Bros.; Spang Chalfante Co.; Standard Gas & Electric Co. preferred; Standard Oil of California; St. Louis-San Francisco R.R. Co.; Studebaker; Teloutograph, Underwood-Elliott-Fisher Co.; Union Carbon & Carbide Co.; United Carbon; U.S. & Foreign Securities; U.S. Rubber Co.; U.S. Smelting & Refining Co.; Utility Power & Light "A"; Walworth Co.; Weber & Heilbroner. Westvaco Chlorine Co.; L. A. Young Spring & Wire Corporation; Zenith Radio (pt. 17, p. 7049).

[91] American Telegraph & Telephone Co., Shell Union Oil (pt. 17, p. 7953).

[92] American Smelting & Refining Co., 6 percent preferred, Blaw-Knox Co., Canada Dry, Chrysler Corporation, common, Coca-Cola, Columbia Carbon, Consolidated Film Industries, Coty & Co., Davison Chemical Co., General Gas & Electric "A", General Refractories, W. F. Hall Printing Co., Kreuger & Toll, Lane Bryant, Inc., P. Lorillard Co. common, Monsanto Chemical Works, National Supply Co., National Supply Co. preferred, New York Investors, Park & Tilford Co., Petroleum Corporation of America, Phillips Petrol Co. common, Radio Corporation "A", Seaboard Airline Co., Sears Roebuck, F. G. Shattuck Co., Spang-Chalfante Co., U.S. Industrial Alcohol, Warner Bros. Pictures, Warren Foundry & Pipe Corporation, Wilys-Overland common (pt. 17, p. 7950).

[93] Budd Wheel, Canada Dry, General American Investment Trust, General Theaters Equipment, Inc. (pt. 17, p. 7953).

[94] Canada Dry, Colgate-Palmolive Peet, Hershey Chocolate Co., North American Aviation, Petroleum Corporation of America, Sharp & Dohme (pt. 17, p. 7950).

[95] Coca-Cola Co., S. S. Kresge Co. (pt. 17, p. 7950).

which they managed.[96] In the same year, 10 issues listed on the exchange were subject to one or more syndicate, pool, and/or joint accounts in which the individual members had an interest and which they managed.[97]

On the New York Curb Exchange during the year 1929, 27 issues of stock were subject to one or more syndicate, pool, and/or joint accounts which member firms of the New York Stock Exchange, or partners thereof, who were also either associate or regular members of the New York Curb Exchange, managed, or acted for the managers, and in the profits or losses of which they participated.[98] During the year 1930 there were three such issues,[99] and during the year 1933 there was 1.[1]

In 1929, 22 issues of stock listed on the New York Curb Exchange were subject to one or more joint, syndicate, and/or pool accounts which were managed by member firms of the New York Curb Exchange, or partners thereof, and in the profits or losses of which they participated.[2] In 1930 there were 2 such issues;[3] in 1931 there was 1;[4] and in 1933, 3.[5]

In 1929, 22 issues of stock listed on the New York Curb Exchange were subject to one or more joint, syndicate, and/or pool accounts which were managed by associate members of the exchange, or partners thereof, and in the profits or losses of which they participated[6] In 1930 there were 3 such issues;[7] in 1931 there were 3;[8] and in 1933 there were 3.[9]

In addition, for the period from January 1, 1928, to August 31, 1933, 14 issues of stock listed on the New York Curb Exchange were

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[96] Addressograph Multigraph, Archer Daniels Midland Co., Armour & Co., Barnsdall Corporation, Crown Cork & Seal Co., Detroit Edison Co., Federal Motor Truck, F. Goodrich & Co., Goodyear Tire & Rubber Co., Hayes Body Co., International Paper & Power "B" common, International Paper & Power preferred, Zonite Corporation. (Pt. 17, p. 7950).

[97] American Metal Co., Ltd., common, American Metal Co., Ltd., preferred, Atlas Tack, Eitington Schild Co., Inc., common, Eitington Schild Co., Inc., preferred, General Foods Corporation, Lehman Corporation, Lambert Pharmaceutical, Paramount-Publix Corporation certificates, Phillips Petroleum Co. (pt. 17, p. 7953).

[98] Associated Rayon preferred, Bellanca Aircraft Corporation common, Blue Ridge Corporation preferred, Caterpillar Tractor, Cohn Rosenberger common, Curtis Airport Co., Douglass Aircraft Co., Eisler Electric Corporation, Federal Screw Works common, Globe Underwriters, Goldman Sachs, Jones & Mamburg, Langdorf United Groceries, New York Investors, North American Aviation, Petoleum Corporation of America, Sharp & Dohme, Shenandoah Corporation 6 percent preferred, Southland Royalty Co., Starrett Corporation, Thermoid Corporation, United Light & Power Corporation preferred, U. S. Electric Power Corporation, U. S. Electric preferred, U. S. & International Securities Corporation preferred, Willow Cafeteria common, Willow Cafeteria preferred (pt. 17, p. 7966).

[99] Peoples Drug Stores, Standard Oil Export Co., U.S. Dairy Products (pt. 17, p. 7966).

[1] Molybedenum Corporation (pt. 17, p. 7966).

[2] Aeronautical Industries, Automatic Registering Machine Co., Inc., American Cyanamid Corporation preferred, American Cyanamid Corporation, Blaw-Knox common, Blue Ridge Corporation common, Consolidated Copper, Darby Petroleum Corporation, General Capitol Corporation, General Realty & Utilities, Graymur Corporation, Grocery Stores Products, Hercules Motor Corporation, Irving Air Chute, Inc., Lazarous Co., G. C. Murphy Co., National Aviation Corporation, Prudential Investors, Inc., Shenandoah Corporation, Sikorsky Aviation Corporation, A. Stein & Co., United Gas Improvement (pt. 17, p. 7966).

[3] Cosden Oil, Grocery Store Products (pt. 17, p. 7967).

[4] Community Water Seervice Co. (pt. 17, p. 7967).

[5] Croft Brewing Co., Distillers & Brewers, National Bellas Hess, Inc. (pt. 17, p. 7967).

[6] Automatic Registering Machine Co., Inc., Canco Syndicate, Claude Neon Lights, Inc., Consolidated Gas & Electric Light & Power Co. of Baltimore, Federal Aviation Stocks, F. T. Loy, Inc., Hartman Tobacco Co. common, International Hydro-Electric Co., Louisiana Land & Apparatus Co., Missian Oil Syndicate, National Bond & Share, Ohio Industries Stock, Ohio River Sand Co., Pacific Western Oil Corporation, Pender Grocery Co., Pennroad Corporation common, Penn Water & Power common, Phelps Dodge common, Prince & Whitely Trading Co., Reliance International Corporation, St. Louis Aviation Corporation, Utilities Securities Corporation (pt. 17, p. 7967).

[7] National Screen Service, Reynolds Bros., Inc., Securities Investment Co. (pt. 17, p. 7967).

[8] Commonwealth & Southern Warrants, Leaders of Industry Shares, Public Service E. & G. $5 preferred (pt. 17, p. 7967).

[9] Aero Supply Canufacturing Co., Elizabeth Brewing Co., Mavis Bottling Co. (pt. 17, p. 7967).

subject to one or more syndicate, pool, and/or joint accounts in which individual members of the New York Curb Exchange participated and which they managed.[10]

From January 1, 1929, to November 1, 1933, 19 issues of stock listed on the other organized exchanges throughout the country were subject to one or more syndicate, pool, or joint accounts which were managed by individual members of such exchanges and in the profits or losses of which they participated.[11]

From January 1, 1929, to August 31, 1933, inclusive, 175 member firms of the New York Stock Exchange participated in the profits or losses of syndicate, pool, or joint accounts in issues listed on the New York Stock Exchange; 36 member partners and 68 nonmember partners similarly participated. The number of firms on whose books syndicate, pool, or joint accounts were maintained in which the firms or partners thereof had no proprietary interest, during the same period was 62. The number of individual members of the New York Stock Exchange who participated in the profits or losses of syndicate, pool, or joint accounts in issues listed on that exchange during the same period was 20.[12]

On the New York Curb Exchange, 85 member firms participated in the profits or losses of syndicate, pool, or joint accounts in issues listed on that exchange during the period from January 1, 1929, to August 31, 1933, and 12 member partners participated in such syndicate, pool, or joint accounts. The number of firms on whose books syndicate, pool, or joint accounts were maintained in which the firms or partners thereof had no proprietary interest during this period was 7. The number of individual members of the New York Curb Exchange who participated in the profits or losses of syndicate, pool, or joint accounts in issues listed on that exchange was 39, and 3 individual members maintained pool accounts on their books in which they had no proprietary interest.[13]

On all other exchanges, 37 firms and 3 firm partners participated in the profits or losses of syndicate, pool, or joint accounts in issues listed on their respective exchanges. On the books of 3 firms, syndicate, pool, or joint accounts were maintained in which the firms or partners thereof had no proprietary interest. Individual members participating in the profits and/or losses of such accounts for the period numbered 5.[14]

It should be noted that the figures given above do not include all the listed securities which were subject to pool manipulations during the period mentioned, but include only those issues subject to pools where individual members, member firms, or partners thereof, participated in the profits or losses and were the managers.

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[10] Acoustics Products common, Acoustic Products preferred, American Cyanamid "B", Auto Register Machine Co., Consolidated Gas & Electric Light & Power Co. of Baltimore, Cosden Oil Co., Eastern Utilities Investment Corporation "A", Eisler Electric Corporation, Fox Theaters Corporation "A", Goldman-Sachs Trading Corporation, Investors Equity Co., Inc., Pantepec Oil Co., Tidal Osage Oil Co., Wetark Radio Stores (pt. 17, p. 7971.)

[11] Tintic Corporation, Big Jim Mining Corporation, Middle West Securities, Borg Warner, Caterpillar Tractor, Commercial Solvents, Freeport Texas, General American Tank, Graham Paige, International Shoe, Lambert, Prairie Oil & Gas, Reynolds Tobacco "B", Sims Petroleum, Sinclair Consolidated, Trans-American Corporation, Warren Pipe & Foundry, Great Northern Ore, Prairie Pipe Line (pt. 17, p. 7910).

[12] Pt. 17, pp. 7863, 7874.

[13] Pt. 17, pp. 7880, 7884.

[14] Pt. 17, pp. 7800, 7915.

Participation in a pool or its management by a broker is more than likely to entail a violation of that elementary fiduciary relation which he bears to his customers. By virtue of his connection with the pool, he has a personal pecuniary interest in the account and also incurs an obligation to his coparticipants to operate and manage the pool in a manner consonant with their best interests. Both his personal interest and his obligation to the other participants inevitably clash with the duty of unswerving loyalty and ungrudging disclosure which he owes to his customers. However honest his intentions, an interest in a pool prompts him to encourage his customers to purchase the securities which are the subject of the pool operations. It is difficult to perceive how he could act disinterestedly on behalf of a customer if such action would be inimical to the welfare of the pool. The conclusion is inescapable that members of the organized exchanges who had a participation in or managed pools, while simultaneously acting as brokers for the general public, were representing irreconcilable interests and attempting to discharge conflicting functions. Yet the stock exchange authorities could perceive nothing unethical in this situation.

(2) *The modus operandi of a pool.*—In connection with an ordinary pool operation, certain factors are usually considered advantageous to the pool operators: (i) A propitious time; (ii) the acquisition by the participants of a block of stock or an option to purchase a block; (iii) stimulation of activity in the stock by purchases and sales for the account of the pool; and (iv) the dissemination of information of a favorable character to encourage the purchase of the security by the general public.

(i) The propitious time to commence operations is when public attention has been attracted either by the condition of the corporation issuing the stock or the industry of which it is a part, or by external factual conditions, such as the possibility of legislation affecting the industry.

By way of illustration, such factors as the real or apparent prospect of a merger, a stock split up, a favorable earning statement, a resumption of or increase in dividends, an encouraging trade report, and the like, are useful in determining whether the time is ripe for a pool. In the case of the so-called "repeal" stocks, during the months of May, June, and July, 1933, the possibility of the repeal of the eighteenth amendment to the Constitution rendered the time propitious for the operation of pools in those stocks. A pool in Libbey-Owens-Ford Glass Co., which operated in June 1933, was materially aided by a popular delusion that the company was engaged in manufacturing glass bottles and was therefore classified as a repeal stock, whereas in fact it made no bottles and its business was in no way enhanced by the repeal of prohibition.

Mr. PECORA. Now, Mr. Day, let me ask you this: This stock, the Libbey-Owens-Ford Glass Co. stock, was commonly known as one of the "repeal stocks", was it not?

Mr. DAY. By the average person who never took the trouble to look up what its business was.

Mr. PECORA. That is just what I am coming to. It was commonly known as a "repeal stock", in the belief by those who regarded it as a repeal stock that the company did a kind of business that it was assumed would be made considerably more profitable through the repeal of the eighteenth amendment. Is not that so?

Mr. DAY. It is a rather hard question to answer the layman's mind. Of course, the Libbey-Owens-Ford Glass Co., as I understand it—I have tried to study it—does not make a bottle of any kind.

Mr. PECORA. And to that extent the public had a wrong impression concerning this stock being properly a repeal stock, in the sense in which that term was used. Don't you know that to be a fact?

Mr. DAY. I have heard it said a number of times that that was the fact.

Mr. PECORA. The public apparently got the notion, from the title of the company, namely, Libbey-Owens-Ford Glass Co., that it manufactured, among other things, glass bottles, and proceeded on the assumption that the business of the company would be considerably enhanced and made more profitable through the repeal of the eighteenth amendment. Was that the common notion entertained by the lay public?

Mr. DAY. I thought, from the number of people that have spoken about it, that it, having the name "Owens" in it, the average person on the street, knowing that the Owens-Illinois——

Mr. PECORA. The Owens-Illinois Glass Co.?

Mr. DAY. The Owens-Illinois Glass Co. being a big manufacturer——

Mr. PECORA. It is a big manufacturer of bottles.

Mr. DAY. And wonderfully administered, with profits rising all the time—that it was fair to assume that the layman in the street confused the two.

Mr. PECORA. And got the impression that the Libbey-Owens-Ford Glass Co. was also engaged in the business of manufacturing bottles, which business would be considerably enhanced and improved through the repeal of the eighteenth amendment?

Mr. DAY. I think that is true.

Mr. PECORA. Whereas the fact of the matter is that it was not that kind of a company; that is, it was not engaged in the kind of a business that would necessarily be enhanced or improved through the repeal of the eighteenth amendment.

Mr. DAY. That is absolutely true.[15]

(ii) A supply, or source of supply, of the security which is the subject of the pool manipulation is necessary to its successful consummation. It would be futile for pool participants to create activity in a security and bring about an increase in price unless they had previously assured themselves of a supply of the stock at a lower price. The pool sometimes depresses the price of the stock in advance through short selling or the dissemination of unfavorable rumors, and then accumulates substantial blocks at the reduced price. The more usual proceeding, however, is for a member of the pool to take an option at a fixed or graduated price on substantial blocks of the stock. Such an option may be procured from the corporation itself or from a director, officer, or large stockholder of the company who may also be a participant in the pool. The extent to which the option is exercised depends upon the appetite of the public for the stock.[16]

(iii) After the source of supply is established, various methods are employed to create activity in the stock. Different brokers are authorized by the pool to execute orders for the purchase and sale of the stock in order to create the false impression that the general public is trading in it. "Puts" and "calls"[17] are frequently granted to individuals to induce them to buy or sell the security. Formerly this activity did not violate the rules of organized exchanges, provided the buy and sell orders did not technically meet or constitute "wash" sales. Any amount of buying and selling by a pool group, or the members thereof, at substantially the same time,

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[15] Henry Mason Day, Feb. 21, 1934, pt. 14, pp. 6242–6243.

[16] A discussion of the use of options will be found in the subsection entitled "Options."

[17] A "put" is the privilege of delivering or not delivering the securities sold. A "call" is the privilege of calling or not calling for the securities sold.

in substantially the same volume, at substantially the same prices, was regarded as fair practice by the exchanges, provided there was a change of beneficial ownership in each transaction.[18]

A specialist on the New York Stock Exchange admitted that the essential mode of operation in a pool was to stimulate activity in the security by purchases and sales for the account of the pool group.

Mr. PECORA. How does such a pool actually operate in the market? How does it make a market?
Mr. WRIGHT. By creating activity.
Mr. PECORA. And how does it do that?
Mr. WRIGHT. By trading in the stock.
Mr. PECORA. That is, the pool buys and sells the stock.
Mr. WRIGHT. Yes, sir.
Mr. PECORA. For its own account?
Mr. WRIGHT. Yes, sir.
Mr. PECORA. And frequently, if not invariably, such a pool has an option covering the stock in which it trades.
Mr. WRIGHT. That is right.
Mr. PECORA. And it gets that option as a rule from what kind of persons?
Mr. WRIGHT. Sometimes from individuals, and sometimes from officers of the company, and sometimes from large stockholders, and sometimes from the corporation which might hold a good block of stock and which wanted to get rid of it.
Mr. PECORA. And as a rule what is the object sought to be accomplished by those persons who organize a pool account in order to make a market in the stock?

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Mr. WRIGHT. To redistribute the stock at a higher price if possible.
Mr. PECORA. That is, to raise the price level of the stock as much as possible.
Mr. WRIGHT. Yes, sir.
Mr. PECORA. So that they may distribute whatever accumulation of stock they have at a higher price and at a profit.
Mr. WRIGHT. But it does not often work out at a profit.
The CHAIRMAN. In short, you are trying to make money? That is the idea, isn't it?
Mr. WRIGHT. Trying to make money; yes.[19]

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Mr. PECORA. So that where a pool operates under an option, the fact that it has such an option is a sure indication that the purpose of the pool, or at least one of the purposes of the pool, is to distribute the stock covered by the option at higher prices.
Mr. WRIGHT. That is right.
Mr. PECORA. And in order to do that they operate, of course, through brokers who are members of exchanges where the stock is listed.
Mr. WRIGHT. Yes, sir.
Mr. PECORA. And frequently members of exchanges who execute orders for such pools are participants in the pool themselves.
Mr. WRIGHT. Yes, sir.
Mr. PECORA. And that has been your experience, hasn't it?
Mr. WRIGHT. Yes, sir.[20]

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Mr. PECORA. Now, Mr. Wright by such processes or activities on behalf of pool accounts, especially where trading for such pool accounts is done by brokers who are also members of the pool or participants in it, isn't it a fact that the public get a false notion of the activity in the stock?
Mr. WRIGHT. I would have to think for a second before I try to answer that question.
Mr. PECORA. Surely, you may do that.

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[18] The effect of the Securities Exchange Act of 1934 on these practices is discussed in the subsection entitled "Regulation of Manipulative Devices."
[19] Chas. C. Wright, Feb. 20, 1934, pt. 13, pp. 6083–6084.
[20] Chas. C. Wright, supra, p. 6085.

Mr. WRIGHT (after a pause of a few moments). Do you want me to talk freely and frankly on this?

Mr. PECORA. Yes; very frankly, indeed.

Mr. WRIGHT. Because the public will not trade in stocks that are not active. Naturally when you make a stock active the public will trade in that stock. And many times you are successful, and many times you are unsuccessful in such an effort in any particular stock; and if you are running a pool and they do not trade in the stock, that is your hard luck.

Mr. PECORA. Then activities engendered by pools that are organized to distribute stocks that they hold under option, or which they have already accumulated, at prices which would represent profits to themselves, are activities designed primarily to induce the public to come in and buy, so that distribution may be effected at higher levels?

Mr. WRIGHT. Yes, sir; which is just the same as distributing groceries or any other commodities.[21]

In the instance of a pool formed to trade in Sinclair Consolidated Oil Corporation stock, it was deemed advisable by the members to form an auxiliary trading syndicate for the purpose of prodding the market when it showed signs of languishing.

Mr. PECORA. For the purpose of enabling this syndicate, this purchasing syndicate, to sell its stock to the public at a profit, it was deemed advisable by the members of the syndicate to form a trading account?

Mr. CUTTEN. Yes, sir.

Mr. PECORA. That is correct, is it not?

Mr. CUTTEN. Yes.

Mr. PECORA. How was it intended that the trading account should act? What business had it intended that the trading account should do in order to enable it to sell the stock of the purchasing group to the public at a profit?

Mr. CUTTEN. Well, to keep a market, that we would buy and sell the stock.

Mr. PECORA. What do you mean by "keeping the market?" Was there not an open public market?

Mr. CUTTEN. Yes.

Mr. PECORA. Where anybody could go in and buy or sell some stock?

Mr. CUTTEN. Yes; but when the stock was a little weak, on the weak days when the public was selling, we would buy it.

Mr. PECORA. In order to give support to the market and keep the price up?

Mr. CUTTEN. To support the market at times.

Mr. PECORA. Is that how it was intended to work?

Mr. CUTTEN. Yes, sir.

Mr. PECORA. When the buying on the part of the general public was light or weak?

Mr. CUTTEN. When the market was weak we would support it.

Mr. PECORA. How would you support it—by buying?

Mr. CUTTEN. Yes.

Mr. PECORA. By buying what the public had to sell; is that right?

Mr. CUTTEN. Yes.

Mr. PECORA. And that enabled the price to be maintained?

Mr. CUTTEN. Yes.

Mr. PECORA. Or even to go up a bit?

Mr. CUTTEN. It might; yes.

Mr. PECORA. And if it went up a bit, what was the trading account to do in behalf of the syndicate?

Mr. CUTTEN. Sell the stock.

Mr. PECORA. You would sell a part of these 1,130,000 shares?

Mr. CUTTEN. Yes.

Mr. PECORA. As well as the stock you had bought in the open market, to keep the price up, would you?

Mr. CUTTEN. Yes, sir.

Mr. PECORA. So that this trading account was to both buy and sell as the market conditions required?

Mr. CUTTEN. Yes.

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[21] Charles C. Wright, supra, p. 6086.

Mr. PECORA. Is that right?

Mr. CUTTEN. That is right.

Mr. PECORA. The ultimate purpose all the time being to enable your syndicate, your purchasing syndicate, not only to dispose of those shares it bought in the open market to keep up the price but also to sell at a profit the 1,130,000 shares that it had acquired at $30 a share? Is that right?

Mr. CUTTEN. That is right; yes, sir.[22]

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Senator GORE. I asked if this trading account was a sort of an apothecary shop or drug store where you could get stimulants in case you did need them?

Mr. CUTTEN. That is right.

Mr. PECORA. In other words, to give it some artificial stimulation; is that right?

Mr. CUTTEN. To take the stock when it was offered; yes.

Mr. PECORA. A shot in the arm.

Mr. CUTTEN. We were willing to buy the stock when the public wanted to sell it, or whoever the sellers were.[23]

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Mr. PECORA. Mr. Cutten, on this day that I am speaking of, namely, October 29, 1928, when the purchasing syndicate bought 34,100 shares but sold 37,800 shares, did they buy those 34,100 shares because the market showed a tendency to drop and the purchasing syndicate wanted to stop that tendency?

Mr. CUTTEN. I believe so. It must have.

Mr. PECORA. As those transactions go over the ticker there is nothing to inform the public which reads the ticker in order to keep abreast of the market that the purchase of these 34,100 shares was made at the instance of a group that had 1,130,000 shares which it wanted to sell to the public at a profit?

Mr. CUTTEN. No, sir.

Mr. PECORA. To that extent the information conveyed by the ticker of that day's transaction failed to inform the public that the buying was not done by the public in a disinterested fashion, but rather a substantial portion of it was done by a small group, the existence of which was not known to the public, which small group was actuated by the desire to maintain the price because it has a large block of that stock for sale?

Mr. CUTTEN. Yes, sir.[24]

In the instance of the American Commercial Alcohol pool, Ruloff E. Cutten, who managed the account, gave " puts " and " calls " to brokers during the course of his operations in the security for the purpose of protecting them against loss, and thus encouraging them to " churn " the market.

Mr. PECORA. Why did you give puts and calls in the stock during the period of your activity in it? What purpose was derived by it?

Mr. CUTTEN. On the put end, if a broker would be bullish on an alcohol stock or bullish on the market and wanted to buy two or three hundred shares, sometimes he would call me up on the telephone and say he would buy two or three hundred shares of this particular stock if I would give him a put on it, say, a point under the price at which he may have purchased it. It is limiting their loss.

Mr. PECORA. It is a limitation on the loss of the speculator?

Mr. CUTTEN. That is right.

Mr. PECORA. That is pure speculation, is it—or speculation leaving out the word "pure"?

Mr. CUTTEN. Yes.

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Mr. PECORA. What would be your purpose in doing that?

Mr. CUTTEN. To give them a put at the same price that they may have purchased the stock at?

Mr. PECORA. Yes.

Mr. CUTTEN. Just so he would buy the stock, that is all.

[22] Arthur W. Cutten, Nov. 9, 1933, Chase Securities Corporation, pt. 6, pp. 3080-3081.
[23] Arthur W. Cutten, supra, p. 3082.
[24] Ruloff E. Cutten, Nov. 14, 1933, Chase Securities Corporation, pt. 7, p. 3246.

Mr. PECORA. Isn't it also to guarantee him against loss?
Mr. CUTTEN. Oh, absolutely; of course. To limit his loss.
Mr. PECORA. In other words, it is a process whereby persons might be induced to buy the stock because they are assured of being protected against loss?
Mr. CUTTEN. Absolutely.
Mr. PECORA. What was the advantage to you or to the members of your group in doing that, Mr. Cutten?
Mr. CUTTEN. Well, I don't know in doing that, Mr. Pecora, whether there was any direct advantage or not. It brings in some outsiders, of course, with maybe 100 shares or 200 shares or 500 shares of that particular stock. That is what it does. It creates another interest.
Mr. PECORA. It stimulates the market, doesn't it?
Mr. CUTTEN. Yes; in effect.
Mr. PECORA. And that is the purpose for which it is done, isn't it?
Mr. CUTTEN. Yes.
Mr. PECORA. To sort of help churn the market, isn't it?
Mr. CUTTEN. Well, "churn" is a kind of a large word for an account about that size. I don't know whether you could churn 200 shares one day or 300 the next.
Mr. PECORA. You know it is churning just the same, isn't it?
Mr. CUTTEN. All right; call it that; yes, sir.
Mr. PECORA. We are not doing violence to the facts when we call it that, are we?
Mr. CUTTEN. Well, I don't know whether you are or not. You may be in the minds of some people.
Mr. PECORA. In your own mind?
Mr. CUTTEN. No; not in my mind.
Mr. PECORA. I simply want your opinion, of course.
Mr. CUTTEN. No; not in my mind; no, sir.
Mr. PECORA. And is that a device, Mr. Cutten, that, from your experience covering many years as a stockbroker, is often resorted to to stimulate activity in the market of a stock?
Mr. CUTTEN. Sometimes; yes, sir.
Mr. PECORA. And the general effect is to inform the public that there is an activity in the market for that stock without telling the public how the activity is excited?
Mr. CUTTEN. That is quite so. They don't know. Of course not. In other words, the public or any individual could buy a hundred or a thousand shares of that stock and then go out and buy puts on it, and the rest of the people would not know that they had purchased a put. It limits the loss. There are people that are put and call brokers that do that, sell puts and sell calls.[36]

(iv) The dissemination of information flattering to the stock in which the pool is operating is the fourth factor in bringing the operation to a successful conclusion. Although the nature and extent of the pool's own operations are shrouded in utmost secrecy, the participants make use of various channels to disseminate information subtly designed to excite public attention toward the security. A method commonly followed is to cause market letters to be sent by brokerage firms to their branch offices, which letters are made accessible to the investing and speculating public. Typical of this practice were the market letters distributed by E. F. Hutton & Co. with reference to American Commercial Alcohol stock from September 12, 1932, to May 12, 1933, during which period Ruloff E. Cutten, a member of the firm, held options on the stock.

Senator ADAMS. How are these market letters distributed, how widely, and by what means?
Mr. CUTTEN. They are put over our wires, sir. It is a sheet of paper about the size of that, commenting on how the market acted on the particular day,

[36] Ruloff E. Cutten, Feb. 14, 1934, pt. 13, pp. 5908–5909.

and market letters are put out in the morning commenting on the night news and mentioning stocks that acted well or did not act so well the previous day.

Senator ADAMS. Do they go to all members of the exchange?

Mr. CUTTEN. Oh, no, sir.

Senator ADAMS. Just affiliated brokers?

Mr. CUTTEN. Those are just our own offices.

Senator ADAMS. They have no circulation among your customers, other than among those who come and get them at your offices?

Mr. CUTTEN. They put them on a pad, and they come in and read them.

Mr. PECORA. They are available to all the customers of your office?

Mr. CUTTEN. Yes, sir.

Mr. PECORA. And very frequently are quoted in the public press, are they not?

Mr. CUTTEN. I believe they are. I do not think they ever mention any particular stock. I believe they just mention the trend of the market, whether the broker is bullish or bearish on the market.[26]

In a confidential report dated September 8, 1932, on American Commercial Alcohol Corporation, made by S. C. Coleman, a statistician in the employ of E. F. Hutton & Co., it was stated:

* * * I think we can recommend the stock to those people who want to follow a speculative situation that offers considerable promise over the next 6 months to a year. I do not think it is suitable for investment in any sense of the word. The exceedingly small capitalization, coupled with the fact that over 50 percent of the stock is very closely held, indicated that the stock could be established at higher levels without any large amount of buying.[27]

Commencing September 12, 1932, market letters were distributed by E. F. Hutton & Co. making copious references to the stock. As is the custom, the letters did not directly advise the purchase of the stock but stimulated purchases by including statistical data or by favorable comparisons with other issues. For example, the market letter of September 12, 1932, upon which date Cutten received two options on the stock, stated:

A few issues displayed unusually stubborn resistance to further decline, such as American Commercial Alcohol and Coco Cola. The pronounced firmness in the former issue in the face of weakness in United States Industrial Alcohol directs attention to the comparative earning power of these two alcohol companies this year. It is conservatively estimated that American Commercial Alcohol will report net of $3.50 a share this year, while United States Industrial Alcohol is not expected to earn more than $2.50 to $3 on the common. Some students of comparative market values are predicting that American Commercial Alcohol will cross United States Industrial Alcohol.

Some issues that we believe are in a favorable position to score a sharp rally when the list turns are American Can, United Aircraft, North American, American Commercial Alcohol, Southern Pacific, General American Tank, Kennicott, Chrysler, International Telephone, Continental Can, American Power & Light, Atlantic Refining, Gillette, General Electric, Canadian Pacific, Union Carbide.[28]

In the market letters of September 13, 1932, and September 14, 1932, it was asserted that various securities, including American Commercial Alcohol, were recommended as being in a favorable position to score a sharp rally. The letter of September 14, 1932, stated:

American Commercial Alcohol advanced to a new high for the year in the morning's trading before encountering selling, when the list turned sharply downward. Some students of the alcohol industry who are impressed with the favorable competitive position of this company predict that American Commercial Alcohol will cross U.S. Industrial Alcohol in the not distant future.[29]

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[26] Ruloff E. Cutten, Feb. 14, 1934, pt. 13, pp. 5902–5903.
[27] Committee exhibit no. 7, Feb. 14, 1934, pt. 13, p. 5808.
[28] Ruloff E. Cutten, supra, p. 5900.
[29] Ruloff E. Cutten, p. 5901.

In letters dated October 4, 1932 and October 6, 1932, various stocks, among them American Commercial Alcohol, were characterized as giving a better-than-average performance and recommended as worth watching.

Under date of October 13, 1932, a letter stated:

A cold winter would result in substantial sales of antifreeze mixtures by the alcohol companies, swelling final quarter net. It is estimated, in informed quarters, that American Commercial Alcohol earned upwards of 85 cents in the third quarter, bringing 9 months net to $2.10 a share. It seems likely that balance of income available for the common in the fourth quarter will exceed $1.50, giving full year net of around $3.60.[30]

Again on October 28, 1932, favorable predictions regarding the earnings of American Commercial Alcohol were made.

At various intervals down to and including May 5, 1933, enthusiastic comment and comparisons favorable to American Commercial Alcohol were made in these market letters.[31] Needless to say none of the letters disclosed that Cutten had options on the stock and a special interest in inducing the public to come in and buy. There appeared no hint of an ulterior motive on the part of the brokers in lauding the stock. The practice cannot be condemned too severely.

Even so experienced an operator as Ruloff E. Cutten finally conceded that the practice was not a good one.

Mr. PECORA. In the face of this evidence, do you still say that your firm did not recommend American Commercial Alcohol to its customers during the times covered by these options?

Mr. CUTTEN. Of course, I look on the recommending of things to a customer as putting out a prospectus and analyzing the individual company to the customer, and suggesting that the customer purchase the shares of that company.

Mr. PECORA. Would you interpret any of these references to American Commercial Alcohol that I have read from these market letters as suggestions to your customers not to purchase American Commercial Alcohol?

Mr. CUTTEN. No; I would not.

Mr. PECORA. They were put in there to influence the customers in purchasing the stock, weren't they?

Mr. CUTTEN. Well, it was to call that particular stock to their attention; yes.

Mr. PECORA. And to call it to their attention in a favorable way, so as to induce them to buy?

Mr. CUTTEN. That is right.

Mr. PECORA. Yes; and that is not recommending a stock to them, is it, according to your conception of the term?

Mr. CUTTEN. Perhaps it is. But no more so than any of the other stocks that are mentioned there, though, sir.

Mr. PECORA. When you recommended the stock in this way, did you tell your customers that you had an interest in the stock represented by these option agreements on 30,000 shares?

Mr. CUTTEN. No; I did not.

Mr. PECORA. That is rather a common factor, isn't it, Mr. Cutten, among brokerage houses?

Mr. CUTTEN. That have options you mean?

Mr. PECORA. To have options.

Mr. CUTTEN. Yes.

Mr. PECORA. And then to stimulate the market by recommending the stock in which they have options to customers?

Mr. CUTTEN. It has been; yes, sir.

Mr. PECORA. Do you think it is a good practice?

Mr. CUTTEN. I do not.[32]

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30 Ruloff E. Cutten, p. 5901.
31 Ruloff E. Cutten, pp. 5901–5902.
32 Ruloff E. Cutten, Feb. 14, 1934, pt. 13, p. 5903.

Other methods used by pool operators to distribute propaganda included the employment of professional publicity agents; the subsidizing of financial writers; and the distribution of "tipster sheets" purporting to emanate from reputable financial services and to contain scientific and statistical data concerning the security, all calculated to entice the public into purchasing the security.

David M. Lion, who characterized his business as "financial publicity", testified before the subcommittee that he was the publisher of a paper known as "The Stock and Bond Reporter." This sheet publicized particular stocks which formed the basis of pool operations. As compensation for such publicity, Lion received calls on substantial blocks of stock from the pool operators.[33] Lion also hired William J. McMahon to broadcast over the radio on stock-market topics. McMahon was introduced to the radio audience as an economist and as president of the McMahon Institute of Financial Research. At the conclusion of his radio discussions on general market conditions, it was McMahon's function to boost the particular stock which was currently the subject of pool operations, and for these services Lion paid him $250 per week. Lion also testified that he employed newspaper writers to publish articles concerning the securities, and that he paid for their services either by options on stock or by cash. The extent of his activities is manifested by the fact that he engaged in as many as 30 operations at one time on behalf of various pool operators.[34] During the years 1928, 1929, and 1930, he realized a net profit of half a million dollars on the calls granted to him as compensation for his publicity work in connection with about 250 operations.[35]

John J. Levenson, a free-lance trader, testified that from May 1929 to March 1930 he conducted operations in various stocks which netted him a profit of $1,138,322.41. To assist him in his market transactions, Levenson availed himself of the services of Raleigh T. Curtis, who conducted a financial column under the name of The Trader in the New York Daily News, a metropolitan newspaper of wide circulation.[36] Under the guise of impartial, disinterested discussion of the stock market, Curtis treated his readers to "tips" on the particular issues in which Levenson was interested.[37] Although Levenson testified that he did not pay Curtis directly for this propaganda, it was conceded that Curtis, without putting up any money, received a profit of over $19,000 from trading accounts guaranteed by Levenson, who bought and sold for those accounts the various stocks which he employed Curtis to boost.[38]

Indisputable evidence was adduced at the hearings demonstrating that in connection with pool operations it was usual and customary for the operators to pay newspaper writers for publicity and propaganda disguised as financial news. The compensation was paid in the form of cash or options on the securities so publicized. Congressman LaGuardia set forth several instances of such payments

[33] David M. Lion, June 8, 1932, pt. 2, p. 673.
[34] David M. Lion, supra, pp. 677–678.
[35] David M. Lion, supra, pp. 680–691.
[36] John J. Levenson, May 20, 1932, pt. 2, pp. 602–603.
[37] John J. Levenson, supra, p. 610.
[38] John J. Levenson, supra, p. 604.

and substantiated them by documentary proof, particularly describing the activities of one Plummer, a publicity man, who expended on behalf of his pool-operating employers the sum of $286,279 for the publication of articles in the press favorable to their stocks.[39]

(*b*) *Extent of use of options.*—Options have thus far been discussed in their relation to pool operations. Their uses, however, are by no means confined to pools but extend into many fields of manipulative activity. Through the medium of options, manipulators of every sort are enabled to carry on large-scale operations with a minimum of financial risk. The data compiled by the subcommittee manifest the wide-spread employment of options among members of the organized exchanges.

During the year 1929, 41 issues of stock listed on the New York Stock Exchange were the subject of options involving not less than 10,000 shares each, in which member firms of the New York Stock Exchange, or partners thereof, participated and acted for the optionees.[40] During 1930, there were 27 such stock issues;[41] during 1931 there were 18;[42] during 1932 there were 13;[43] and from January 1, 1933, to September 30, 1933, there were 43.[44]

There were 286 options involving not less than 10,000 shares each in those stocks during the period from January 1, 1929, to August 31, 1933. The member firms of the New York Stock Exchange which participated in the options numbered 78, and 25 partners of member firms also participated. The shares involved in those 286 options totaled 17,380,478.[45]

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[39] Representative LaGuardia, Apr. 26, 1932, pt. 2, pp. 450–463.

[40] Airway Electric Appliance, Allegheny Corporation, Artloom Corporation, Aviation Corporation, Blaw-Knox Co., Bloomingdale Bros., Bendix Aviation, Bristol Meyers Co., Burroughs Adding Machine, Canada Dry, Commercial Credit Corporation, Coty, Crosley Radio Corporation, Cutler-Hammer, Follansbee Bros. Co., Foster Wheeler Corporation, Freeport Texas Co., General Refractories, Goodyear Tire Co., Hahn Department Store, Mengel Co., Minneapolis Moline Power Implement, Petroleum Corporation of America, Pittsburgh Bolt & Screw, Procter & Gamble, Purity Bakeries Corporation, Radio-Keith-Orpheum, Remington Rand, Royal Dutch Co., Servel, Inc., Sharon Steel Hoop, Sharp & Dohme, Inc., Spang-Chalfant & Co., Starrett Corporation, Sterling Securities, Thermoid Co., Tide Water Associated Oil, Truax-Traer Coal Co., United States & Foreign Securities, Walworth Manufacturing Co., Wilcox-Rich Co. "A" (pt. 17, p. 7947).

[41] Canada Dry, Colgate-Palmolive-Peet, Curtiss-Wright Corporation, Federal Light & Traction preferred, Foster Wheeler Corporation, General Refractories, Hartman Corporation, Lambert Co., McLellan Stores, Melville Shoe Corporation, Mesta Machine, National Cash Register Co., North American Aviation, Park & Tilford Corporation, Remington Rand, Reynolds Springs, Rossia Insurance, Savage Arms Co., F. G. Shattuck Co., Spang Chalfant & Co., Super-Heater Co., Thatcher Manufacturing Co., Thompson Products, Tri-Continental Corporation preferred, Universal Pipe & Radiator common, Warner Quinlan Co., F. & W. Grand Silver Stores common (pt. 17, p. 7947).

[42] American Commercial Alcohol, Adams Mills Corporation, American Power & Light Co., Chicago Pneumatic Tool Co., Curtis Publishing Co., Harbison-Walker Refractories, Hartman Corporation "B", Hershey Chocolate Co., Houdaille-Hershey Corporation "B", J. Kaiser Co., Kelvinator Co., Kroger Grocery, Melville Shoe Co. common, Mesta Machine Co., National Steel Co., Petroleum Corporation of America, Pittsburgh Screw & Bolt Co., Tri-Continental Corporation preferred (pt. 17, p. 7947).

[43] American Water Works Electric Co., Burroughs Adding Machine, Campbell Cannon Foundry Co., Kelvinator Co., S. S. Kresge Co., Kroger Grocery, McCall Corporation, National Distillers, Plymouth Oil Co., Safeway Stores, Inc., Warren Foundry & Pipe, Wilcox Oil Gas, Zonite Products Corporation (pt. 17, p. 7947).

[44] Addressograph Multigraph Corporation, American Water Works & Electric Co., Archer Daniels Midland Co., Barnsdall Corporation, Checker Cab Manufacturing Co., Commercial Investment Trust Corporation, Consolidated Gas of Baltimore, Consolidated Gas, Consolidated Railway, Cuba, Continental Motors, Cream of Wheat, Cuba Company, Curtiss-Wright Corporation, Davega Corporation, Electric Boat Co., Electro Storage Battery, Equitable Office Building Co., Federal Motor Co., Freeport Texas Corporation, General Realty & Utilities Co., B. F. Goodrich, Goodyear Tire & Rubber Co., Graham-Paige Motors Corporation, Hercules Motor Co., Industrial Rayon, Interborough Rapid Transit Co., International Paper & Power, Kelvinator Corporation, Kresge Co., Kroger Grocery Co., Libbey-Owens-Ford Glass Co., Madison Square Garden Corporation, Marmon Motor Co., Mohawk Carpet, Motor Wheel Co., National Distillers, North American Aviation, Peerless Motor Co., Pittsburgh Screw & Bolt Co., Republic Iron & Steel, Schenley Distillers, Standard Brands, Thompson Starrett Co. (pt. 17, p. 7048).

[45] Pt. 17, pp. 7862–7863.

Individual members of the New York Stock Exchange, between January 1, 1929, and August 31, 1933, participated in options exceeding 10,000 shares each, covering four issues of stock.[46] During that period, three individual members of the New York Stock Exchange participated in four such options, and 62,400 shares were involved.[47]

During the year 1929, 21 stocks listed on the New York Curb Exchange were the subject of options in excess of 10,000 shares each, in which members of the New York Stock Exchange participated and acted for the optionees.[48] During 1930 there were 9 such issues;[49] during 1931 there were 6;[50] during 1932 there were 4;[51] and from January 1 to September 30, 1933, there were 9.[52]

Regular member firms of the New York Curb Exchange, aside from those who were also members of the New York Stock Exchange, participated in options exceeding 10,000 shares each, involving 6 issues listed on the New York Curb Exchange during 1929;[53] 3 issues during 1930;[54] 4 issues during 1931;[55] 1 issue during 1932;[56] and 7 issues from January 1, 1933, to September 30, 1933.[57]

Associated member firms of the New York Curb Exchange, aside from those who were also members of the New York Stock Exchange, participated in options exceeding 10,000 shares each, involving 1 issue listed on the New York Curb Exchange during 1929;[58] 1 issue during 1932;[59] and 4 issues during 1933.[60]

From January 1, 1929, to August 31, 1933, 32 issues of stock listed on the New York Curb Exchange were subject to options in excess of 10,000 shares each in which the individual members of the New York Curb Exchange participated and acted for the optionees.[61]

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46 Budd Wheel, General Asphalt, General American Investment Trust, General Theatres Equipment, Inc. (pt. 17, p. 7952).

47 Pt. 17, p. 7874.

48 American Capital Corporation, Central Airport, Inc., Curtiss Airport Corporation, Curtiss Caproni, Eastern Gas & Fuel, Eisler Electric Corporation, Foremost Dairy Products, General Realty & Utility Co., Globe Underwriters, Merritt Chapman Scott Corporation, Prosperity Co., Reliance Management, Reynolds Investing Co., Inc., Roosevelt Field, Inc., Root Refining Co., Helena Rubinstein & Co., Schlettee & Zander, Selected Industries, Southern Corporation, Sun Investing Co., United States Securities Investment Co. (pt. 17, p. 7964).

49 Chess Wymond Co., Copeland Products, Inc., General Mills Corporation, Hygrade Food Products, Merritt Chapman Scott Co., Reliance International, South Pennsylvania Oil Co., United Carr Fastener Corporation, United States Foil "B" (pt. 17, p. 7964).

50 Continental Shares, Empire Bond, May Radio & Television, Moss Gold Mines, National Union Radio, Pilot Radio & Tube (pt. 17, p. 7964).

51 Copeland Products, Inc., Fuel Oil Motor Corporation, General Mills Corporation, Indestructo Glass Corporation (pt. 17, p. 7964).

52 Angostura Wuppermann, Consolidated Aircraft Corporation, Ferro Enamel Corporation, General Mills Corporation, Harvard Brewing Co., Kreuger Brewing Co., Laird & Co., Swift & Co., Tung-Sol Lamp (pt. 17, p. 7964).

53 Aeronautical Industries, Inc., Campbell, Wyant & Camon, General Laundry Machine Corporation, Graymur Corporation, National Aviation Corporation (1928), United States Electric Power Corporation (pt. 17, p. 7964).

54 Cosden Oil, Radio Products, Thermoid Corporation (pt. 17, p. 7964).

55 Apponaug Co., Art Metal Works, British Can Shares, Grocery Store Products (pt. 17, p. 7965).

56 Atlas Utilities (pt. 17, p. 7965).

57 Consolidated Theatres, Ltd., common, Croft Brewing Co., Distillers & Brewers Corporation, European Electric Corporation, Grocery Stores Products common, Molydenum Corporation of America, Swift & Co. (pt. 17, p. 7965).

58 Consolidated Gas Electric Light & Power Co. of Baltimore, common. Pt. 17, p. 7965.

59 Seaboard Utilities Shares Corporation, common. Pt. 17, p. 7965.

60 General Mills Corporation, Long Lighting Co., common; Mavis Bottling Co., McCord Radiator "B." Pt. 17, p. 7965.

61 Acoustic Products, Aluminum Goods Manufacturing Co., Associated Gas & Electric Co., Bellanca Aircraft Corporation, Beneficial Industrial Loan, Brunner-Winkle Aircraft Corporation, Canadian Industrial Alcohol, Cities Service, DeForest Radio, Dunhill International, Inc., preferred; Durant Motors, Eastern Utilities, Fokker, Foremost Dairy Products, Fox Theaters, General Alloys Co., General Gas & Electric, preferred; General Theaters, Globe Underwriters, Hecla Mining Co., Hiram Walker-Gooderham & Worts, International Projector, Investors Equity Co., Inc.; Kreuger Breweries, Pennroad Corporation, Safe-T-Stat, Sentry-Safety Control, Sharp & Dohme, Southwest Dairy Products, Technicolor, Inc., United States Foil, Utility Equities Corporation, common (pt. 17, p. 7970).

The participations in those options were held by 4 individual members of the New York Curb Exchange, and the number of shares involved was 1,490,068.[62]

On the other organized exchanges from January 1, 1929 to August 31, 1933, 11 member firms held participations in 20 options involving 3,137,251 shares; and 3 individual members of such exchanges participated in 3 options involving 50,000 shares.[63]

(*o*) *Price manipulation by specialists.*—Manipulative practices on the exchanges have been materially abetted in many cases by the cooperation of specialists. In pool operations, particularly, the services of the specialist in the security marked for manipulation have proved invaluable to the pool managers. The specialist's information regarding the state of the market or its trend was important to persons conducting large operations in the security.[64] The pool manager customarily gave discretionary orders to the specialist, relying on him to exercise those orders at such times and prices as would be best calculated to manipulate the price of the stock in furtherance of the objectives of the pool. The record contains several examples of the value of the specialist's services in pool operations.

On March 7, 1929, a syndicate was organized to trade in the common stock of Radio Corporation of America. The participants comprised 2 groups, 1 formed through the brokerage firm of M. J. Meehan & Co. and 1 through the brokerage firm of W. E. Hutton & Co. Among those brought into the pool through M. J. Meehan & Co. were Mrs. M. J. Meehan, wife of M. J. Meehan, and Mrs. David Sarnoff, wife of the president of Radio Corporation of America. Although Thomas Bragg and Bradford Ellsworth were nominally the managers of this pool, most of the stock was bought and sold through M. J. Meehan & Co., which firm was actually conducting the pool.[65]

The specialist in Radio Corporation stock was Esmonde F. O'Brien, a member of the firm of M. J. Meehan & Co. The pool commenced operations on March 12, 1929, and concluded on March 19, 1929, during which period 1,493,400 shares were purchased and sold for the pool account, at a gross profit of $5,563,198.48, and a net profit of $4,924,078.68.[66] Although a substantial part of the trading in Radio Corporation stock cleared through Esmonde F. O'Brien, he denied that at any time during the course of the pool operation he had disclosed the condition of his book to any other member of the firm of M. J. Meehan & Co.[67] Nevertheless, as a specialist in Radio Corporation stock on the one hand and as a member of the brokerage firm which had helped to organize and was conducting the operation of a pool in that stock on the other, his position was extremely vulnerable to temptation. Whether or not the superior knowledge derived by him from his possession of the book was actually employed to advance the interests of his partners and their friends and relatives, it is apparent that the opportunity for collusion was conspicuously present.

[62] Pt. 17, p. 7884.
[63] Pt. 17, pp. 7889, 7915.
[64] Matthew C. Brush, Apr. 22, 1932 (pt. 1, p. 306).
[65] Thomas Bragg, May 10, 1932, (pt. 2, p. 479).
[66] Committee exhibit no. 3, May 10, 1932, pt. 2, p. 475.
[67] Esmonde F. O'Brien, May 19, 1932, pt. 2, p. 515.

That this opportunity was not always ignored is illustrated by another case reported to the subcommittee. In 1927 and 1928 Stevens and Legg were specialists in Fox Film stock. While acting as specialists they became participants in a pool organized to trade in the stock and were vested with authority to execute discretionary orders on behalf of the pool. Not only did Stevens and Legg make a profit of $42,361.50 as participants in the pool, but, in addition, while the pool was still in operation, they received $10,000 from the pool manager, which was described by Stevens as having been paid "in appreciation for the work that we had done in running an orderly market." [68]

After the revelations before the subcommittee regarding the role played by specialists in connection with pool activities, the New York Stock Exchange adopted the following rule:

> No member acting as a specialist and no partner of such a member and no firm in which such a member is a general or special partner shall, directly or indirectly, be interested in a pool dealing or trading in the stock in which such a member is a specialist, nor shall any such member, partner, or firm, directly or indirectly, acquire or grant, in connection with a pool operation, an option to buy or sell or to receive or deliver shares of the stock in which such a member is a specialist.[69]

The rule left a great deal to be desired. While the specialist and his partners were forbidden to participate in a pool involving the stock in which he specialized, the rule did not prevent collusion with lone traders whose activities did not conform to the exchange's definition of a pool. Neither did it limit his or their participation in pools involving other specialists' stocks, such, for example, as the stock in which the specialist at an adjacent post held the book. The rule prohibited the specialist or his partners from acquiring an option on the stock in which he specialized, but only in connection with a pool operation. He was still free to acquire an option on a security in which he specialized, provided the option had no connection with a pool operation; and no limitation whatsoever was imposed on his power to accept an option on a stock in which he did not specialize. The rule, of course, in no way hampered pool operations or the acquisition of options by members who were not specialists.

The fact that pools continued to flourish on the New York Stock Exchange with the assistance of specialists after the adoption of this rule is plain from the evidence of pool activities in the so-called "repeal stocks." Charles C. Wright, specialist in American Commercial Alcohol, testified that during the operation of a pool conducted by Thomas Bragg in the stock, he received discretionary orders from Bragg for the account of the pool between May and July 1933.[70] Since Wright had no personal participation in the pool, his activities violated the rule in no manner, yet they materially aided the manipulations of the pool.

After the market crashed in July 1933, the New York Stock Exchange adopted a rule requiring members to report all substantial pools in which they were interested or of which they had knowledge,

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[68] Byam K. Stevens, June 17, 1932, pt. 3, pp. 1001–1002.
[69] Rules of the New York Stock Exchange, ch. XIV, sec. 11, adopted Sept. 28, 1932.
[70] Charles C. Wright, Feb. 20, 1934, pt. 13, p. 6092.

and the committee on business conduct was authorized to disapprove of the connection of any member with any such pool which it should determine to be contrary to the best interests of the exchange, or to be likely to create prices which would not fairly reflect market values.[71]

A rule was also adopted requiring members to report all substantial options in which they were interested, or of which they had knowledge, and the committee on business conduct was authorized to disapprove of the connection of any member with any option which it should determine to be contrary to the best interests of the exchange, or to be likely to create prices which would not fairly reflect market values.[72]

Evasions of these rules were easily possible on the part of the members of the exchange by causing participations in pool accounts and in options to be taken in the names of persons who were not members of the exchange, and consequently not bound by its rules. The record shows that many flagrant abuses in connection with pools and options were committed or instigated by persons who, not being members of the exchange, were exempt from its disciplinary powers.

On February 13, 1934, an amendment to the rules was adopted by the New York Stock Exchange which prohibits a specialist and his partners from acquiring or granting any option in the stock in which he is a specialist.[73] The effect of the amendment is to eliminate the qualification in the original rule that the option be acquired or granted " in connection with a pool operation." On the same date the following rule was promulgated:

> No member of the exchange or firm registered thereon and no general or special partner of any such registered firm shall, directly or indirectly, participate in or have any interest in the profits of a manipulative operation. No such member, firm, or partner shall knowingly manage or finance a manipulative operation.
>
> For the purpose of this rule (1) any pool, syndicate, or joint account, whether in corporate form or otherwise, organized or used intentionally for the purpose of unfairly influencing the market price of any security by means of options or otherwise and for the purpose of making a profit thereby shall be deemed to be a manipulative operation; (2) the soliciting of subscriptions to any such pool, syndicate, or joint account, or the accepting of discretionary orders from any such pool, syndicate, or joint account shall be deemed to be managing a manipulative operation; and (3) the carrying on margin of either a long or a short position in securities for, or the advancing of credit through loans of money or of securities to, any such pool, syndicate, or joint account shall be deemed to be financing a manipulative operation.[74]

Here again a rule ostensibly framed to combat a practice universally acknowledged to be in derogation of the public interest, was emasculated by the inclusion of restrictive phraseology. Apparently, before a pool is deemed by the stock exchange to be so detrimental to the public interest as to deserve abolition it must be " organized or used intentionally to unfairly influence the market price of any security ", and " for the purpose of making a profit thereby."

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[71] Rules of the New York Stock Exchange, ch. XV, sec. 6, adopted Aug. 2, 1933.
[72] Rules of the New York Stock Exchange, ch. XV, sec. 7, adopted Aug. 2, 1933.
[73] Rules of the New York Stock Exchange, ch. XIV, sec. 11, as amended Feb. 13, 1934
[74] Rules of the New York Stock Exchange, ch. XIV, sec. 15, adopted Feb. 13, 1934.

The participants in many pools studied by the subcommittee during its investigation might readily have evaded whatever penalties the stock exchange reserved for violation of the rule by proof either that it was not their intention to "unfairly influence the market price", or that the pool was not organized or used "for the purpose of making a profit thereby", but merely for the purpose of effecting distribution. Yet such pools have been found to violate the public interest in no small degree.

(*d*) *Short selling.*—Few subjects relating to exchange practices have been characterized by greater differences of opinion than that of short selling. The proponents of short selling contend that it is a necessary feature of an open market for securities; that in a crisis short sellers are useful in maintaining an orderly market; and that their activities serve as a cushion to break the force of a decline in the price of stocks. Its opponents assert that short selling unsettles the market, forces liquidation, depresses prices, accelerates declines, and has no economic value or justification. Between these extreme views a welter of divergent opinion exists. Before an intelligent appraisal may be made of the relative virtues and vices of short selling, it is essential to comprehend the mechanics of a short sale.

(1) *Mechanics of short selling.*—Short selling is a device whereby the speculator sells stock which he does not own, anticipating that the price will decline and that he will thereby be enabled to "cover", or make delivery of the stock sold, by purchasing it at the lesser price. If the decline materializes, the short seller realizes as a profit the differential between the sales price and the lower purchase or covering price.[75]

An order is given to a broker to sell the stock short, and the order is executed on the floor of the exchange and recorded in precisely the same manner as any other order to sell. The purchaser is altogether unaware whether he is buying from a short seller or an actual owner of stocks. The seller is required to make delivery of the stocks he has sold within the period limited by the rules of the exchange. Since he has no shares to deliver, he must obtain them somewhere. The usual practice is for the broker executing the sale to borrow the stock on his customer's behalf. Usually, it is borrowed from another broker. There must be deposited with the lender of the stock the market value of the stock loaned, and the amount of this deposit varies with changes in the price of the security. If the market price rises, the deposit must be increased; and, conversely, if the market price drops, the borrower of the stock may request the return of the difference between the amount which he has deposited and the then market value of the stock. In brief, the lender is entitled at all times to have on deposit a sum equivalent to the market value of the stock. The broker uses the borrowed stock to make delivery to the person who has purchased from his customer, the short seller. Later, when the short seller covers, his broker purchases the stock in

[75] Richard Whitney, Apr. 12, 1932, pt. I, p. 110.

the market and delivers it to the lender. When the borrowed stock is returned, the lender repays the sum which is on deposit with him and the transaction is closed.[76]

Where the stock borrowed is in demand, a premium is exacted by the lender for the loan of the stock.[77] This premium at times may be substantial. On one occasion the premium on Wheeling-Lake Erie stock mounted to $7 and $8 a share, which meant that the short seller was required to pay $7 to $8 a day for each share of stock borrowed.[78]

In a " flat loan ", the stock is loaned without the payment of interest or premium. A loan that is " flat " in the first instance may change to a loan on interest or a loan on premium when there is a change in rate.[79]

Where a lender is also a broker, he generally lends the securities of his customers who have authorized him to do so. In the absence of agreement to the contrary, customers whose securities are loaned receive no part of any premium paid for the loan—that is retained by their broker. Nor do they participate in the interest earned on the funds deposited with their broker when he loans their stock—that also he keeps.[80]

(2) *Short selling against options.*—Options are frequently employed by traders as a hedge in connection with their short-selling operations. In the event of a rise in the market price, a short seller holding an option can exercise his option and cover his short position without loss. In the event of a decline, he can refrain from exercising the option and cover his short position by purchasing stock in the open market. Thus, the option insures him against loss.

In 1928 George F. Breen and Arthur W. Cutten were granted two options by Rudoph Spreckels, a large stockholder and chairman of the board of Kolster Radio Co. One option, dated October 26, 1928, covered 150,000 shares, or any part thereof, and the other, dated October 30, 1928, covered 100,000 shares, or any part thereof. Breen immediately assumed a short position in the stock.

Mr. GRAY. As a matter of fact, what you did in this case was to assume a short position right away?

Mr. BREEN. Yes.

Mr. GRAY. Now, what you could have done and assured yourself as being absolutely safe was this, was it not: That if the stock went up, you having sold it, you could get your stocks under your option for the purpose of squaring your position?

Mr. BREEN. Yes, sir.

Mr. GRAY. So that you might either have made or lost a little bit of money, but your risk would not have been great; that is correct, is it not?

Mr. BREEN. Yes.

Mr. GRAY. Now, if your stocks went down—not what you did, but what can be done—the practice—what you could have done was to cover at any price you thought it ought to be covered on the way down?

Mr. BREEN. Yes.

Mr. GRAY. And therefore, without any risk to yourself, make a decided profit and not take your option up at all?

Mr. BREEN. Yes; that could have been done.

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[76] Richard Whitney, supra, pp. 120–123.
[77] Richard Whitney, supra, p. 203.
[78] Richard Whitney, supra, p. 134.
[79] Richard Whitney, supra, p. 128.
[80] Richard Whitney, supra, pp. 131–132.

Mr. GRAY. Yes; because the option simply provides that if you do not take it up it falls?

Mr. BREEN. That is correct.

Mr. GRAY. And you are under no legal obligation under your agreement to take it up at all?

Mr. BREEN. No.

Mr. GRAY. Except your danger of losing your option.

Mr. BREEN. In some instances.[81]

Breen commenced trading on October 29, 1928, selling 100,000 shares of the stock and buying 30,000 shares. In a period of about 6 weeks he sold 456,900 shares and bought 206,900 shares, leaving him with a net short position of 250,000 shares, which he covered by exercising his options. According to the witness, this was not a pool operation. It was a trading account against an option. Spreckels received $19,000,000 for his stock. The four participants in the trading account, none of whom were required to put up any money, realized a profit of $1,351,152.50, which was divided equally among them.[82]

The failure to exercise an option after short-selling operations have driven the price of a security down, is considered unethical among traders.[83] Nevertheless, in the case of two options, each for 30,000 shares of American Commercial Alcohol Corporation, given to Ruloff E. Cutten by Russell R. Brown, chairman of the board of that corporation, Cutten assumed a short position and when the market receded covered his short position by purchases in the open market, rather than by the exercise of his options.[84]

Joseph E. Higgins, a member of the New York Curb Exchange, obtained an option to purchase 50,000 shares of Electric Auto-Lite Co. stock from C. O. Minniger, president of the company. Michael J. Meehan operated a trading account against this option and assumed a substantial short position from time to time, which was covered by purchasing stock in the open market. The option was never exercised.[85]

(3) *Sales "against the box."*—A type of sale not technically a short sale, but similar in nature, is a sale "against the box." In such a transaction, the seller owns and possesses stock which he can deliver but which for some reason he prefers not to deliver. This is a devise which can be employed by corporate officials and insiders who desire to sell their corporation's stock short without disclosing such short selling. Like the ordinary short seller, he borrows stock for the purpose of making delivery.[86] It is contended by stock-exchange authorities that a sale "against the box" is not a short sale, since the customer need not buy the stock back but may make delivery from the securities in his box.[87] It is plain, however, that where a person initially makes a sale "against the box" but subsequently changes his mind, there is nothing to prevent him from covering in the open market. In such case he is indistinguishable from any other short seller.[88]

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[81] George F. Breen, May 10, 1932, pt. 2, pp. 556-557.
[82] George F. Breen, supra, pp. 559-561.
[83] George F. Breen, supra, p. 559.
[84] Ruloff E. Cutten, Feb. 14, 1934, pt. 13, p. 5807.
[85] Joseph E. Higgins, June 3, 1932, pt. 2, pp. 751-755.
[86] Richard Whitney, Apr. 18, 1932, pt. 1, p. 161.
[87] Richard Whitney, supra, pp. 160, 169.
[88] Richard Whitney, supra, p. 161.

(4) *Effect of short selling.*—A great deal of testimony was heard by the subcommittee regarding the effect of short selling. The president of the New York Stock Exchange testified that short selling steadies the market on a decline because it brings into the market compulsory buyers.

Mr. GRAY. I should like to have a direct answer as to why you believe short selling aids the market when the market is on a decline. You have so stated. Why?

Mr. WHITNEY. As one part of the whole situation, the whole question, short selling gives to the market its only compulsory buyers. The short seller must buy. No other person entering the market must buy, except the short seller. That is an aid.[89]

Whitney further distinguished between short selling and "bear raiding." The objection of the New York Stock Exchange to "bear raiding" was predicated not upon the fact that it involved short selling but upon the fact that it resulted in illegal demoralization of the market and created fictitious prices.

Senator GLASS. Mr. Whitney, I am beginning to wonder what we are here for. What culpability is involved in selling short?

Mr. WHITNEY. To make the distinction, if I understand your question, Senator Glass, as to what we consider selling short legitimately we know of no culpability. But bear raiding we are most antagonistic against, and——

Senator GLASS (interposing). I may understand—but at least I do not—but I may understand why you abhor bear raiding, and yet I want to know what there is culpable in it. You talk about demoralizing the market. As I conceive it, the market could be more dangerously demoralized by being bet way up than it might be by short selling.

Mr. WHITNEY. That may be.

Senator GLASS. Why do you make rules against demoralizing the market in short selling and put no restrictions upon betting the market up?

Mr. WHITNEY. Perhaps I failed, Senator Glass, to impress upon you just that point this morning when I stated that our rules were in both directions, that our rules covered absolutely any demoralizing of the market or depressing of the market and giving a tendency toward fictitious prices. I will quote from the constitution of the exchange if we have it here. I do not find it. Anyway, it is in a single paragraph. The effect of the rule is to prevent doing something that will demoralize the market or create the impression of fictitious prices whether it be by bear raiding or bull raiding, as you describe it.[90]

Matthew C. Brush, an independent trader, testified that if short selling were barred, terrific swings in the market would ensue, since the only stock available would be the stock that somebody owned and wanted to sell outright.[91]

Otto H. Kahn ascribed considerable weight to the argument that short selling in times of stress provided a resiliency to the market which would otherwise not exist. Nevertheless, he stated:

* * * and yet my moral sense tells me that there is something inherently repellent to a right-thinking man about short-selling activities to the extent that they can depreciate another man's property or that they will induce fear or produce alarm to harm normal activities. * * * [92]

The "cushion" theory advanced in defense of short selling disregards several important points. First, it overlooks the obvious fact that, while buying by short sellers may raise prices, their selling has

[89] Richard Whitney, supra, p. 100.
[90] Richard Whitney, Apr. 11, 1932, pt. I, p. 43.
[91] Matthew C. Brush, Apr. 22, 1932, pt. I, p. 800.
[92] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 8, p. 1312.

previously depressed prices. The buying support furnished to the market by short covering is certainly no greater than the downward thrust received by the market when the sales were made. In fact, as the record shows, the buoyant power of short covering is likely to be far less effective than the depressive power of short selling.

Second, the theory assumes that short sellers cover when prices are declining sharply. The contrary has frequently been proven. During the summer of 1929, at the height of the great bull market, the short interest was relatively small. But after the break it increased; and as the decline gained in severity the short interest continued to expand. As a general rule, only when it appears that the bottom is in sight does short covering come into the market in volume. Thus the cumulative influence of short selling is exerted toward exaggerating, rather than checking, the downward swing of prices.

The theory that short selling tends to restrain speculative rises is likewise untenable in practice. It is apparent that the run-away market of 1928–29 was in no way curbed by activities on the part of short sellers. The bears shun such a market like the plague. When the demand for stocks has spent its force and an exhausted public has begun to retreat from the market, then—and then only—the barrage of short selling begins, the decline is accentuated, and demoralization ensues.

(*e*) *Regulation of manipulative devices.*—The Securities Exchange Act of 1934 has erected certain safeguards around the exchanges in order that their legitimate function of furnishing a free and honest market may no longer be defeated by manipulative practices. Certain devices employed for the purpose of artificially raising or depressing security prices are specifically prohibited by the act. Others have not been forbidden outright but have been placed under the control of the Securities and Exchange Commission.

The act makes it unlawful for any person to effect any transaction in a registered security which involves no change in the beneficial ownership; or to enter an order for the purchase of such security with the knowledge that an order of substantially the same size at substantially the same time and at substantially the same price for the sale thereof, has been or will be entered by anyone for the purpose of creating a false or misleading appearance of active trading in the security.[93] This section aims to eliminate wash sales, matched orders, and all other devices designed to create a misleading appearance of activity, with a view to enticing other persons to come into the market and trade.

The act likewise makes it unlawful to effect either alone or in concert with others a series of transactions in any registered security, creating actual or apparent active trading in the security or raising or depressing the price thereof, for the purpose of inducing the purchase or sale of the security by others.[94] This provision should perform the wholesome service of outlawing pool operations, as well as every other device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage.

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[93] Securities Exchange Act of 1934, sec. 9 (a) (1).
[94] Securities Exchange Act of 1934, sec. 9 (a) (2).

Dealers and brokers are forbidden to induce the purchase or sale of a security by false or misleading statements with respect to any material fact or by the circulation or dissemination, in the ordinary course of business, of information to the effect that the price of such security is likely to rise or fall because of market operations designed to raise or depress the price.[95] All persons who receive a consideration from a broker and dealer are likewise forbidden to induce the purchase or sale of a security by the circulation or dissemination of information to the effect that the price is likely to rise or fall because of market operations designed to raise or depress the price.[96] These provisions make it unlawful to circulate rumors or reports concerning activities for the rise or operations for the decline, and will serve as deterrents against the employment of publicity agents and radio voices to tout stocks, and against the promiscuous dissemination of tips on stocks.

Practices such as pegging, fixing, or stabilizing the price of a security are subjected to regulation by the Commission, which is authorized to prescribe such rules as may be necessary or appropriate to protect investors and the public from the vicious and unsocial aspects of these practices.[97]

In like manner, the Commission has been vested with control over the subject of puts, calls, straddles, or other options or privileges.[98]

Short selling and the employment of stop-loss orders have not been abolished by the act, but have been placed under the supervision of the Commission, which is empowered to promulgate rules and regulations to purge the markets of the abuses connected with these practices.[1]

In order to render effective the prohibitions against manipulation, violators are not only subject to the penalties prescribed in the act, but are liable in damages to any person who purchases or sells a security at a price which was effected by the violation.

8. Market Activities of Directors, Officers, and Principal Stockholders of Corporations

Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others. Several illustrations follow:

(*a*) *The pools in American Commercial Alcohol.*—The manipulation of the "repeal" stocks on the New York Stock Exchange during the summer of 1933, graphically illustrates the vice of participation

[95] Securities Exchange Act of 1934, sec. 9 (a) 3, 4.
[96] Securities Exchange Act of 1934, sec. 9 (a) 5.
[97] Securities Exchange Act of 1934, sec. 9 (a) 6.
[98] Securities Exchange Act of 1934, sec. 9 (b).
[1] Securities Exchange Act of 1934, sec. 10 (a).

by officers, directors, and principal stockholders in pools involving their own securities, as well as a host of other evils and abuses prevalent on organized exchanges. On July 18, 1933, there was a violent fluctuation downward in security prices, led by the repeal stocks. A few days later, counsel for the subcommittee requested the New York Stock Exchange to institute an inquiry for the purpose of ascertaining whether pool operations had been conducted in repeal stocks between May 15, 1933, and July 24, 1933. On October 16, 1933, a report was submitted by the exchange detailing the results of its examination made in connection with trading and operations in the securities of American Commercial Alcohol, Commercial Solvents, Libbey-Owens-Ford Glass, National Distillers Products Corporation, Owens-Illinois Glass, and United States Industrial Alcohol. The report expressed the conclusion that "there were no material deliberate improprieties in connection with transactions in these securities" and that there was no evidence of "activities which might have stimulated improperly the activity of these stocks."[2]

Thereupon the subcommittee caused an independent inquiry to be made by its investigating staff, and a series of hearings were held at which the evidence collected was made public. The record of those hearings is replete with proof of manipulation of prices in the repeal stocks, of pool operations in which corporate officials participated and profited, and of unsavory practices in connection with the listing of securities. The failure of the stock-exchange authorities even to discover these flagrant abuses indicated how urgent was the need for a Federal regulatory body equipped to deal with such practices.

The activities in American Commercial Alcohol stock, presenting a glaring example, are hereinafter described in detail.

American Commercial Alcohol Corporation was organized in March 1929 under the laws of Maryland, with a capital structure of $4,000,000 in bonds, $2,000,000 in preferred stock, and 380,000 shares of common stock without par value. The common stock was later changed to $10 par value, and finally converted into 190,000 shares of $20 par value.[3]

From April 1931 Russell R. Brown was chairman of the board, Richard H. Grimm was president, William S. Kies was chairman of the executive committee, and Philip Publicker was a director.[4]

These four officials of the company, commencing February 15, 1932, gave a series of options on their individual holdings in the common stock of the corporation to several members of the New York Stock Exchange. The first four options were granted to Frank E. Bliss, a member of the exchange, one by Russell R. Brown for 9,000 shares, one by Philip Publicker for 6,000 shares, one by William S. Kies for 6,000 shares, and one by Richard H. Grimm for 9,000 shares. The prices mentioned in each option ranged between $7 and $11 per share.[5] Brown testified that neither he nor his fellow optionors were desirous of having the options exercised, but their sole purpose was to have a man on the floor of the exchange who was interested in the company

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[2] Statement of Ferdinand Pecora, Feb. 14, 1934, pt. 13, pp. 5916, 5917.
[3] Russell R. Brown, Feb. 14, 1934, pt. 13, p. 5853.
[4] Russell R. Brown, supra, p. 5852.
[5] Exhibits nos. 3-A, 3-B, 3-C, 3-D, Feb. 14, 1934, pt. 13, pp. 5850-5861.

and would maintain a stable market for its stock. Nevertheless, Bliss, the optionee, called all the stock covered by the options. It is difficult to see how Brown expected Bliss to stabilize the market unless he traded in the stock, which would result in the exercise of the options. Moreover, Brown received no commitment from Bliss that the options would not be exercised. In view of the fact that Brown owned 24,000 shares and Publicker over 30,000 shares at the time, it is apparent that they were personally interested in exciting the market and raising the quotations. If this was their aim, it was realized since the stock rose from 6¾ on February 13, 1932, to over 11 when Bliss called for delivery of the stock.[6]

On June 11, 1932, July 11, 1932, and July 22, 1932, Brown and Grimm granted options to Prentice & Slepack, members of the New York Stock Exchange covering a total of 13,000 shares of American Commercial Alcohol stock at prices ranging between $12.50 and $14.50 per share.[7] A member of the firm of Prentice & Slepack was a director of American Commercial Alcohol Corporation at that time. The options, according to Brown, were given for the same purpose as those granted to Bliss.[8]

On August 9, 1932, Stephen Ames, another member of the exchange, received an option for 10,000 shares at prices ranging between $16.50 and $21 per share.[9] The option was signed by Brown on behalf of Grimm, Publicker, Kies, and himself. Despite the fact that the stock had been steadily increasing in value since February 1932 Brown maintained that he and his associates still considered that it needed stabilization.

Mr. PECORA. Now, you went to three different outstanding figures at three different times, Bliss, Goodwin, and now Ames. You gave them options covering tens of thousands of shares of the stock of your company?

Mr. BROWN. Yes, sir.

Mr. PECORA. To be delivered out of your personal holdings?

Mr. BROWN. And my associates; yes, sir.

Mr. PECORA. You and your associates in the company?

Mr. BROWN. Yes, sir.

Mr. PECORA. And your purpose in giving these options and hope was that the market in the stock would be stabilized?

Mr. BROWN. That is correct.

Mr. PECORA. You cannot point to any specific circumstance that indicated to you at the time that the market needed stabilization?

Mr. BROWN. No, sir.

Mr. PECORA. And you hoped that they would not call upon you for delivery of the stock under the options?

Mr. BROWN. Yes, sir.

Mr. PECORA. Now, how in the world did you expect these gentlemen, then, to profit by their activities under these options?

Mr. BROWN. I assumed that they would trade under the option.

Mr. PECORA. You assumed that they would trade for their own account?

Mr. BROWN. Yes.

Mr. PECORA. Couldn't they trade without the options?

Mr. BROWN. Apparently not.

Mr. PECORA. Why not?

Mr. BROWN. I don't know.[10]

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[6] Russell R. Brown, Feb. 14, 1934, pt. 13, pp. 5863, 5869.
[7] Exhibits nos. 4-A, 4-B, 4-C, Feb. 14, 1934, pt. 13, pp. 5870-5871.
[8] Russell R. Brown, Feb. 14, 1934, pt. 13, p. 5872.
[9] Committee Exhibit No. 5, Feb. 14, 1934, pt. 13, p. 5877.
[10] Russell R. Brown, Feb. 14, 1934, pt. 13, pp. 5881-5882.

All the options contained provisions whereby the optionors agreed to loan to the optionees at any time during the option period the portions of the stock remaining unsold under the options, plainly indicating that short selling of their company's stock was in the contemplation of these directors.

Mr. PECORA. So that in all of these options, beginning with those given to Bliss in February 1932, the discussion between you and the optionees respectively contemplated short selling, too; is that right?
Mr. BROWN. On their part; yes, sir.
Mr. PECORA. On their part, and that was part of the scheme to stabilize the market, was it?
Mr. BROWN. I assume so.
Mr. PECORA. Was it?
Mr. BROWN. Yes, sir.[11]

On September 12, 1932, Russell R. Brown granted to Ruloff Cutten two options on a total of 30,000 shares of American Commercial Alcohol Corporation common stock at prices from $22 to $30.[12] On December 12, 1932, he granted Cutten an additional option on 25,000 shares at prices between $20 and $26; and on March 12, 1932, he granted Cutten a fourth option for 10,000 shares at prices between $16 and $20.[13] Brown again acted for Grimm, Publicker, Kies, and himself.[14] Brown reiterated that it was not contemplated at the time the options were given to Cutten that they would be exercised; but that the sole purpose was to have Cutten stabilize the market, although he was unable to disclose any circumstance indicating that the market in the stock needed stabilizing.

Mr. PECORA. At the time you went into these options, can you point to any circumstance that indicated the market needed stabilization?
Mr. BROWN. No, sir.[15]

Cutten did not draw down any stock under the first three options, but he exercised in full the last option for 10,000 shares. The options granted to Cutten contained a provision that a trading account would be formed to conduct transactions under the options and that 25 percent of any profits were to be paid to the optionors, without any liability on their part for losses. A trading account was formed under the option exercised by Cutten, and 25 percent of the profits from this account were distributed among Brown, Grimm, Publicker, and Kies.[16]

Cutten testified that his reason for not exercising the first three options was that he had assumed a net short position which he was able to cover by purchases in the open market, when the price of American Commercial Alcohol securities declined. Brown's testimony to the contrary notwithstanding, Cutten stated that he had taken the options at prices above the prevailing market because he hoped to accomplish a rise in the price of the stock.[17]

A confidential report on American Commercial Alcohol, prepared for Ruloff Cutten by a statistician in his employ, stated that the stock was not suitable for investment in any sense of the word but

[11] Russell R. Brown, supra, p. 5884.
[12] Committee exhibits nos. 6–A, 6–B, Feb. 14, 1934, pt. 13, p. 5885.
[13] Committee exhibits nos. 6–C, 6–D, Feb. 14, 1934, pt. 13, p. 5886.
[14] Russel R. Brown, supra, p. 5887.
[15] Russell R. Brown, supra, p. 5889.
[16] Russell R. Brown, supra, pp. 5893–5894.
[17] Ruloff Cutten, Feb. 14, 1934, pt. 13, p. 5897.

could be recommended to persons who wanted to follow a speculative situation, and that the small capitalization, coupled with the fact that a majority of the shares were closely held, indicated that the stock could be established at higher levels without any large amount of buying.[18]

A series of market letters were sent out by E. F. Hutton & Co., Cutten's firm, commenting upon the stock.[19] Detailed reference to these market letters has been previously made in this report.[20] Cutten admitted that the practice of taking options and then recommending the stock to customers was a bad one, since the public is unaware that the broker has a private interest in the recommended security.[21]

During the life of the four options Cutten bought and sold approximately 100,000 shares, assuming at times a long position and at times a short position. Puts and calls in the stock were granted by him for the avowed purpose of stimulating activity and churning the market.[22]

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On May 2, 1933, Brown granted an option to Thomas E. Bragg for 25,000 shares of American Commercial Alcohol stock at $18 per share.[23] As on previous occasions, Kies, Publicker, and Grimm were associated with Brown in this transaction, but the purpose of this option was entirely dissimilar. Brown testified that the granting of the option to Bragg was actuated by the corporation's desire to raise additional capital in the sum of $450,000 to meet bank loans which were currently maturing.[24] The record shows that this sum could readily have been raised by the simple expedient of offering additional shares to the stockholders, who had a preemptive right to subscribe to new stock. Instead of resorting to that method, however, a labyrinthine scheme was evolved by Brown which circumvented the stockholders' preemptive right. There was in the employ of American Commercial Alcohol Corporation one Dr. Maister, a fermentologist from Germany, who was reputed to possess a secret process for the manufacture of vitamin products. Under the direction of Brown, a certified public accountant named Phagan, acting as dummy for Brown and the company, organized a corporation called Maister Laboratories, Inc., under the laws of the State of Maryland, with 10,000 shares of authorized capital stock. The initial assets of this corporation consisted of the goodwill of Dr. Maister and the alleged secret process for the manufacture of vitamin products. All the stock was issued to Phagan at $18 per share, and he paid for it by executing his promissory note in the sum of $180,000, endorsed by his wife.

Brown had no ground for believing that Phagan could pay the note. Phagan exchanged his 10,000 shares of Maister Laboratories, Inc., for 10,000 shares of American Commercial Alcohol Corporation, newly issued, whereupon Maister Laboratories, Inc., became a wholly owned subsidiary of American Commercial Alcohol Corporation.

[18] Committee exhibit no. 7, Feb. 14, 1934, pt. 13, p. 5898.
[19] Committee exhibit no. 8, Feb. 14, 1934, pt. 13, pp. 5900–5902.
[20] Supra, this report, pp. 41–43.
[21] Ruloff Cutten, supra, pp. 5903–5904.
[22] Ruloff Cutten, supra, pp. 5908, 5909.
[23] Committee exhibit no. 9, Feb. 14, 1934, pt. 13, p. 5912.
[24] Russell R. Brown, Feb. 15, 1934, pt. 13, pp. 5920–5923.

The good will of Dr. Maister and his secret process, estimated by Brown to be worth in excess of $180,000, had not realized one dollar in royalties up to the time of the hearings.[25]

Simultaneously with the formation of Maister Laboratories, Inc., Brown, through another dummy, C. C. Capdevielle, caused a corporation to be organized, known as "Noxon, Inc.", under the laws of Maryland, with 2,700 shares of preferred stock and 6,000 shares of common stock authorized. Noxon, Inc., agreed to purchase all the properties of Noxon Chemical Products Co., a corporation already in existence, for $80,000. Capdevielle purchased 2,700 shares of preferred and 3,900 shares of common stock of Noxon, Inc., giving his note for $270,000 in payment thereof. He then exchanged those shares for 15,000 shares of American Commercial Alcohol Corporation, newly issued, thereby giving to American Commercial Alcohol Corporation 65-percent control of Noxon, Inc. Brown admitted that he had absolutely no knowledge of Capdevielle's financial worth.[26]

The next step in the plan was to have Phagan and Capdevielle transfer their stock in American Commercial Alcohol Corporation and liquidate their notes to the subsidiary companies. The stock received by Phagan was delivered to Bragg to cover 10,000 of the 25,000 shares optioned to Bragg by Brown; and the 15,000 shares received by Capdevielle were also delivered to Bragg to make up the balance under the option. The funds received from Bragg for the 25,000 shares at $18 per share were then used to pay off Phagan's $180,000 note held by Maister Laboratories, Inc., and Capdevielle's $270,000 note held by Noxon, Inc.[27]

Under the charter of American Commercial Alcohol Corporation, the stockholders had a preemptive right to subscribe to new issues of capital stock, except where such stock was issued for the purpose of acquiring property. Brown's tortuous plan technically enabled the corporation to defeat the stockholders' preemptive right, since it involved the issue of 25,000 shares for property. The reason advanced by Brown for not having offered the additional shares directly to the stockholders was that he considered it impossible to secure any underwriting for such additional issue in May 1933, and that the stockholders would not have taken up the stock at $18 a share. Yet in June 1933, an additional issue of 40,949 shares of capital stock was offered directly to stockholders, and all but 700 shares were subscribed for by them.[28]

On May 31, 1933, when the board of directors approved the issuance of 25,000 shares of additional capital stock, which was destined ultimately to be used for deliveries to Bragg under his option of May 2, 1933, at $18 per share, the price range for the stock was 30⅞ to 33½.[29]

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[25] Russell R. Brown, supra, pp. 5926–5936.
[26] Russell R. Brown, supra, pp. 5931–5940.
[27] Russell R. Brown, supra, p. 5942.
[28] Russell R. Brown, supra, pp. 5944, 6040.
[29] Russell R. Brown, supra, p. 5949.

On June 2, 1933, application was made to list 51,293 shares of additional capital stock of the corporation on the New York Stock Exchange, 10,000 shares of which were to be exchanged for 10,000 shares of Maister Laboratories, Inc., and the balance to be offered to stockholders at $20 a share.[30]

On June 27, 1933, application was made for the listing of 15,000 additional shares of American Commercial Alcohol on the New York Stock Exchange, which were to be used in exchange for 2,700 shares of preferred stock and 3,900 shares of common stock of Noxon, Inc.[31]

On May 2, 1933, the date when the option for 25,000 shares was given to Bragg, a pool was organized by him to trade in American Commercial Alcohol stock. The pool account was carried as "B. E. Smith no. 296 account" on the books of W. E. Hutton & Co. The participants ostensibly were Knox B. Phagan, John C. Brennon, J. L. Kauffman, C. C. Capdevielle, T. E. Bragg, L. Young, and Carle C. Conway.[32] Actually, Brown, chairman of the board, and Richard H. Grimm, president of American Commercial Alcohol Corporation, had an interest in this pool, which was concealed in the name of Knox B. Phagan; and Philip Publicker, a director, Humphrey W. Chadbourne, a director, and W. S. Kies, chairman of the executive committee, had an interest which was concealed in the name of J. L. Kauffman.[33]

The pool commenced operations on May 3, 1933, and terminated on July 24, 1933. Approximately 29,000 shares of the corporation's stock were purchased and approximately 44,000 shares were sold through the "B. E. Smith no. 296 account."[34] During the period of the operations of this pool the price of the stock rose from 20 to a high of 89⅞ on July 18, 1933. On July 18, 1933, a sharp decline began, and by July 21 the quotations ranged from a low of 29⅛ to a high of 44½.[35]

The officers, directors, and principal stockholders of American Commercial Alcohol Corporation, above named, not only had a secret interest in the pool organized by Thomas Bragg, but also had a secret participation in the profits of an agreement to underwrite the 40,949 shares of additional capital stock offered to stockholders in June 1933. On May 31, 1933, an agreement was made between American Commercial Alcohol Corporation and Thomas Bragg, whereby the latter undertook to purchase any of the 40,949 shares that were not subscribed for by the stockholders, at $20 per share, in consideration of which he was to receive $1 per share commission for such underwriting.[36] Phagan and Capdevielle were awarded a participation in this underwriting and the interests of Brown, Grimm, Publicker and Kies were hidden in their names.[37]

On May 31, 1933, when the underwriting agreement was executed, the market price of the stock was 30⅞ to 33½. The stock was offered to stockholders at $20 per share; and, needless to say, they exercised

[30] Committee exhibit no. 11, Feb. 15, 1934, pt. 13, pp. 5944–5945.
[31] Committee exhibit no. 12, Feb. 15, 1934, pt. 13, p. 5946.
[32] Committee exhibit no. 27, Feb. 16, 1934, pt. 13, pp. 6043–6045.
[33] Russell R. Brown, Feb. 16, 1934, pt. 13, pp. 6030–6038.
[34] Charles N. Foster, Feb. 16, 1934, pt. 13, p. 6061.
[35] Russell R. Brown, Feb. 14, 1934, pt. 13, p. 5877.
[36] Committee exhibit no. 26, Feb. 16, 1934, pt. 13, pp. 6033–6035.
[37] Russell R. Brown, Feb. 16, 1934, pt. 13, pp. 6036–6038.

their preemptive right to subscribe to all but 700 shares, which were taken up by the underwriting syndicate. In this transaction the underwriters received approximately $40,000 as commissions.[38]

The secret profits divided among the officers, directors, and principal stockholders of American Commercial Alcohol Corporation, above named, and other participants in the pool and underwriting syndicate, aggregated about $210,000.[39]

(*b*) *The pool operations of Albert H. Wiggin in Chase Bank stock.*—Albert H. Wiggin, while chairman of the governing board of the Chase National Bank, participated in pool operations in Chase Bank stock through the medium of private corporations owned by himself and members of his family. He also traded actively in the stock for his own account and on behalf of his corporations.

On July 19, 1929, an account was organized by Dominick & Dominick for the purpose of trading in Chase National Bank stock. Among the participants in this account was Chase Securities Corporation, the securities affiliate of Chase National Bank. Subsequently, Chase Securities Corporation reallotted three-quarters of its interest to Metpotan Securities Corporation, one of its wholly owned subsidiaries, and one-quarter to Shermar Corporation, a private corporation owned by the family of Wiggin.[40] Dominick & Dominick took an option on 80,000 shares from Chase Securities Corporation for the purposes of this trading account, although when it granted the option Chase Securities Corporation owned only 40,000 shares. It was contemplated that the remaining 40,000 shares would be supplied by Shermar Corporation.[41] A private arrangement was made between Dominick & Dominick and Metpotan Securities Corporation under which the latter was to share in the fees and commissions received by Dominick & Dominick as managers of the account; and on September 21, 1929, Metpotan Securities Corporation allotted to Shermar Corporation 25 percent of its interest in such fees and commissions.[42] Although Dominick & Dominick took options on 80,000 shares of Chase Bank stock, the trading account was formed on the basis of 25,000 shares, indicating that short selling of the bank's stock was contemplated by the participants.[43]

On September 9, 1929, an additional option was given to Dominick & Dominick, as managers, by the Chase Securities Corporation for 20,000 shares, although Dominick & Dominick still held unexercised options on 45,000 shares. Chase Securities Corporation did not have the 20,000 shares on hand and Shermar Corporation undertook to supply the stock.[44]

Shermar Corporation furnished 50,000 of the 100,000 shares optioned in this deal. From July 19, 1929, to November 11, 1929, 92,096 shares were acquired by Dominick & Dominick under the options and 80,710 shares were bought in the open market, making a total of 172,806 shares purchased for the trading account.[45] Of this

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[38] Russell R. Brown, supra, p. 60[illegible].
[39] Russell R. Brown, supra, p. 6000.
[40] Albert H. Wiggin, Oct. 10, 1933, Chase Securities Corporation, pt. 5, pp. 2434–2437.
[41] Albert H. Wiggin, supra, pp. 2443–2445.
[42] Albert H. Wiggin, supra, pp. 2448–2449.
[43] Albert H. Wiggin, supra, pp. 2454–2455.
[44] Albert H. Wiggin, supra, pp. 2457–2458.
[45] Committee exhibit no. 20, Oct. 10, 1933, Chase Securities Corporation, pt. 5, p. 2462.

total, 115,483 shares were sold in the market and 55,227 shares were distributed among the participants upon the termination of the account. The profit derived by the trading account in cash was $1,452,314.68.[46] The share of Chase Securities Corporation was $261,416.64, of which sum Shermar Corporation received $65,354 on its subparticipation and, in addition, $9,682.10 as its part of the management fee.[47] Thus, in a pool operation wherein short selling was contemplated and shares of stock in the bank of which he was the chief executive were bought and sold in large volume, Albert H. Wiggin and his family-owned corporation made a profit of $75,036.10.

(c) *The pool in Sinclair Consolidated Oil.*—The Sinclair Consolidated Oil Corporation was incorporated under the laws of the State of New York on September 23, 1919, as the result of an agreement between Sinclair Oil & Refining Corporation, Sinclair Gulf Corporation, and Sinclair Consolidated Corporation. By its articles of incorporation it was authorized to issue 5,500,000 shares of common stock without par value.[48]

In the month of August 1928 Harry F. Sinclair, chairman of the executive committee of the Sinclair Consolidated Oil Corporation, approached Arthur W. Cutten, a member of the Chicago Board of Trade, and a market operator, with the proposal that Cutten purchase from the corporation 1,130,000 shares of the common stock at $30 a share. At that time the common stock was quoted on the New York Stock Exchange at $28 per share.[49]

After some negotiations between Cutten and Sinclair, an agreement was entered into between Sinclair Consolidated Oil Corporation and Arthur W. Cutten, dated October 24, 1928, whereby the corporation agreed to sell to Cutten 1,130,000 shares of its common stock at $30 per share. Delivery of the shares and payments against the purchase price were to be made from time to time, as designated by Cutten, within a period of 12 months from October 24, 1928, subject to the right of the corporation after November 24, 1928, upon written notice, to require Cutten to take up and pay for such shares, or the balance thereof, within 30 days after such notice. If Cutten failed to take up and pay for the shares before November 24, 1928, he agreed to pay to the corporation, if and when requested, up to 20 percent of the purchase price and interest at 6 percent per annum on the balance until paid, with an appropriate adjustment for dividends.[50]

At the same time, pursuant to their previous arrangement, an agreement was entered into between Harry F. Sinclair and Arthur W. Cutten whereby Cutten contracted to sell to Harry F. Sinclair 130,000 shares of common stock of the Sinclair Consolidated Oil Corporation upon the terms and conditions governing Arthur W. Cutten's purchase from the Sinclair Consolidated Oil Corporation.[51]

On October 24, 1928, a memorandum of agreement was executed by Blair & Co., Chase Securities Corporation, Shermar Corporation (a private corporation owned by Albert H. Wiggin and members of his family), Arthur W. Cutten, and Harry F. Sinclair, wherein it was

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[46] Committee exhibit no. 21, Oct. 10, 1933, Chase Securities Corporation, pt. 5, p. 2468.
[47] Albert H. Wiggin, supra, p. 2464.
[48] Committee exhibit no. 117, Nov. 10, 1933, Chase Securities Corporation, pt. 6, p. 3122.
[49] Ruloff E. Cutten, Nov. 14, 1933, Chase Securities Corporation, pt. 7, p. 3225.
[50] Exhibit no. 92, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 2998.
[51] Exhibit no. 93, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3000.

provided that the parties thereto would participate on the original terms in the agreement between Sinclair Consolidated Oil Corporation and Arthur W. Cutten in the proportions specified. Sinclair took three-twelfths, Cutten three-twelfths, and the others divided the remainder. The memorandum of agreement also provided for the formation of a trading account in the stock of Sinclair Consolidated Oil Corporation and further provided that Cutten was to be the manager of such trading account with the customary powers.[52]

On October 25, 1928, a formal agreement for the formation of the purchasing syndicate was executed by the parties, embodying the terms previously agreed upon and providing that the manager was not to have a net commitment at any time for the purchasing syndicate exceeding in the aggregate 1,130,000 shares of said stock.[53]

Cutten transferred his 25-percent interest to the Cutten Co., Ltd., a Canadian corporation, wholly owned by members of his family, which corporation gave subparticipation to others, as did the other members of the original group.[54] Harry F. Sinclair granted subparticipations to 17 persons.[55]

Contemporaneously, a trading syndicate was organized, with Blair & Co., Arthur W. Cutten, Chase Securities Corporation, Shermar Corporation, and Harry F. Sinclair as the original participants. Subparticipations in this trading syndicate were likewise awarded to various persons and corporations.[56] This trading syndicate limited its manager, Arthur W. Cutten, to a maximum net commitment at any one time of 1,000,000 shares.

Since the purchasing syndicate was limited to a net commitment of 1,130,000 shares, which it acquired immediately upon its formation, it could not buy any further common stock until it had disposed of some of its holdings. Hence, the auxiliary syndicate was organized to carry on the active trading in the stock.

Mr. PECORA. What was said concerning the purposes for which this trading account was to be formed, at the time it was first discussed?

Mr. CUTTEN. It was to help maintain a market. If——

Mr. PECORA. What do you understand by that term?

Mr. CUTTEN. To be able to purchase shares when necessary if the market should start to decline. In other words, if the syndicate account had been unable to dispose of any shares in the open market, the original agreement was so written that the syndicate account could not have purchased 100 shares of stock. They were limited to a commitment of 1,130,000 shares of stock, which they had made a firm purchase on.

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Mr. PECORA. What occasion was there to believe that the trading syndicate or trading account was necessary in order to maintain an orderly market, if there had been no disorderly market prior to October 24?

Mr. CUTTEN. The only way I can answer that is that such groups usually have buying power enough to maintain a market after such syndicates are formed.

Mr. PECORA. That is, after the formation of purchasing syndicates it is usual for them to cause to be formed a trading account or syndicate to maintain the market. That is the usual procedure, is it?

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[52] Exhibit no. 94, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3001.
[53] Exhibit no. 95, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3006–3008.
[54] The list of participants in the syndicate as finally constituted and the percentages and shares of profits received are set forth in exhibit no. 114, Nov. 9, 1933, Chase Securities Corporation, pt. 6, p. 3093.
[55] The names of these persons and their respective interests are set forth in exhibit no. 119, Nov. 9, 1933, Chase Securities Corporation, pt. 6, p. 3157.
[56] The interests and profits of all the participants in this trading group are set forth in exhibit no. 115, Nov. 9, 1933, Chase Securities Corporation (pt. 6, p. 3094).

Mr. CUTTEN. If the original syndicate is not formed for a greater amount of shares than they contract for privately, yes, sir; I believe that a secondary account is formed.

*   *   *   *   *   *   *

Mr. CUTTEN. * * * As I say, the group had no purchasing power whatsoever when the original syndicate was formed, and, the second day after the contract was signed, had the stock gone down, had there been a break in the general market, had the original syndicate been unable to dispose of 100 shares of stock, they could not have bought 100 shares of stock, regardless of where the market went. If the market went to $20 a share, they could not have purchased 100 shares of stock.[57]

Among the participants and subparticipants in the purchasing syndicate and/or the trading syndicate were Harry F. Sinclair, chairman of the executive committee of the Sinclair Consolidated Oil Corporation; Harry Payne Whitney, member of the executive committee of the corporation; J. F. Farrell, treasurer and a director; J. H. Markham, Jr., a director; E. W. Sinclair, a brother of Harry F. Sinclair, and a director; Nellie Klein Crowley, wife of Eugene Crowley, one of the vice presidents; G. T. Stanford, counsel to the corporation; P. W. Thirtle, a director; and A. E. Watts, vice president and a director.[58]

On October 24, 1928, the day when the agreement of purchase was made and the trading syndicate agreement signed, the stock opened at 32 and closed at 35¾, as a result of which the value of the 1,130,000 shares was increased by about $6,000,000 above the contract price. On October 25 the range was 35½ low, 37¼ high, and 36¾ close.[59] The trading account did not commence to function until November 5, 1928, but in the interim the purchasing syndicate actively traded in the stock. With the commencement of operations by the trading account, buying and selling took place in both accounts on the same days. For example, on November 5, 1928, 210,000 shares of Sinclair Consolidated Oil Corporation stock were traded in on the New York Stock Exchange. The purchasing syndicate sold 100,600 shares and bought 11,600 shares; while the trading account purchased 50,900 shares. On November 19, 1928, the purchasing syndicate sold 29,300 shares and bought 1,700 shares, while the trading syndicate bought 2,300 shares and sold 10,100 shares. On many other days the activities of these accounts bordered perilously upon the forbidden domain of "wash" sales.[60]

The purchasing account was closed April 16, 1929. During the period of its operation it sold not only the entire 1,130,000 shares which it had acquired from the Sinclair Consolidated Oil Corporation, but also 700,000 shares which it had bought in the open market.[61] The purchasing syndicate realized a net profit of $12,200,109.41.[62] The trading syndicate was closed May 17, 1929, with a record of 634,000 shares purchased and 634,000 shares sold, resulting in a gross profit of $464,870.60, and a net profit of $418,383.54, after deducting 10 percent commission to the syndicate manager.[63]

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[57] Ruloff E. Cutten, Nov. 14, 1938, Chase Securities Corporation (pt. 7, pp. 3233–3235).
[58] G. T. Stanford, Nov. 9, 1933, Chase Securities Corporation (pt. 6, pp. 3127–3128).
[59] Ruloff E. Cutten, Nov. 14, 1933, Chase Securities Corporation, pt. 7, pp. 3232–3236.
[60] Exhibits nos. 112, 113, Nov. 9, 1933, Chase Securities Corporation, pt. 8, pp. 4200–4201.
[61] Ruloff E. Cutten, Chase Securities Corporation, pt. 7, p. 3256.
[62] Exhibit no. 114, Nov. 9, 1933, Chase Securities Corporation (pt. 6, p. 3093).
[63] Ruloff E. Cutten, Chase Securities Corporation, pt. 7, p. 3256.

This profit of nearly $13,000,000 was realized without any of the participants, except Blair & Co., being called upon to advance one dollar toward the purchase price of the 1,130,000 shares. The purchasing syndicate, prior to December 27, 1928, when the first delivery of 500,000 shares was made under the original purchase agreement between Cutten and Sinclair Consolidated Oil Corporation, had sold 200,000 shares short in the market, and had realized a profit of $2,000,000 on its short selling. The short position was covered out of the first delivery and the profit of $2,000,000 constituted a 25-percent margin on the other 300,000 shares, delivered on December 27, 1928.[64]

On December 31, 1928, the remaining 630,000 shares were delivered by the Sinclair Consolidated Oil Corporation under the agreement. E. F. Hutton & Co., members of the New York Stock Exchange, made the payments of $15,000,000 and $18,000,000, respectively, for these deliveries. The sum of $12,000,000 was loaned by Chase National Bank to E. F. Hutton & Co. to assist it in making these payments. The balance was financed by E. F. Hutton & Co. except the sum of $3,300,000, which Blair & Co. advanced.[65]

Mr. TOMPKINS. I should like to have this made clear on the record: That this stock which was purchased by the syndicate from the Sinclair Consolidated Oil Corporation was delivered for syndicate account to E. F. Hutton & Co. in the following amounts: On December 27, 1928, delivery was made by Sinclair of 500,000 shares of the Sinclair Co. stock, and the Sinclair Co. was paid $15,000,000. On December 31, 1928, 630,000 shares were delivered by the Sinclair Consolidated Oil Co., and they were paid $18,000,000.

Senator TOWNSEND. Hadn't they previously sold it?

Mr. TOMPKINS. Not all of it. That is why I say Mr. Cutten was in error in answering Senator Goldsborough's question. What happened was this: No participant in this trading syndicate was required, although they were obligated, to put up the necessary money to carry the stock. And they were not required to put it up because between the interval of the purchase price of $30 a share and the delivery price on December 27 the stock had gone up and was selling in the neighborhood of $40 a share, so when they took delivery at $30 a share there was ample collateral, approximately 25 percent additional, and it was handled and financed by the brokers.

Mr. PECORA. What banks financed the brokers?

Mr. TOMPKINS. The brokers borrowed on December 31 from the Chase National Bank on a part of this stock as collateral the sum of $12,000,000, and it has been paid.

Mr. PECORA. How much did they pay all told to Sinclair Consolidated Oil Co. in December?

Mr. TOMPKINS. The first payment was $15,000,000, and the last payment was $18,000,000.

Mr. PECORA. And out of the $15,000,000 payment $12,000,000 were advanced by Chase National Bank?

Mr. TOMPKINS. I think it was out of the December 31 payment.[66]

The share of the profits received by the officers, directors, and large stockholders of Sinclair Consolidated Oil Corporation, hereinabove named, as a result of these speculative activities aggregated the sum of $2,706,179.88.

(*d*) *The pool in General Asphalt Co.*—On May 15, 1929, a pool was formed to deal in shares of the common stock of General Asphalt Co., with a maximum position of 150,000 shares long or short. The firm of Luke, Banks & Weeks, members of the New York Stock Exchange, were managers of the pool. John L. Weeks, a member

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[64] Ruloff E. Cutten, supra, p. 3231.
[65] Elisha Walker, Nov. 15, 1933, Chase Securities Corporation, pt. 7, pp. 3344–3345.
[66] Millard F. Tompkins, Nov. 9, 1933, Chase Securities Corporation, pt. 6, pp. 3091–3092.

of the firm, was a director of General Asphalt Co., at the inception of the pool and during the period of its operation. Another participant in the pool was Horatio G. Lloyd, a partner in Drexel & Co., and chairman of the executive committee of General Asphalt Co.[67]

Prior to the formation of the pool, no dividends had ever been paid on the common stock of General Asphalt Co. On August 27, 1929, a communication was addressed to the security holders of the company, stating that the policy of turning back earnings into the business had resulted in building up a strong corporate position and had made it possible for the company to simplify its financial structure with a view to initiating dividend payments on the common stock. The proposed simplification was duly effected, and a dividend of $1 per share was paid to holders of the common stock in November 1929 and quarterly thereafter.[68]

Meanwhile, the pool had not been idle. Commencing in May 1929 it had been accumulating stock at an average of $80 per share. When the letter was sent to security holders in August 1929 the stock reach 94¼. After the market break in October 1929 the pool resumed the accumulation of stock at considerably lower prices. Its activities continued until May 15, 1931, and in the intervening period the pool dealt in half a million shares of stock.[69]

During the year 1930 the General Asphalt Co. paid out in dividends on its common stock $1,549,292, although its earnings for the year were only $1,006,796, leaving a deficit of $542,921. Of the dividends paid, the participants in the pool, including as heretofore mentioned the chairman of the executive committee and a director of the company, received the sum of $448,850 as their share—29 percent of the total paid, and 45 percent of the entire net income of the company for the year. Similarly, in 1931, although the company incurred a deficit of 41 cents per share on the common stock, the pool received the sum of $102,600 as dividends. During the existence of the pool it received total dividends of $613,750. In 1930 the dividend was reduced to $3 per annum. In September 1931 after the pool had wound up its affairs the dividend was cut to $2 per annum, and in February 1932 to $1.[70]

It is difficult to believe that the conduct of Messrs. Weeks and Lloyd was not influenced by their interest in the pool, when as directors they approved the payment of an initial dividend in November 1929 and the payment of subsequent dividends while the company was showing a deficit. Furthermore, it would be naive to suppose that in his management of the pool, Weeks was not guided by his intimate knowledge of the condition and plans of the company—confidential knowledge which he derived as a fiduciary, and was by every legal and ethical standard bound to refrain from using for his personal profit.

An attempt has been made by exchange officials to minimize the unpleasant stigmata of this pool on the ground that its participants

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[67] John L. Weeks, May 19, 1932, pt. 2, pp. 531–534.
[68] John L. Weeks, supra, pp. 537–538.
[69] John L. Weeks, supra, pp. 539–540.
[70] John L. Weeks, supra, pp. 541–542.

ultimately lost money. A betrayal of trust gains neither merit nor justification by the trustee's failure to profit by the betrayal.

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The record contains many other instances where officers, directors, and principal stockholders of corporations participated in pool operations and underwritings involving stock of the corporation which they dominated. Among such additional instances may be mentioned the participation of officers, directors, and large stockholders of Anaconda Copper Co., Chile Copper Co., Andes Copper Co., and Greene Cananea Co. in pools involving the copper stocks,[71] and the participations by William Fox and members of his family in pool operations and underwritings involving stock of the Fox Film Corporation and Fox Theatres Corporation.[72]

(*e*) *Regulation of market activities of officers, directors, and principal stockholders.*—The Securities Exchange Act of 1934 aims to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty. Every person who is the beneficial owner of more than 10 percent of any class of equity security registered on an exchange or who is a director or officer of the issuer of such security must report to the Commission whenever any change occurs in his ownership of stock in the corporation. In the event that he realizes any profits from the purchase and sale or sale and purchase of an equity security within a period of less than 6 months, he is bound to account to the corporation for such profits. It is also made unlawful for corporate insiders to sell the security of their corporations short or to make " sales against the box." [73] By this section it is rendered unlawful for persons intrusted with the administration of corporate affairs or vested with substantial control over corporations to use inside information for their own advantage.

9. Listing Requirements and Corporate Reports

It is universally conceded that adequate information as to the financial structure and condition of a corporation is indispensable to an intelligent determination of the quality of its securities. The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of an enlightened judgment as to what constitutes a fair price. Insofar as the judgment of either is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of the law of supply and demand. One of the prime concerns of the exchanges should be to make available to the public, honest, complete, and correct information regarding the securities listed.

(*a*) *Listed and " unlisted " securities.*—Upon organized exchanges, securities are classified as " listed " or " unlisted." On the New York Stock Exchange, all securities traded in are " listed " securities. On

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[71] Stock Exchange Practices, June 3, 1932, pt. 2, pp. 758–772; June 4, 1932, pt. 3, pp. 794–795, 800–814.

[72] Stock Exchange Practices, June 17, 1932, pt. 3, pp. 995–1088.

[73] Securities Exchange Act of 1934, sec. 16.

the New York Curb Exchange, the second largest exchange in the country, there are "listed" and "unlisted" securities. Seventeen other exchanges admit "unlisted" securities to trading privileges. The Milwaukee Grain & Stock Exchange maintains only an "unlisted" department.

"Listed" or "fully listed" securities are admitted to trading on organized exchanges upon the application of the issuer. The application for full listing includes an agreement by the issuing company to comply with the exchange requirements relating to the furnishing of data and information as to its financial structure and condition, and also to comply with future demands of the exchange with respect thereto.[74] The information obtained by the exchanges upon full listing is supposedly authentic data furnished by the proper officials of the issuing company and is periodically brought down to date by the company.[75]

"Unlisted" securities are securities which have been listed and admitted to trading privileges on the exchange not upon the application of the company, but upon the application of a member of the exchange, who must be a stockholder of the company.[76] The information required upon an application for admission to the "unlisted" securities department of an exchange is supplied by such member of the exchange.[77]

Organized exchanges maintaining "unlisted" departments have imposed certain conditions precedent to admission thereto. The New York Curb Exchange requires that an authorized issue of stock be at least 100,000 shares and that a bond issue be at least $5,000,000. There must be an adequate distribution among the public in and around New York and an active market must prevail in the vicinity. The company must have been in actual operation for not less than 2 years and must also have established and continued the principle of furnishing to stockholders periodical reports.[78]

Necessarily, the information concerning the financial condition of the company which is available to the prospective purchaser of a security in the "unlisted" department, is confined to the usual pro forma statements issued by the corporation to its stockholders, and the data appearing in statistical manuals. Obviously, the information obtained upon application for admission to "unlisted" trading is not as adequate and complete as upon application for "full listing" and does not have equal authenticity.

The "unlisted" departments on organized exchanges account for a substantial part of the securities business, both in respect of the number of securities dealt in and the extent of trading.

On December 31, 1933, 355 stocks and 19 bonds were "listed" on the New York Curb Exchange as compared with 1,069 stocks and 620 bonds in the "unlisted" department.[79] As of November 23, 1933, 82 percent of all the securities traded in on the New York Curb Exchange were in the "unlisted" department. The value of

[74] E. Burd Grubb, Mar. 8, 1934, pt. 15, p. 7099; William A. Lockwood, Mar. 8, 1934, pt. 15, p. 7127.
[75] E. Burd Grubb, supra, pp. 7103, 7115.
[76] William A. Lockwood, supra, p. 7125.
[77] A form of application and the requirements for admission to the "unlisted" department of the New York Curb Exchange appears in pt. 15, pp. 7106–7122.
[78] E. Burd Grubb, supra, p. 7102.
[79] E. Burd Grubb, supra, p. 7115.

the "unlisted" securities was approximately $10,400,000,000 for the common stocks, $1,700,000,000 for the preferred stocks, and $4,500,000,000 for the bonds, or a total of approximately $17,000,000,000.[80]

(*b*) *Deficiencies in listing requirements.*—Although the New York Stock Exchange has proclaimed the searching nature of its listing requirements, evidence was adduced before the subcommittee establishing that the exchange authorities were lax in their investigation of listing applications.

Frank Altschul, chairman of the committee on stock list of the New York Stock Exchange, testified that in connection with an initial listing of stock, an exhaustive and thorough examination was always made of the facts contained in the listing application. On the other hand, where listing of additional stock was sought by a company with securities previously listed, it was the practice of the exchange not to review the business judgment or motives of the directors in seeking the new listing, and unless there appeared patently suspicious matter in the listing application, the listing committee accepted as truthful and accurate the statements contained in such application, without independent investigation.[81]

The facts placed upon the record with respect to the listing of 51,293 shares of American Commercial Alcohol Corporation on the New York Stock Exchange during the summer of 1933 raised substantial doubt as to the effectiveness of the stock list committee. On June 2, 1933, American Commercial Alcohol Corporation made application to list 51,293 additional shares of stock.[82] On June 27, 1933, American Commercial Alcohol Corporation made application to list 15,000 additional shares.[83] Altschul stated that nothing appeared in these applications to disturb the committee on stock list, and both applications were approved.[84]

The application of June 2, 1933, stated that 10,000 of the additional shares of common stock for which listing was sought were to be exchanged for 10,000 shares of the common stock of Maister Laboratories, Inc., which was the owner of valuable processes for the manufacture of yeast and other vitamin products; and that the directors of American Commercial Alcohol Corporation valued the Maister Laboratories stock at more than $300,000. The application of June 27, 1933, stated that the 15,000 shares of stock for which listing was sought were to be exchanged for 2,700 shares of the preferred and 3,900 shares of the common stock of Noxon, Inc. Altschul admitted that an independent inquiry into the matters set forth in these applications might have brought to light the facts unearthed by the investigators of the subcommittee, viz, that the real purpose behind the issuance of these additional securities was not to acquire property but to raise additional working capital for the company, and that the stockholders' preemptive rights were being circumvented. He also admitted that, had the committee on stock list been aware of the facts disclosed at the hearings, the applications for additional listing would have been denied.[85]

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[80] William A. Lockwood, supra, p. 7128.
[81] Frank Altschul, Feb. 15, 1934, alcohol pools, pt. 13, p. 5966.
[82] Exhibit no. 11, Feb. 15, 1934, pt. 13, p. 5987.
[83] Exhibit no. 12, Feb. 15, 1934, pt. 13, p. 5995.
[84] Frank Altschul, Feb. 15, 1934, pt. 13, p. 5965.
[85] Frank Altschul, supra, p. 5965.

Altschul attributed the exchange's failure to investigate the application to the absence of suspicious circumstances. Nevertheless, matters were developed at the hearings which ought reasonably to have placed the stock list committee on notice. The listing application disclosed that although Maister Laboratories, Inc., had been freshly organized, the board of directors of American Commercial Alcohol Corporation had fixed a value of $300,000 on its stock. An independent investigation could profitably have been made into this item alone.

In connection with the application of June 27, 1933, one of the examining officers of the stock list committee prepared a memorandum to the effect that due to the private nature of the business of Noxon, Inc., no formal financial statements were available, but that the assets to be acquired were appraised by the directors of the applicant company at a value considerably greater than that of the stock which was to be issued.[86] No inquiry was made by the committee on stock list into the financial worth of Noxon, Inc. According to Altschul, where listing was sought of an additional issue which was small in relation to the total stock outstanding, his committee did not deem the financial statement of the issuing company essential. He admitted that in view of the testimony presented at the hearings, this omission was a deficiency in the mechanics of the stock list committee.[87]

A pro forma balance sheet of Noxon, Inc., was produced before the Senate subcommittee from the files of the New York Stock Exchange. Altschul testified that it was never brought to the attention of the stock list committee and stated that, had the committee or its employees seen it, the application for listing would not have been approved. The balance sheet would have aroused the suspicion of his committee because of such items as $270,000 for notes receivable, $80,000 for purchase contracts payable, and $380,000 for goodwill, licenses, and processes.[88] He explained that the pro forma balance sheet found among the files of the New York Stock Exchange had never been brought to the notice of the stock-list committee, either for the reason that the balance sheet reached the exchange after the formal approval of the listing on July 10, 1933, "in which case it should still have been drawn to the attention of the committee", or that the balance sheet was actually in the hands of the staff at the time the memorandum was prepared to the effect that no balance sheet was available, "in which case a mistake was made."[89]

Mr. PECORA. Now, I want to call your attention again this morning to the second one of these applications, being the one covering the 15,000 additional shares.

Mr. ALTSCHUL. All right.

Mr. PECORA. You will recall that I showed you a typewritten copy of a so-called "pro forma balance sheet" of the corporation called "Noxon, Inc.", which was the corporation whose shares were to be acquired by American Commercial Alcohol Corporation on exchange of stock basis.

Mr. ALTSCHUL. Yes, sir.

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[86] Exhibit no. 17, Feb. 15, 1934, Alcohol Pools, pt. 13, p. 5971.
[87] Frank Altschul, supra, p. 5972.
[88] Frank Altschul, supra, pp. 5972–5974.
[89] Frank Altschul, supra, p. 5981.

Mr. PECORA. And you stated that that pro forma balance sheet had never been submitted to your committee in connection with that application.

Mr. ALTSCHUL. That is correct. And I so state again.

Mr. PECORA. Yes; you then stated that, and you so state again.

Mr. ALTSCHUL. Yes, sir.

Mr. PECORA. And you also stated that if that pro forma balance sheet had been brought to the notice of the committee on stock list, that the committee undoubtedly would not have approved the application.

Mr. ALTSCHUL. That is correct.

Mr. PECORA. You say that is correct?

Mr. ALTSCHUL. Yes, sir.

Mr. PECORA. In other words, the statements contained in that pro forma balance sheet would have put the committee on notice, and would have prompted it to make inquiry which would have revealed undoubtedly the facts that were testified to here on yesterday by Mr. Brown within your hearing.

Mr. ALTSCHUL. It would have put us on notice, and have caused us to make inquiry.

Mr. PECORA. And if the inquiry had developed the facts testified to by Mr. Brown, your committee would have undoubtedly rejected or denied the application.

Mr. ALTSCHUL. That is correct.[90]

The meeting of the committee on stock list was held about 3:10 p.m. on July 10, 1933, and concluded at 5:30 p.m. on that day. The balance sheet of Noxon, Inc., bore a stamp reading:

Received, committee on stock list, July 10, 1933, 11:54 a.m.

This pro forma balance sheet was identical with the one which Altschul testified would have impelled the committee on stock list to deny the listing application had it been seen by the committee.[91]

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In the case of General Theatres Equipment, Inc., 1,000,000 shares of the common stock of International Projector Corporation, having a book value of $2.22 a share, were exchanged for 1,999,933 shares of General Theatres Equipment, Inc. The shares of International Projector Corporation, with a total book value of $2,225,616, were taken over by General Theatres Equipment, Inc. at $28.50 a share and were carried on the books of General Theatres Equipment, Inc., at a valuation of $28,500,000—a mark-up of over $26,000,000.[92]

Murray W. Dodge, vice president of Chase Securities Corporation and a director of International Projector Corporation at the time of the exchange, wrote the following letter to Harley L. Clarke:

OCTOBER 14, 1929.

Mr. HARLEY L. CLARKE,
President Utilities Power & Light Corporation,
Chicago, Ill.

DEAR HARLEY: Enclosed is the latest list of members of the stock exchange committee on stock listing. Of course, I could be of assistance to you if Charlie Sargent were here. He is on the board of directors of Chase Securities Corporation and has been very helpful to us in the past. Unfortunately, however, he is abroad. He sails the end of this week and will not be back until the end of next week. We may be able to do something with Ruxton, of Spencer Trask & Co., but I do not like to ask favors of them until we get into a tough position. Frank Altschul, of Lazard Freres, is the one I called up this morning. He will probably be back for next week's meeting, and I think will be friendly and helpful. Gibson, the chairman, is the most important one, but we do not know him very well. He is a hard nut to crack. I

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[90] Frank Altschul, supra, pp. 6007–6008.
[91] Frank Altschul, supra, p. 6014.
[92] Harley L. Clarke, Nov. 10, 1933, Chase Securities Corporation, pt. 6, p. 3201.

am always fearful in cases like this that we would do more harm than good pressing the matter too hard. I do feel that when the right time comes, whether it is a week from today, or 2 weeks from today, after Charlie Sargent is back, that if you appear before them and I go with you we may be able to push the matter over.

Enclosed find also memorandum given me by Tim Edwards. I think this is the one you are working on. If so, do you want me to call Mahoney off, or can we make use of him in some way? This conversation took place while I was out West.

Sincerely yours,

M. W. D.[93]

The application of General Theatres Equipment, Inc., for listing on the New York Stock Exchange was duly approved by the committee on stock list. Although this was an original issue and therefore supposedly subject to rigorous scrutiny by the committee on stock list, Altschul testified that the committee was deceived by the listing application and hence did not discover the enormous mark-up of $26,000,000 when the application was approved.[94]

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Similarly, in connection with the listing of Kreuger & Toll Co. 30-year 5-percent secured sinking-fund gold debentures, the committee on stock list of the New York Stock Exchange claimed to have been deceived.[95] The indenture behind the debentures permitted the withdrawal of pledged securities and the substitution of other securities for those pledged, provided that a ratio of 120 percent was maintained between the par value of the pledged securities and the principal amount of outstanding debentures.[96] The listing application provided that Kreuger & Toll was to notify the stock exchange if deposited collateral were changed or removed, excepting for incidental items which would be reported annually.[97] The committee on stock list was fully cognizant of the provision permitting the substitution of pledged collateral. Altschul admitted that the substitution privilege contained in this indenture was unique and that no American corporation had ever been accorded a similar sweeping privilege to effect substitutions. Yet the committee on stock list did not even consult with counsel regarding this provision. No audited statement of Kreuger & Toll was ever obtained by the committee, and it merely relied upon the reputation of Ivan Kreuger.[98] Ivan Kreuger, subsequent to the listing, effected a series of substitutions and replaced valuable securities with less valuable ones, concerning all of which the New York Stock Exchange remained in ignorance.

(*c*) *Regulation of listing requirements for securities and corporate reports.*—Responsible officials of the leading exchanges have unqualifiedly recognized in public utterances the vital importance of furnishing to the public complete, accurate, and current information regarding the financial condition of corporations with securities listed on the exchanges. The Securities Exchange Act of 1934 sup-

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[93] Committee exhibit no. 150, Nov. 21, 1933, Chase Securities Corporation pt. 7, pp. 3528-3529.
[94] Frank Altschul, Alcohol Pools, pt. 13, p. 6077.
[95] Frank Altschul, Jan. 12, 1933, Kreuger & Toll, pt. 4, p. 1332.
[96] Listing application, Kreuger & Toll, pt. 4, p. 1337.
[97] Listing application, supra, p. 1345.
[98] Frank Altschul, supra, pp. 1354-1356.

plements the Securities Act of 1933, which requires information to be filed only as to the situation existing at the time the security is issued. Under the Securities Exchange Act of 1934, it is made unlawful for a member, broker, or dealer to effect any transaction in any security on a national securities exchange unless a registration is effective as to such security in accordance with the provisions of the act. The security may be registered on a national securities exchange only after the issuer has filed an application with the Securities and Exchange Commission together with such information in such detail as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors.[90] It is anticipated that the information filed by a corporation as a condition precedent to registration will be so complete as to present to the stockholder, or the prospective stockholder, a picture of the corporation's financial condition which will enable him intelligently to evaluate its securities.

The Commission is directed to make a study of trading in unlisted securities upon exchanges and to report the results of its study and its recommendations on or before January 3, 1936, with power, in the meanwhile, to continue until June 1, 1936, unlisted trading privileges to which a security had been admitted on an exchange prior to March 1, 1934.[1]

Corporations with listed securities are required to keep reasonably current the information and documents filed at the time of registration, and are also required to file such annual reports and such quarterly reports as the Commission may require, with power in the Commission to prescribe the forms in which the required information shall be set forth, the items or details to be shown in balance sheets and earnings statements, and other matters reasonably necessary to make available an accurate representation of each corporation's condition as of a recent date.[2]

The reporting provisions of the act will fill a long-felt need by aiding the exchanges to secure proper information for the investor. Careful provision is made against the disclosure of trade secrets and processes.[3] Henceforth it is intended that corporations shall present a truthful face to the world, and that the evasions, suppressions, distortions, exaggerations, and misrepresentations practiced by some corporations with intent to cloak their operations and to present to the investing public a false or misleading appearance as to their financial condition shall be eliminated.

10. Proxies

(*a*) *Abuse of proxies.*—In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings. Too often proxies are solicited without explanation to the stockholder of the real nature of the matters for which authority to cast his vote is sought.

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[90] Securities Exchange Act of 1934, sec. 12 (a), (b), (c).
[1] Securities Exchange Act of 1934, sec. 12 (f).
[2] Securities Exchange Act of 1934, sec. 13.
[3] Securities Exchange Act of 1934, sec. 24.

In the instance of American Commercial Alcohol Corporation, a special meeting of the stockholders was called for July 21, 1933. A printed notice of meeting was sent to the stockholders by the corporation, together with an attached form of proxy and a letter purporting to disclose to the stockholders all the pertinent information regarding the matters which the board proposed to submit to the stockholders for approval.[4] The formal proxy constituted and appointed Russell R. Brown, Richard Grimm, William Kies, and Philip Publicker, or any one or more of them, as attorneys in fact, with full power of substitution. The special meeting called for July 21, 1933, was adjourned to August 1, 1933. When the meeting was held not a single stockholder was present in person. The secretary of the corporation, appeared as a substitute proxy for the persons originally designated, and voted 179,614 shares by proxy to ratify the acts of the officers, directors, and members of the executive committee of the corporation.

The special meeting was called ostensibly to have the stockholders ratify the issuance of the shares of common stock used in connection with the Maister Laboratories, Inc., and Noxon, Inc., deal.[5] and the shares offered directly to stockholders.[6]

The letter to the stockholders failed to disclose the action of the board of directors authorizing the underwriting of the shares of capital stock offered to the stockholders; failed to disclose the secret interest of the chairman of the board and other officers and directors of the corporation in the underwriting agreement; failed to disclose the actual assets or the value of the assets of the Maister Laboratories, Inc., or Noxon, Inc.; failed to disclose that the Maister Laboratories, Inc., and Noxon, Inc., were organized by two dummies of the president of the board; failed to disclose the existence of an option to Thomas E. Bragg for 25,000 shares of capital stock of the corporation at $18 per share; and failed to disclose that the president of the board and other officers and directors of the corporation were secret participants in a pool organized to operate under that option.[7] The letter to the stockholders and the proxy requested the stockholders to ratify the acts of the very officers and directors who were betraying them by participating secretly in the underwriting agreement and pool operation, from which they obtained substantial profits.

Mr. PECORA. Well, now, if you had the same thing to do over again, you would do it precisely the same way that those things were done; is that what you say now?

Mr. BROWN. No. But if financial conditions, or the same conditions, existed, whereby this company was, as at that time, in bad financial shape, we might have to go ahead and use unusual and abnormal methods. But under ordinary conditions I should not do that; no, sir.

Mr. PECORA. Well, why, when you sought approval subsequently by the stockholders of the company of those acts and transactions, didn't you give the stockholders full knowledge of what those acts and transactions were, so that they might give their approval in an intelligent manner, with full knowledge of the actual facts?

Mr. BROWN. I assume that should be done.

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[4] The notice appears in pt. 14, p. 6207; the letter in pt. 14, pp. 6212–6213.
[5] Described on pp. 59 to 62 of this report.
[6] Russell R. Brown, Feb. 21, 1934, pt. 14, pp. 6209–6211.
[7] Russell R. Brown, supra, p. 6214.

Mr. PECORA. What did you say?
Mr. BROWN. I assume that should be done.
Mr. PECORA. You assumed that that was done?
Mr. BROWN. I say, I assume that should be done.
Mr. PECORA. Then why wasn't it done?
Mr. BROWN. I don't know.
Mr. PECORA. Who prepared that printed letter to stockholders I last read into the record?
Mr. BROWN. I think Mr. Grimm and I did.
Mr. PECORA. Well, then, there was nothing to have prevented you in the preparation of that letter from disclosing full information to the stockholders.
Mr. BROWN. No, sir.[8]

(*b*) *Proxies on shares in brokers' names.*—Another problem with reference to proxies is presented by the situation where shares of stock are carried in brokers' or "street" names. Particularly in the case of nondividend paying stocks, customers do not ordinarily effectuate transfers of ownership upon the books of corporations in order to save transfer taxes, but permit stock to remain in the names of brokers.

By means of a questionnaire addressed to various corporations, statistics were obtained by the subcommittee indicating that a substantial portion of the total outstanding shares of those corporations is held in brokers' or "street" names. In the absence of any regulation on the subject, the broker, and not the customer who is the beneficial owner of the stock, can and does grant proxies on the stock. Through the use of such proxies, brokers may exert material influence upon the management of corporations without any personal investment in the stock.

As of July 1, 1929, 3,563,502 shares of the Consolidated Oil Corporation out of 5,468,008 shares outstanding, or 65.27 percent, were in brokers' names; 2,859,148 shares of Chrysler Corporation out of 4,431,465 shares outstanding, or 64.52 percent, were in brokers' names; 102,263 shares of Auburn Motor out of 169,686 shares outstanding, or 60.27 percent, were in brokers' names; 1,380,273 shares of Pan-American Petroleum out of 2,360,740 shares outstanding, or 58.47 percent, were in brokers' names; and 1,029,969 shares of Radio-Keith-Orpheum out of 1,930,032 shares outstanding, or 53.37 percent, were in brokers' names. In the case of 15 out of 43 corporations studied for 1929, more than 25 percent of the outstanding shares were in brokers' names.[9]

As of July 1, 1933, 1,668,275 shares of Chrysler Corporation out of 4,305,200 shares outstanding, or 38.75 percent, were in brokers' names; 361,352 shares of Celanese Corporation out of 987,800 shares outstanding, or 36.58 percent, were in brokers' names; 1,668,286 shares of Montgomery Ward & Co. out of 4,467,240 shares outstanding, or 37.34 percent, were in brokers' names. In the case of 8 out of 23 corporations studied for 1933, more than 25 percent of the outstanding shares were in brokers' names.[10]

(*c*) *Regulation of the use of proxies.*—By the Securities Exchange Act of 1934 it is made unlawful for any person to solicit, or to permit the use of his name to solicit, any proxy or consent or authorization in respect of a registered security in contravention of the rules and regulations of the Commission.[11] It is also made unlawful for any

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[8] Russell R. Brown, supra, p. 6215.
[9] Pt. 17, p. 7942.
[10] Pt. 17, p. 7941.
[11] Securities Exchange Act of 1934, sec. 14 (a).

member of a national securities exchange, or any broker or dealer who transacts a securities business through such member, to give a proxy, consent, or authorization in respect of any registered security carried for the account of a customer in contravention of the rules and regulations of the Commission.[12]

It is contemplated that the rules and regulations promulgated by the Commission will protect investors from promiscuous solicitation of their proxies, on the one hand, by irresponsible outsiders seeking to wrest control of a corporation away from honest and conscientious corporation officials; and, on the other hand, by unscrupulous corporate officials seeking to retain control of the management by concealing and distorting facts. The rules and regulations will also render it impossible for brokers having no beneficial interest in a security to usurp the franchise power of their customers and thereby deprive the latter of their voice in the control of the corporations in which they hold securities.

11. The Government of the Exchanges

Although it has long been evident that market conditions intimately affect the welfare of millions of persons, organized exchanges have hitherto been subject to regulation by no governmental authority and have exercised unrestricted dominion over the activities of their members.

Mr. Pecora. The stock exchange, as now constituted, is subject to no official regulatory power, is it?

Mr. Whitney. Well, it is not an incorporated company, if that is what you mean.

Mr. Pecora. No. You know of no public agency that exercises any regulatory power over it, do you?

Mr. Whitney. I know of none that has been exercised; yes.

Mr. Pecora. You know of none that has the power of exercising regulation over its affairs, do you?

Mr. Whitney. I will grant that there is none, Mr. Pecora. From a legal point of view I perhaps do not follow you, but I will grant it.

* * * * * * *

Mr. Pecora. As it now stands, the stock exchange has absolute autocratic power over the discipline of its members?

Mr. Whitney. Yes, sir.

Mr. Pecora. And over the conduct of members on its floor?

Mr. Whitney. By its members; yes, sir.[13]

(*a*) *Self-regulation and public relations activities.*—A brief survey of the largest exchange in the United States may be useful in arriving at an estimate of the type of self-regulation practiced by the exchanges.

The New York Stock Exchange is an unincorporated association organized in 1791.[14] Prior to February 7, 1929, the authorized membership was 1,100; as of that date the membership was increased to 1,375, each member receiving the right to one-quarter of one new membership.[15]

The government of the exchange is vested in the governing committee consisting of 40 members and the president and treasurer

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[12] Securities Exchange Act of 1934, sec. 14 (b).
[13] Richard Whitney, Mar. 1, 1933, National City, pt. 6, p. 2228.
[14] Richard Whitney, Mar. 1, 1933, National City, pt. 6, pp. 2203, 2206.
[15] Committee exhibit no. 113, Feb. 26, 1934, pt. 15, p. 7288.

of the exchange.[16] The elected members of the governing committee are divided into 4 classes, each consisting of 10 members, 1 of which classes is elected each year to serve 4 years. The governing committee has all powers necessary for the government of the exchange, the regulation of the business conduct of its members, and the promotion of its welfare, objects, and purposes. It also has power to appoint and dissolve all standing and other committees except the nominating committee; to define, alter, and regulate their jurisdiction; to discipline the members of the exchange; and to control its property and finances.[17]

There are various standing committees, the more prominent of these being the committee on business conduct, the committee on stock list, the committee on admissions, the committee on arrangements, the committee on publicity, the law committee, and the committee on arbitration. The committee on business conduct is the principal disciplinary agency of the exchange and investigates all cases of alleged improper transactions except those which fall within the jurisdiction of some other standing committee, such as the committee on odd lots and specialists or the committee on arrangements. The business conduct committee has the power to censure the delinquent member or prefer charges against him before the governing committee.[18]

Complaints by customers against members are usually submitted in writing. The business conduct committee either calls upon the member complained of to furnish it with an answer to the charges or makes an independent investigation. Personal appearances by complainants are infrequent and are permitted only in important cases. The complainant is entitled to professional counsel only with the consent and permission of the committee. The number of complaints considered by the committee on business conduct affecting customers' accounts or involving allegedly improper transactions by members follows:

1929	3,551
1930	1,866
1931	992
1932	903
1933	1,745

The majority of such complaints dealt with the execution of orders and the management and conduct of customers' accounts.

The business conduct committee expresses no opinion in cases which involve an irreconciliable conflict of evidence on material points and does not undertake to pass upon claims which involve complicated legal questions. Nor does it undertake to settle claims between members and nonmembers, since such claims are within the jurisdiction of the committee on arbitration.[19]

The arbitration committee consists of nine members. It has jurisdiction of any claim or matter of difference between members and customers. The decision of the committee is final unless an appeal be taken by a member of the committee, or the case involves

[16] Constitution of the New York Stock Exchange, art. III.
[17] Constitution of the New York Stock Exchange, art. IV.
[18] Constitution of the New York Stock Exchange, art. X, sec. 1.
[19] For a list of the disciplinary actions taken by the governing committee and various other committees of the New York Stock Exchange against member firms and individual members of the New York Stock Exchange from Jan. 1, 1920, to Sept. 1, 1933, the charges and the penalties imposed, see pt. 15, pp. 7345 to 7354.

the sum of $2,500 or over, and one of the parties appeals within 10 days to the governing committee. The arbitration committee, before hearing any claim or matter of difference, may require the party at whose instance the same is brought to make such deposit or furnish such other security for the costs of the proceeding as it may deem proper, and may, in its decision, determine how such costs shall be borne.[20]

Ordinarily in arbitration outside the exchange, the claimant and the respondent each have the right to select an arbitrator, who in turn select a third; but under the constitution of the New York Stock Exchange, the differences must be arbitrated before the nine members of the arbitration committee, who are all members of the governing committee of the exchange.

The costs in an arbitration outside the exchange are negligible, but in arbitrations on the New York Stock Exchange deposits are required, and the costs are substantial. For example, in the arbitration of *Henry Buisson* v. *Hardy & Co.*, the claimant was compelled to pay in advance of the hearings the sum of $800 costs and $91.75 for stenographers' fees. The claim involved approximately $30,000, and a verdict was rendered in favor of the broker firm.[21]

In 1933, 11 disputes between customers and members were arbitrated. The customer claimants were successful in two arbitrations which involved $327.50 and $100, respectively. In the other nine instances verdicts were rendered in favor of the members, and the amounts involved were $73,000, $15,000, $8,636.53, $4,600, and several lesser amounts, making a total of $104,155. The costs taxed against claimant customers ranged from a maximum of $600 costs and $88.50 stenographers' fees to a minimum of $100 costs.[22]

In 1932, 10 disputes between customers and members were arbitrated. Only one customer was successful, the dispute involving $3,458.59. The other nine claims, in which the members were successful, involved $30,000, $29,400, $13,005.82, $9,863.70, $8,400, $4,000, $1,784.34, and some lesser amounts, making a total of $70,953.86. Costs against the customers ranged from a maximum of $800 costs and $91.75 stenographers' fees, to a minimum of $100 costs.[23]

In 1931, 6 disputes involving nonmember customers and members were arbitrated, the members being successful in 4 proceedings and the customers partially successful in 1 proceeding and wholly successful in another.[24]

In 1930 there were 10 disputes arbitrated by the committee. In 4 cases the customers were successful, and in 4 cases partially successful.[25]

In 1929 there were 6 disputes arbitrated by the committee. Three decisions were rendered in favor of the members, and 2 decisions and 1 partial decision in favor of the claimants.[26]

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The committee on publicity is composed of five members appointed by the governing committee. It is charged with the duty, under the

[20] Constitution of the New York Stock Exchange, art. X, sec. 1.
[21] Pt. 17, p. 7957.
[22] Pt. 17, p. 7956.
[23] Pt. 17, p. 7957.
[24] Pt. 17, p. 7957–7958.
[25] Pt. 17, p. 7959–7960.
[26] Pt. 17, p. 7960.

direction of the president, "to keep the public correctly informed concerning matters of public interest having to do with the exchange." [27]

For the year 1933, up to October 1, 55,000 copies of the speeches of the president of the New York Stock Exchange were distributed; during 1932, 260,000 copies of 6 speeches by him were distributed; during 1931, 2,250,000 copies of 12 speeches by him were distributed; during 1930, 790,000 copies of 13 speeches by him were distributed; and during 1929, 466,000 copies of 11 speeches by him were distributed.[28]

In addition, the New York Stock Exchange distributed gratis many copies of two books, The Work of the Stock Exchange and Short Selling, written by Edward Meeker, economist of the New York Stock Exchange.[29] There were distributed without charge to public libraries, college libaries, economics faculties of colleges, newspapers, magazines, public officials, etc., approximately 5,000 copies of The Work of the Stock Exchange and approximately 1,500 copies of Short Selling.[30]

From January 1, 1929, to September 1, 1933, the New York Stock Exchange distributed 3,830,150 pamphlets and books, as compared with 1,507,204 pamphlets distributed by all other organized exchanges.[31]

The number of persons employed by the New York Stock Exchange in public relations work, including the committee on publicity and the department of economist, was 24 in 1929, 30 in 1930, 24 in 1931, 24 in 1932, and 26 in 1933. The other exchanges combined employed in public relations work 19 persons in 1929, 23 in 1930, 23 in 1931, 20 in 1932, and 22 in 1933. Approximately 20 exchanges employed no persons in public relations work.[32]

	1929	1930	1931	1932	Sept. 1, 1933
New York Stock Exchange [1]	$174,846.11	$243,964.91	$284,863.94	$206,439.25	$92,970.51
Other exchanges	160,608.43	222,551.07	132,391.78	85,344.66	72,334.50
Total [2]	335,454.54	466,515.98	417,255.72	291,783.91	165,305.01

[1] Includes expenditures by committee on publicity and department of economist.
[2] Pt. 17, p. 7853.

From 1929 to September 1, 1933, the New York Stock Exchange expended $1,003,084.72 in public relations work,[33] as compared with $673,230.44 expended by all other exchanges during the same period.

(*b*) *Necessity for regulation under the Securities Exchange Act of 1934.*—For many years stock exchanges resisted proposals for their regulation by any governmental authority on the ground that they were capable of regulating themselves sufficiently to afford protection

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[27] Constitution of the New York Stock Exchange, art. X, sec. 1.
[28] George U. Harris, Feb. 23, 1934, pt. 14, pp. 6350–6355, 6394. For a complete list of the titles of the president's addresses together with a statement of the number of copies of each purchased and distributed by the exchange, see committee exhibit no. 113, Feb. 26, 1934, pt. 15, pp. 7290–7292.
[29] George U. Harris, supra, p. 6352.
[30] Committee exhibit no. 113, Feb. 26, 1934, pt. 15, p. 7293.
[31] Pt. 17, p. 7853.
[32] Pt. 17, p. 7853.
[33] George U. Harris, Alcohol Pools, pt. 14, p. 6355.

to investors. From time to time, and especially during periods of popular agitation or when legislative action was threatened, the exchanges have taken steps to raise the standards for the conduct of business by their members. Such steps, however, far from precluding the necessity for legislative action, emphasized its need.

The view that internal regulation obviated the need for governmental control was unsound for several reasons. In the first place, the interests of exchanges and their members frequently conflicted with the public interest. Thus, it was amply demonstrated before the subcommittee that some of the methods employed by stock-exchange members to stimulate active trading were technically in conformity with stock-exchange rules and yet worked incalculable harm to the public. Second, the securities exchanges have broadened the scope of their activities to the point where they are no longer isolated institutions but have become so important an element in the credit structure that their regulation, to be effective, must be integrated with the protection of our entire financial system. Third, stock-exchange authorities have taken the position that they would regulate only their own members and that they had no power to prevent abuses by operators who were not members of the exchanges, but who used their facilities to impose upon the public. Fourth, the attitude of exchange authorities toward the nature and scope of the regulation required was sharply at variance with the modern conception of the extent to which the public welfare must be guarded in financial matters.

During the speculative orgy of 1928 and 1929, stock-exchange authorities made no adequate effort to curb activities on their exchanges. On the contrary, they conceived it as no part of their function to discourage excessive speculation or to warn the public that security values were unduly inflated.[84]

Clearly, any conception of regulation of the securities markets which ignores the prime necessity for restricting excessive speculation is fundamentally defective. The exposures before the subcommittee of the evils and abuses which flourished on the exchanges, and their disastrous effects upon the entire Nation, finally compelled the conclusion, even among partisan advocates of the exchanges themselves, that Federal regulation was necessary and desirable. This phase of the investigation culminated in the passage of the Securities Exchange Act of 1934.

The purpose of the act is identical with that of every honest broker, dealer, and corporate executive in the country, viz., to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control. The act strikes deeply not only at defects in the machinery of the exchanges but at causes of disastrous speculation in the past. It seeks to eradicate fundamental and far-reaching abuses which contain within themselves the virus for destroying the securities exchanges.

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[84] Richard Whitney, Feb. 28, 1933, National City, pt. 6, pp. 2233–2234.

CHAPTER II. INVESTMENT BANKING PRACTICES

1. Nature and Growth of Investment Banking

Out of the multitudinous changes in the economic situation of this country during the past two decades a technique of investment banking has emerged involving practices of grave significance. Prior to the World War the United States was a debtor nation, a period during which considerable amounts of capital had been raised through the flotation and sale of American securities in foreign countries. With the transformation in the status of the Nation from debtor to creditor, a perceptible change occurred in the method of raising capital. Not only were the funds necessary for domestic purposes raised at home, but to a more and more substantial extent foreign industry and foreign governments sought financing through the flotation and sale of securities in this country.

The practice (in some measure an outgrowth of the methods of financing employed by the Government during the World War) of selling bonds directly to small investors contributed to the development of a machinery of distribution which while raising vast sums for domestic and foreign borrowers, has passed on to the American people an inordinate volume of indebtedness.

(*a*) *Relationship of investment banker to borrower and to investing public.*—The investment banker is the intermediary between the borrowing corporation or government and the investing public. His principal activities are in connection with the initial flotation of securities and their primary distribution. Organized securities exchanges furnish a market for the secondary distribution of securities after the investment banker has succeeded in distributing them to the public. As a condition precedent to the listing of a security, organized exchanges generally require that there be a substantial initial or primary distribution of the security among the public.[1]

In relation to the borrower, the investment banker assumes a role which is charged with heavier responsibilities than that of a mere purchaser of the securities for resale to the investing public. The investment banker performs the functions of a financial advisor to the borrowing corporation, determining many important questions such as the kind of security to be issued—mortgage bond, convertible bond, debenture, preferred or common stock—the time of issuance of the security, and the price of the security to the public.[2] The relationship between the investment banker and the borrowing corporation is of a semi-permanent character. Once established, it generally is respected by other investment bankers.

In relation to the investing public, the investment banker likewise takes a position more intimate than that of an ordinary seller.

Organized exchanges refuse to assume any responsibility with respect to the intrinsic value of securities listed and traded in on the exchange.

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[1] E. Burd Grubb, Mar. 8, 1934, pt. 15, p. 7008.
[2] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 960.

On the other hand, the investment banker sponsors the issue. He is the person best qualified to appraise the value of a security by virtue of his superior facilities and resources for testing its soundness. Since the association of the name of a large banking house with an issue is generally a potent factor in inducing the public to participate, it is equitable that some measure of responsibility should be imposed upon such banking house to exercise reasonable diligence in ascertaining the value of the security or the truth of statements made in relation thereto. In bringing out an issue the banker enters upon a quasi-fiduciary relation with the investing public which should survive the distribution of the security and should endure as long as the security is outstanding. This view was expressed by J. P. Morgan, head of the largest private banking house in the world.

Mr. MORGAN. * * * If he (the banker) makes a public sale and puts his own name at the foot of the prospectus he has a continuing obligation of the strongest kind to see, so far as he can, that nothing is done which will interfere with the full carrying out by the obligor of the contract with the holder of the security * * *.[3]

The investment banker should be a disinterested intermediary between the issuing corporation and the investing public. As the American system now operates, it is difficult for the investment banker to attain this requisite disinterested viewpoint.

The investment banker recognizes no distinction between the interests of the investor and those of the issuer.

Mr. PECORA. The banker, you feel, is justified in having some regard for his own interests, do you not?

Mr. KAHN. Yes; I do.

Mr. PECORA. And you feel that the circumstances warrant his giving some special consideration to the peculiar interests of the client, which is the railroad corporation, do you not?

Mr. KAHN. I am afraid in this general sense I cannot vary my answers that I believe the interests of the public and of the railroad corporation, of the buyer and of the seller, are precisely identical.

Mr. PECORA. Well, is it not to the interest of the railroad corporation to get as big a price for its bonds as it can?

Mr. KAHN. In my judgment, no. I think it is to the interest of the railroads to build up a regular investment clientele through the bankers, which investment clientele feels that they are being fairly dealt with by the railroad, and if the railroad in any one particular instance attempts to gouge the public and gets more out of it than its securities are worth, in my opinion, it is a very short-sighted policy.

Mr. PECORA. Do you not recognize that there is a distinction between the interests of the investor who buys the bond and the interests of the issuer who sells them?

Mr. KAHN. In my opinion, they ought to be, and by any enlightened conception of the matter they are identical.

Mr. PECORA. You recognize no distinction between them?

Mr. KAHN. I do not; no. I think they are identical interests. The one wants to offer at a fair price and the other wants to buy at a fair price. And if either of them is unfair it reacts against him ultimately.

The CHAIRMAN. You cannot usually get both sides to see that, can you?

Mr. KAHN. Well, we have been fairly successful, Senator, in persuading our clients equally to the effect which I have just tried to express to Mr. Pecora. We frequently argue that very point. We have not always succeeded, but we are always endeavoring to succeed.

Mr. PECORA. In the general method by which bankers bring out issues for railroad corporations and sell them to the public, the price at which the bonds are purchased by the banker is one that is determined in negotiations between the banker and his client, the railroad corporation, is it not?

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[3] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, pp. 4–5.

Mr. KAHN. Between himself and his client, the railroad corporation; yes.

Mr. PECORA. Yes. The investor has nothing to do with those negotiations and has no participation therein, has he?

Mr. KAHN. The investor directly, no; except to the extent that he looks to the banker to have a decent regard for his interests.[4]

In contradistinction to those generalizations, the record contains many specific instances of unfair dealing on the part of investment bankers. In the case of projects with no prospect of recurrent financing the incentive for fair dealing with the client corporation was generally absent, and the bankers readily forfeited the good will of the corporation where essential to swell their profits. Likewise, where bankers underwrote issues only sporadically, considerations of profit were paramount to those of building up good will.

So far as the investor was concerned, the banker frequently did not "have a decent regard for his interests." A glaring instance was the flotation of $90,000,000 bonds of the Republic of Peru sold to the American public in 1927–28 and now in default. The American bankers completely subrogated the interests of the investor to their own interests and to those of their client, Peru. It was admitted by officials of the National City Co., one of the sponsors of the issues, that investors were invited to lend $90,000,000 upon the most precarious of risks, in order to assist Peru in extricating herself from a state of economic and political chaos.

Mr. PECORA. And that all means, does it not, that there were flotations of these loans in 1927 and 1928 and the investing public in America was asked something like $90,000,000 for those bonds in order to restore some sort of order out of the economic and political chaos that, to your knowledge, had existed in Peru for many years prior to 1927? Does it not simmer down to that, Mr. Schoepperle? Is not that a true statement?

Mr. SCHOEPPERLE. I feel that that conclusion is impressed with an interpretation which at the time and under the then existing circumstances I would not have accepted. Under the conditions which exist today I feel bound to accept it.

Mr. PECORA. The conditions which exist today bear out the opinion that you had expressed for years prior to 1927——[5]

In cases where the issuing corporation had created an investment subsidiary which performed the function of the investment banker, the investor was stripped of the protection he had a right to expect from the intermediary. Although conceivable that the reputable investment banker may endeavor to fulfill his obligation to both, it is too much to expect impartiality and disinterestedness when the investment banker and the issuing corporation are one.

(b) *Tendency toward monopoly*—(1) *Absence of competitive bidding for corporate and foreign government financing*.—It is customary in this country for investment bankers to refrain from actively soliciting business from corporations which are currently represented by other investment bankers. Once a banking firm has established itself as the financial adviser of a corporation, it continues to perform that function to the exclusion of others, unless the corporation discontinues the relationship.

Senator BARKLEY. Is there not a very well developed code of ethics among bankers that one banker will not try to take business away from another banker?

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[4] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1237–1238.

[5] Victor Schoepperle, Feb. 27, 1933, National City, pt. 6, p. 2114. For a full discussion of the Peruvian loans see the subsection entitled "Bond Issues of the Republic of Peru", infra, this chapter.

Mr. KAHN. I think it is a well-recognized code of ethics, and it is getting better through the country.

* * * * * * *

Mr. PECORA. Would you say fairly, Mr. Kahn, that in the banking profession a system or code of ethics exists among the well-recognized bankers, bankers of reputation, in pursuance of which there is no competition among them for the business of a corporation which has had financing previously done for it by some banker?

Mr. KAHN. As far as we are concerned, that is correct. As far as our firm is concerned, that is correct.[6]

In the marketing of foreign government securities, a tendency toward monopoly likewise exists. N. M. Rothschild & Sons, London bankers, were the principal bankers for the Government of Brazil from 1825 to 1921.[7] It was a common practice for investment bankers floating an issue on behalf of a foreign government to obtain an option for at least 6 months or a year on future financing. In the instance of the flotation of $10,000,000 bonds of the city of Rio de Janeiro in 1919, the investment bankers were granted an irrevocable option by the city on all future financing.[8]

The custom among investment bankers of respecting the "good will" which another firm has established with a particular corporation practically eliminates competitive bidding for the investment banking business of that client.

The compensation of the investment banker and the price of the security are determined by negotiations between the borrower and the investment banker. The banker's compensation or "spread" is the difference between the price paid by him to the issuer and the selling price to the investing public. It is dependent upon the risk, effort, and responsibility involved, the difficulty in marketing the security, the size of the issue, and the prevailing market conditions.[9] The marketability of the security in turn, depends upon whether it is purchasable by savings banks and insurance companies, and whether it is attractive to prudent investors.[10]

In recent years the bulk of all railroad financing in the United States has been done by Kuhn, Loeb & Co. and by J. P. Morgan & Co. From 1927 to 1931, inclusive, Kuhn, Loeb & Co. originated 54 issues of railroad bonds in the aggregate sum of $1,137,429,000 and brought out 632,425 shares of railroad stock.[11] J. P. Morgan & Co. and Drexel & Co. during the same period originated $732,105,003 of railroad securities.[12]

Although the financing of industrial and public utility corporations was mode widely distributed, the major portion of this business has been concentrated among a relatively small group of investment banking houses and the investment affiliates of several large commercial banks.[13]

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[6] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 968–969.
[7] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt 4, p. 1051.
[8] Robert O. Hayward, Oct. 11, 1933, Dillon, Read & Co., pt. 4, p. 1892.
[9] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 962.
[10] Otto H. Kahn, supra, p. 964.
[11] Committee exhibit no. 33, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1380.
[12] Committee exhibit no. 15, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 227, et seq.
[13] A complete, itemized list of all issues of stocks and bonds originated, underwritten, or participated in by Kuhn, Loeb & Co. from 1927 to 1931, inclusive, is contained in committee exhibits nos. 30, 31, 32, 33, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1360–91.

A complete, itemized list of all issues of stocks and bonds originated, underwritten, or participated in by J. P. Morgan & Co. and Drexel & Co. from 1927 to 1931, inclusive, is contained in committee exhibit no. 15, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 228–269.

A complete, itemized list of all issues of stocks and bonds originated, underwritten, or participated in by Dillon, Read & Co. from 1927 to 1931, inclusive, is contained in committee exhibits nos. 38 and 39, Oct. 13, 1933, Dillon, Read & Co., pt. 4, pp. 2170–2223.

(2) *Competitive bidding.*—Competitive bidding among investment bankers in this country is confined almost exclusively to Government, State, and municipal securities and to equipment-trust certificates.[14]

Investment bankers urge that competitive bidding deprives the corporation of valuable financial advice and continuity of service on the part of the investment banking firm most familiar with the background of the corporation.[15] In this connection it is well to observe that competitive bidding has a tendency to reduce the bankers' "spread."

In the case of equipment-trust certificates, which since 1925 have been the subject of competitive bidding under the rules of the Interstate Commerce Commission, the "spread" was reduced from $1.91 per $100 unit in 1920 to 43 cents in 1931.[16]

(c) *Speculation and the investment banker.*—The investment banker dealt primarily in bonds and preferred stock. Such securities, unlike common stock, were not designed for speculative purposes. They were intended purely for investment and were floated to attract persons of average means, with small surplus capital, who did not seek speculative ventures, but were desirous of investing in industries and governments offering definite assurances of safety. In an article entitled "Who Buys Foreign Bonds?" the late Senator Dwight W. Morrow, formerly a member of J. P. Morgan & Co., wrote:

> Who buys foreign bonds? This may seem to be an easy question to answer, but it is not. When a foreign loan is offered to American investors, the managing house in New York, or Boston, or Chicago enlists the cooperation of perhaps five hundred or a thousand investment bankers scattered all over the United States. It is the function of the local investment banker to find the man or woman with savings and to show that man that it is to his interest to exchange his savings for the promise of a foreign government. It is this ultimate saver who really extends the credit to the foreign government. * * *[17]

After analyzing the distribution of five foreign bond issues, Senator Morrow continued:

> * * * it would seem reasonable to draw the conclusion from the statistics presented, that more than 85 percent of the people who bought these foreign bonds purchased them in small amounts ranging from $100 to $5,000, and that approximately 50 percent of the total amount of these foreign issues was purchased by these small investors.
>
> The investment in these foreign loans represents the savings of the person who spends less than he produces, and thus creates a fund which he is able to turn over either to a domestic or to a foreign borrower if he is satisfied with that borrower's promise. These savers live all over the United States. When we talk about the person who is investing in foreign bonds we are not talking about a great institution in New York or Chicago, or Boston. We are talking about thousands of people living in all parts of the United States. We are talking about school teachers and Army officers and country doctors and stenographers and clerks. The man who invests in a foreign bond may be rich or he may be poor. That is all according to our standard. Fundamentally, however, he is a person who has saved something, who is doing without something today in order that he or his children may have something tomorrow.

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[14] Committee exhibit no. 1, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1038.

[15] An analysis by investment bankers of the present American underwriting method is contained in committee exhibits nos. 1 and 2, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1034–1080.

[16] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 997–998.

[17] Reprinted from Foreign Affairs, an American Quarterly Review, in record of hearings before the Senate Committee on Finance, Dec. 21, 1931, pt. 1, p. 151.

Before he invests in the bond he has money which gives him a present command over goods and services. He is willing to transfer this present command over goods and services to the borrower, thereby giving to the borrower the right to buy goods and services. Of course, the investor resumes the command of goods and services at some future time when he is repaid his loan.[18]

The article then points out that the investor in foreign bonds is probably the same person as the investor in domestic bonds.

The person who invests in foreign bonds is probably the same person who invests in domestic bonds. All that the investment banker in a large city or in a small city does, all that an international banker does, is to gather up little rivulets of savings and put them at the disposition of somebody who needs the capital and is willing to make a dependable promise to pay interest upon that borrowed capital from time to time and to repay the principal at the due date. The answer to the question about who buys foreign bonds is clear. The purchasers are people all over the United States who are investing their savings. If the investment in these bonds is helping American foreign trade, it is this saver of money who should be thanked. If the investment in these bonds is helping the restoration of the rest of the world to a normal condition, it is this saver of money who is entitled to the credit.[19]

The investment banker was fully conscious that the prime consideration of that section of the public which invested in bonds was safety of the principal.

The considerations in the minds of most investors are, first, the safety of the principal and, second, the size of the interest yield. It should be borne in mind that the investor is the man who has done without something. He has done without something that he might have presently enjoyed in order that, in the future, his family may have some protection when he is gone, or in order, perhaps, that a son or a daughter may go to college. This investor wants to be certain that he will continue to receive income on the bond which he buys. He wants that income as large as is consistent with safety. Above all, he wants the principal returned to him on the day of the maturity of the bond.[20]

The investor, perforce, relies upon the judgment, the prudence, and the honesty of the banker who offers the bonds.

If that be true, how is the investor to form an intelligent judgment as to the safety of his investment? How does the man in the Middle West, who responds to an invitation from his investment banker to buy an Austrian or a Japanese bond, know that his investment is safe? If he should be asked this question, I think that he would put in the very forefront of his reasons for making the investment the fact that he had confidence in the banker who offered him the investment. After all, the people who buy bonds must rely largely upon the judgment of the offering houses. They must believe that their investment banker would not offer them the bonds unless the banker believed them to be safe. This throws a heavy responsibility upon the banker. He may and does make mistakes. There is no way that he can avoid making mistakes because he is human and because in this world things are only relatively secure. There is no such thing as absolute security. But while the banker may make mistakes, he must never make the mistake of offering investments to his clients which he does not believe to be good. Moreover, when a banker directs savings into an investment he should believe that the borrowed money is to be put to a constructive use. To the cynic that may sound somewhat idealistic. It is, however, just plain common sense. No banker who wants to stay in business throughout the years wants to lend money to people who are not going to use it for a constructive purpose. The use to which the money is put is a very important factor in determining the ability of the borrower to pay his interest promptly and to return, at maturity, the principal.[21]

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[18] Ibid., p. 24.
[19] Ibid.
[20] Ibid.
[21] Ibid., pp. 154–155.

Despite the grave responsibility which his fiduciary position imposed upon him, the investment banker took no steps to curb the speculative fervor which swept over the investors in his field from 1926 to 1929. On the contrary, he was content to float new issues as long as the investing public was willing and able to absorb them, regardless of the inevitable consequences.

Mr. PECORA. * * * Now, like most manias, you found that mania an unhealthy one, didn't you, for the common good—it proved to be so?

Mr. KAHN. It proved to be so, and some of us were in before the event too early, and some of us were in after the event——

Mr. PECORA. But too late?

Mr. KAHN. But too late. And some of us reached the conclusion, let us say March, to give you an arbitrary date, that things could not go on, and then we were persuaded by the course of events that the thing could go on and did go on, and then we were in a position of the twelfth juryman, who said, "I have never seen 11 such obstinate men", and we thought, well, probably—at least some of us thought—probably we are wrong. Everybody else says, "This thing is going on for a few years longer anyhow. There is no sign of a reaction, and probably we are wrong. We do not want to assume that our judgment is right as against everybody else's." [22]

Robert O. Hayward of Dillon, Read & Co., referring to the flotation of $25,000,000 Brazilian 20-year 8-percent gold bonds on June 1, 1921, testified:

The CHAIRMAN. How long were you disposing of these bonds to the public?

Mr. HAYWARD. My recollection is, Senator, they were sold immediately.

Mr. CHAIRMAN. Within a week or 10 days?

Mr. HAYWARD. Yes; they were practically all disposed of. Those were the days when you did not need bond salesmen. People just stood in line to file applications. That seems like a long time ago now.[23]

From 1926 through 1929 the total volume of new securities offered in this country increased from 7 billions yearly to more than 11½ billions in 1929, or a percentage increase of about 60 percent.[24]

Investment bankers succeeded in selling to the public from 1923 to 1930, inclusive, $6,293,000,000 foreign bonds alone, exclusive of the foreign bond issues which were outstanding in 1923. The total outstanding foreign bonds at the end of 1930 aggregated $7,836,000,000.[25]

The results of the unregulated activities of the investment bankers like those of the unregulated activities on securities exchanges were disastrous. The foreign securities outstanding in the hands of the American public as of March 1, 1934, are estimated at about $7,080,000,000, of which approximately $2,900,000,000 in principal amount are in default. From 1928 to September 1, 1933, there were 985 bond issues in default on all organized exchanges, 324 of which were listed on the New York Stock Exchange.[26]

The colossal loss sustained by the public on bond issues sponsored by investment bankers manifests that these bankers were either incompetent or derelict in the performance of their duties. The record of activities in the investment banking field and of the methods

[22] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1007.

[23] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1967.

[24] Clarence Dillon, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2109.

[25] Charles E. Mitchell, Dec. 18, 1931, hearings before Committee on Finance, pt. 1, pp. 64, 67.

[26] Pt. 17, p. 7853. A detailed, itemized list of the bond issues on the New York Stock Exchange in default, for the period from 1928 to 1933, is contained in the record at pp. 7356–7391 of pt. 15.

by which security issues were originated and sold to the American public, when disclosed at the hearings held by our subcommittee, were so shocking as to place beyond controversy the urgent need for legislation such as the Banking Act of 1933 and the Securities Act of 1933.

2. Functions of the Investment Banker

The functions of the investment banker are primarily: (*a*) To raise capital for industry, (*b*) to effect loans for governments, and (*c*) to effect the transfer of corporate ownership. These functions will be discussed seriatim.

(*a*) *Raising capital for industry.*—The investment banker sells new issues to raise capital either for new industries or for industries already in existence. Prior to the boom of 1928 and 1929, these securities were non-equity in nature, consisting of bonds, mortgage certificates, or preferred stock which constituted liens or fixed charges upon industry. The sale of such securities substantially increased the number of persons who had an interest in the industrial development of the Nation.

Under the influence of the speculative fervor of the last decade, the trend toward nonequity securities was deflected. The raising of capital for industry was accomplished to an increasingly greater extent by the flotation of common stocks, which stimulated the speculative appetite of the public by offering the opportunity to participate in the enhancement of equity values.

In the case of nonequity securities, the investment banker usually purchased the issue and resold it directly to the public.[27] With regard to common stocks, the preemptive right of stockholders to subscribe pro rata to an additional issue sometimes necessitated offering the stock to them before a public offering could be made. In such event, the investment banker usually acted as an underwriter, contractually assuming to purchase all or any part of the issue which the stockholders failed to take.[28]

(1) *Domestic industrial financing.*—During the years 1920 to 1932, inclusive, $55,270,500,000 corporate issues, including refundings, were floated for domestic industry. From 1927 to 1931, inclusive, Kuhn, Loeb & Co. originated 54 issues of railroad bonds aggregating $1,137,429,000, and 14 issues of miscellaneous domestic bonds aggregating $413,073,000, or a combined total of 68 bond issues in the sum of $1,550,502,000. In addition, during 1927, Kuhn, Loeb & Co. originated 1 issue of railroad stock of 632,425 shares, and for the period from 1928 to 1929, inclusive, the same firm originated 4 issues of domestic stock aggregating 4,497,576 shares.[29]

Between January 1, 1919, and May 23, 1933, J. P. Morgan & Co. offered $1,825,639,300 railroad bonds, $1,074,750,000 public utility bonds (including obligations of public utility holding companies),

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[27] For a detailed discussion of the purchase and resale method, see sec. 3, subsec. (a) of this chapter.

[28] For a detailed discussion of the practice of underwriting offerings to stockholders, see sec. 3, subsec. (b) of this chapter.

[29] A detailed list of all stock and bond issues originated or participated in by Kuhn, Loeb & Co., together with the profits of Kuhn, Loeb & Co. on said issues, is contained in committee exhibits no. 30, 31, 32, 33, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1360–1391.

$578,297,900 miscellaneous industrial bonds and preferred stock, and $133,000,000 railroad holding company bonds.[80]

From 1927 to 1931, inclusive, Dillon, Read & Co. offered 12 issues of railroad bonds aggregating $62,456,000, and 16 issues of public utility bonds aggregating $255,620,000, and 22 issues of miscellaneous industrial bonds aggregating $229,890,000. In addition, Dillon, Read & Co. offered 40 issues of domestic stocks aggregating 9,422,288 shares, and 1 issue of public-utility stock aggregating 35,000 shares.[81]

(2) *Foreign industrial financing.*—Not only did the investment bankers raise capital for domestic industries, but they assisted in raising substantial amounts for foreign industrial enterprise by the flotation of both stocks and bonds.

$3,222,448,100 securities of foreign corporations were outstanding as of March 1, 1934, with $1,394,395,300, or approximately 43 percent, in default.[82]

(*b*) *Loans to governments*—(1) *Domestic government financing.*—Domestic loans, involving issues of the United States Government, the several States, municipalities and their political subdivisions are sui generis, in that for the most part such issues are purchased by a relatively few institutions, estates, and individuals who are attracted by their tax-exemption features.

The distinguishing feature of such financing is the fact that competitive bidding for the issue is required.

(2) *Foreign government financing.*—The activities of investment bankers resulted in passing on to the public not only the huge indebtedness of foreign industry, now substantially in default, but also the indebtedness of foreign governments. It has been estimated that as of March 1, 1934, $4,970,789,100 foreign government securities were outstanding, of which $1,536,027,300 were in default in principal amount.[83] These foreign government securities were not limited to national governments, but included states, provinces, departments and municipalities. The securities of these various political subdivisions were sold to the American investing public despite the hazardous nature of the risk involved. Robert O. Hayward of Dillon, Read & Co., testified:

> Mr. Hayward, * * * We adopted, some time after the Rio issue, the same policy which Rothschild of London had previously adopted, and that was to restrict ourselves to the banking operations of the National Government. We felt that in looking ahead over a period of years there might be times when there might be some conflict of interest between the Federal Government and the State and cities, and we felt that we would rather devote ourselves exclusively to the interests of the Federal Government * * *.[84]

A recital of the abuses and derelictions of which investment bankers were guilty in relation to these foreign issues is contained in section 4 subsection (*d*) of this chapter.

(*c*) *Effecting transfer of corporate ownership.*—A special type of investment banking operation during the period from 1925 to

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[80] Statement of George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 223. A detailed list of stock and bond issues originated by J. P. Morgan & Co. and Drexel & Co. from 1927 to 1931, inclusive, is contained in committee exhibit no. 15, J. P. Morgan & Co., pt. 1, pp. 228–250, 256–269.

[81] A detailed list of stock and bond issues originated by Dillon, Read & Co., from 1927 to 1931, inclusive, is contained in committee exhibit no. 48, Oct. 13, 1933, Dillon, Read & Co., pt. 4, pp. 2261–2266.

[82] Institute of International Finance, Bulletin No. 70, May 14, 1934, p. 4.

[83] Ibid.

[84] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1975.

1929 was the merchandising of large blocks of securities closely held by a few individuals, not for the purpose of raising capital, but to transfer the ownership or some part thereof, to the general public. Since such a "sell-out" constituted the first public participation in a theretofore close corporation, the investor did not have the benefit of previously published information or historical data concerning the company, to guide him in his appraisal of the securities offered.

The sale by Dillon, Read & Co. of bonds and preferred stock of Dodge Brothers, Inc., the sale by the same firm of class "A" stock of the National Cash Register Co., and the sale by J. P. Morgan & Co. of stock of Johns-Mansville Corporation, are notable examples of this kind of activity.

Clarence Dillon admitted that the price paid for such companies was more or less arbitrarily fixed by the bankers.

Senator COUZENS. * * * To go back to some of these big corporations which you have purchased and refinanced, how do you go about it to compute the value?

* * * * * * *

Mr. DILLON. We would consider their past record of earnings and their present record of earnings, and our estimate of their future earnings. On a combination of that picture, we would fix a price that we thought was fair.

Senator COUZENS. Then you do not use any percentage, as we use in the Government when we come to arrive at the excess-profits tax.

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Mr. DILLON. No.[85]

A "sell-out" is ordinarily effected after a period of favorable earnings for the corporation and while security prices are high. At such a time there is a temptation to the banker to price the security at a figure momentarily attractive to the purchaser, but which in retrospect did not offer him a favorable investment opportunity.

Clarence Dillon, when interrogated regarding benefits derived by the public from the refinancing of large industrial units by the investment bankers, ascribed to this function a constructive result beyond the mere transfer of ownership.

Mr. DILLON. * * * I think that when a great industry in this country, owned by one man, or by one family, reaches the proportions which some industries have reached it is probably better for the general community if that industry is owned by the public rather than being owned by one man or one family, because too great a responsibility attaches to a very small control.

Mr. PECORA. Do you think that might be attended with unhappy social consequences?

Mr. DILLON. It might be, Mr. Pecora, and, again, if that industry needs additional capital for its expansion and development, it is much easier to get that capital when the ownership is a public ownership. It is on a much sounder basis. I should think, from the social point of view, the labor employed in that industry is on a sounder basis if that great industry is owned by the public rather than by one family. * * *[86]

The wide dissemination among the public of the ownership of corporations has given rise to a new set of problems. While the number of investors has multiplied, the control of industry has become concentrated in the hands of a relatively few persons whose personal stake in the enterprises they control may be exceedingly

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[85] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1548.
[86] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1544–1545.

small. The result is a host of evils which accompany the divorcement of control from ownership.

With ownership scattered among hundreds of thousands of stockholders, it becomes difficult for these stockholders to exercise any effective influence over the management.

Mr. PECORA. * * * Are these not factors that make it extremely difficult, even in the case of widespread dissatisfaction with the management of a corporation, for the unorganized stockholders to oust a small minority that may be in control?

Mr. DILLON. I should think that unless the criticism of the management was something very substantial, the minority stockholders would have a difficult job organizing to oust an existing management.

Mr. PECORA. You mean the majority stockholders?

Mr. DILLON. No; the general public. I should think it would be a difficult task to organize them unless there was something very seriously wrong with the management, because I think investors buying stocks, as a rule, buy it because they are satisfied with the management.

Mr. PECORA. Very often because they know nothing about the management.

Mr. DILLON. That is also true.[37]

3. INVESTMENT BANKING METHODS

The primary distribution of securities by investment bankers may be accomplished: (*a*) By purchasing the issue from the corporation and reselling it either to the public or to a selected group; (*b*) by underwriting an offering to stockholders, that is, by agreeing to purchase any portion of the offering not absorbed by stockholders; (*c*) by offering securities against options. In connection with these methods evidence has been presented to the subcommittee covering practices and conditions which merit consideration.

(*a*) *Purchase and resale of investment security issues by investment bankers.*—The most common method of disposal employed by investment bankers, particularly in the case of bond issues, is to purchase the issue from the corporation and to resell it either directly to the public or to a selected group of purchasers. Such an operation, although frequently characterized as an "underwriting", is not a true underwriting, which involves an agreement to purchase the unsubscribed residue of an issue offered to others.

(1) PUBLIC OFFERINGS

(i) *Syndication.*—The mechanics of syndication ordinarily used by investment bankers in connection with a public offering are sometimes inexplicably complex. First, an original group or syndicate is formed which purchases the entire issue from the corporation. A subsequent larger group assumes the commitment of the original group. It is not unusual for three or four such groups or syndicates to be formed for the purpose of assuming the issue successively. The final group is a selling group or syndicate, composed of investment dealers throughout the country, who effect the ultimate merchandising operation and place the issue in the hands of the investing public. These groups are variously known as "the originating syndicate", "the banking syndicate", "the intermediary syndicate", and "the retail or selling syndicate."[38] As the issue is

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[37] Clarence Dillon, supra, p. 1547.

[38] For tables showing the division of offerings among the various groups, see Committee Exhibit No. 15, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 232–247; Committee Exhibits No. 30, 31, 32, 33, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1361–1391; Committee Exhibit No. 48, Oct. 13, 1933, Dillon, Read & Co., pt. 4, pp. 2201–2277.

passed from one to the other, the price is "stepped up" or increased until the security reaches the public, which pays the maximum price.

Mr. PECORA. In putting out a new issue, Mr. Dillon, how many groups are organized as a rule to effect the distribution to the public of the issue?

Mr. DILLON. That varies. In certain securities that have a well-known market, that sell very readily, you probably form the purchase group and then allow a selling commission on the sale. For securities where the risk is greater or the market not so well established or so certain you form intermediate groups. * * *

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Mr. DILLON. * * * Then you would form what is generally called the banking group. They would take a commitment from the original group. Then you form after that the selling group, which in turn takes the commitment from the banking group. You often give the same men interests in the different groups; not always in the same amounts. If a man has a large financial responsibility but does not use as many bonds in the ultimate distribution you might give him a larger interest in the banking group than you give him in the selling group, and if it is the other way you sometimes give him a larger interest in the selling group than you give him in the banking group.

Mr. PECORA. Is it usual in such operations for the banking house which organizes the original terms group to also have an interest in the subsequent groups between themselves and the purchasing public?

Mr. DILLON. Yes; they practically always have. The originating house would have an interest in the originating group and the banking group and the selling group.

Mr. PECORA. Yes; so that the originating house participates in the commissions derived by each group in the process of selling to the general public?

Mr. DILLON. By performing service in each group.

Mr. PECORA. They act virtually as managers of the various groups, do they not?

Mr. DILLON. They usually act as the managers of the various groups.

Mr. PECORA. Yes. Now, in passing the issue on from group to group the price is stepped up, is it not?

Mr. DILLON. Yes.

Mr. PECORA. And when it finally reaches the investing public they pay the highest price?

Mr. DILLON. That is correct.[39]

In the flotation of $20,000,000 Mortgage Bank of Chile guaranteed sinking-fund 6½-percent gold bonds of 1925, Kuhn, Loeb & Co. and the Guaranty Co. were the original contractors who purchased the bonds from the Mortgage Bank of Chile. The contract of purchase was executed June 25, 1925, and a participation on original terms was granted to Lehman Bros. On the same day steps were taken to form a "banking" group, to share the risk of the original contractors. The banking syndicate was organized shortly thereafter. No money was paid by this syndicate to the original group, the participants merely assuming the risk to the extent of their participation. Simultaneously, with the solicitation of participants for the "banking" group, letters were sent to a great many dealers inviting them to join a "selling" group which would market the bonds to the public. The selling group neither purchased the bonds nor assumed any risk, but merely undertook to sell the bonds to the public, receiving a fixed commission for each bond sold. Within 24 hours after the original syndicate had purchased the bonds the selling group had obtained sufficient subscriptions to absorb the entire issue.[40]

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[39] Clarence Dillon, Oct. 4, 1933, Dillon, Read & Co., pt. 4, pp. 1624–1625.
[40] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1114–1116.

(ii) *Pegging or stabilizing the price during primary distribution.*—In order to facilitate the distribution of a new issue to the public, a trading syndicate is usually formed by the original group to artificially support the price of the security until the process of distribution is complete. The syndicate usually takes a short position at the time of the original offering by confirming sales substantially in excess of the total issue. By means of this short position, the syndicate is able to support the market price during the period of distribution.[41] The banker's reason for selling more bonds than he owns was stated by Otto H. Kahn thus:

Mr. KAHN. Our experience is that when we have 20 million bonds for sale we have, as a matter of fact, 21 millions or 21½ millions. It is not guessing. It is based upon many years of experience, that there are perhaps 5 percent, perhaps 2½ percent, perhaps 3 percent, of the subscribers who take more than they really mean to keep. They either take it more as I might go into a department store and buy something that appeals to me, and when I got home my wife would say to me, "What on earth did you buy that for? There isn't a bit of use for it." I say, "Well, I will try and get rid of it again." And I go to the department store, and they say, "No; no giving back here." So I will try and sell it.[42]

The rationale for this general practice of overselling and subsequently maintaining an artificial market during the life of the selling group, according to a member of the firm of Kuhn, Loeb & Co., is that "in the case of a new issue, until it becomes thoroughly absorbed, the syndicate or the selling group, or whatever it may be, must be standing ready to purchase any bonds from customers who want to, so to speak, return their goods from a sale; and, therefore, in order to be able to repurchase these bonds and give them a proper market till they find their ultimate investment status, you must stand ready to purchase them."[43]

Otto H. Kahn testified that it was the duty of the originating bankers to make a market "for a reasonable length of time for the people at large, including distributors, to make up their minds whether these bonds are really definitely placed."[44]

Mr PECORA. What is the extent of that reasonable period of time?

Mr. KAHN. Well, it varies, Mr. Pecora, depending upon the nature of the bond.

Mr. PECORA. Well, in the average case?

Mr. KAHN. If you have a bond which has a ready current, well-established market, a kind of bond that savings banks and insurance companies and conservative investors have been trained to buy, it would not take very long, I should say a month or two.[45]

Obviously, the primary motive for artificially supporting the retail price is to afford the members of the selling group a period of time within which to induce the investing public to absorb the issue. Were the price to drop before all the bonds were sold, the bankers might be unsuccessful in disposing of the entire issue. The investor, relying upon the artificial price, is influenced to purchase the bonds by the apparent stability of the issue.

Mr. PECORA. Isn't it also possible that the main reason, or one of the main reasons, for the forming and operating of these trading syndicates for a

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[41] Benjamin J. Buttenwieser, June 28, 1933, K., L. & Co., pt. 3, p. 1118 and p. 1119.
[42] Otto H. Kahn, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1119.
[43] Benjamin J. Buttenwieser, supra, p. 1119.
[44] Otto H. Kahn, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1120.
[45] Otto H. Kahn, supra, p. 1120.

60-day period following the offering to the public of an issue of bonds, is to help the underwriting bankers sell the issue to the public?

Mr. HAYWARD. I think I gave that to you as my second reason, as far as my opinion is concerned.[46]

Occasionally the motive behind a pegging operation is neither to aid the public nor the issuer, but rather to protect the interests of an individual who dominates the affairs of the corporation.

In the case of International Projector Corporation artificial strength was afforded to the market for the company's stock in order that the holdings of Harley L. Clarke, president of the company, might be safeguarded. A recital of this operation follows.

On September 5, 1925, the Cine Machinery Corporation was organized under the laws of the State of Delaware, and on November 23, 1925 the Cine Machinery Corporation changed its name to International Projector Corporation. Harley L. Clarke was President of the Cine Machinery Corporation from its inception and continued in that office after the company became International Projector Corporation. The authorized capital stock of International Projector Corporation was 50,000 shares of $7 preferred stock and 200,000 shares of common stock without par value.[47] One hundred and fifty thousand shares of common stock were issued to Harley L. Clarke, who donated back to International Projector Corporation 25,000 shares.

On November 23, 1925, a banking group, composed of Pynchon & Co., West & Co., Shermar Corporation, the family corporation of Albert H. Wiggin, and W. S. Hammons & Co., purchased 25,000 shares of the $7 preferred stock at 90, paying a total of $2,250,000, and received 75,000 shares of the common stock as a bonus.[48] The 75,000 shares of common included 50,000 shares which were authorized but unissued, and 25,000 shares which Harley L. Clarke had donated to the corporation.[49]

On October 13, 1925, International Projector Corporation purchased all the assets of Acme Motion Picture Co. of which company also Harley L. Clarke was the president. Of the moneys received from the banking group International Projector Corporation used $171,331 to retire the outstanding bonds of Acme Motion Picture Co., most of which were held by Harley L. Clarke, and the Corporation also assumed and paid the existing liabilities of Acme Co. in the sum of $197,000. The stockholders of Acme Motion Picture Co., of whom Harley L. Clarke was likewise the largest, received stock in the new company in exchange for their own.[50]

The bankers offered for sale to the public 25,000 shares of preferred and common stock in units of one share of preferred and one share of common at $100, retaining for themselves the remaining 50,000 shares of common.[51] The stocks of International Projector Corporation were listed on the New York Curb Exchange. A trading syndicate composed of Murray W. Dodge, William F. Ingold

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[46] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1962.

[47] Harley L. Clarke, Nov. 10, 1933, Chase Securities Corporation, pt. 6, pp. 3162, 3172 (Exhibit No. 123).

[48] Harley L. Clarke, supra, pp. 3163–4, 3174 (Exhibit No. 123).

[49] Committee Exhibit No. 123, Nov. 10, 1933, Chase Securities Corporation, pt. 6, p. 3174.

[50] Harley L. Clarke, Nov. 10, 1933, Chase Securities Corporation, pt. 6, pp. 3164, 3166, 3172 (exhibit no. 123).

[51] Committee Exhibit No. 124, Nov. 10, 1933, Chase Securities Corporation, pt. 6, p. 3210; Harley L. Clarke, supra, p. 3176.

and Harley L. Clarke was organized on December 15, 1928, to deal in the stocks of the company. The trading account was financed by Harley L. Clarke out of his own resources and operated until August 1929. The syndicate realized a net profit of $139,944, which was equally divided among the three participants. Harley L. Clarke testified that the syndicate was formed for the purpose of " protecting the stock "[52] Asked to elaborate upon the " protection " afforded by this account, Clarke testified as follows:

Mr. CLARKE. I would say it was a protection to the preferred stockholders and the security holders of the corporation, to have a market for its stock, so that it could not be sold down, and the stock could be freely purchased. We bought in this stock, and later the public were protected, because by so doing we acquired enough stock to control the situation and to pay out all of the security holders. You will recall that in between a debenture issue had been put on the corporation, and the public was entirely paid out.

Mr. PECORA. Had the security holders asked to have the market protected in their behalf?

Mr. CLARKE. No; I don't know that they had. But the business of a corporation is to protect all of its security holders, isn't it?

Mr. PECORA. Do you think it is the business of a corporation to protect its security holders through the organization of trading accounts to trade in its stock in the public market?

Mr. CLARKE. Yes; I do.[53]

Upon analysis, it is apparent that the real reason underlying the formation of the trading account was to protect Clarke's individual interest, as appears from the following testimony:

Mr. PECORA. At the time of the formation of this trading account there were outstanding 200,000 shares of the common stock of the International Projector Corporation, were there, not?

Mr. CLARKE. That is correct.

Mr. PECORA. There actually had been issued that amount?

Mr. CLARKE. Correct.

Mr. PECORA. And you had 125,000 of those 200,000 shares, did you not?

Mr. CLARKE. Yes, sir; and I had more after that.

Mr. PECORA. I am talking about the time that the trading account was formed. You were the owner of 125,000 shares?

Mr. CLARKE. Yes.

Mr. PECORA. In other words, you were a majority stockholder.

Mr. CLARKE. Yes.

Mr. PECORA. And any protection which the market received as the resul. of the operations of this trading account would inure to your benefit principally, would it not?

Mr. CLARKE. Yes.

Mr. PECORA. Was that one of the reasons that prompted you to have this trading account organized and become a member of it?

Mr. CLARKE. I assume so.

Mr. PECORA. It is more than an assumption on your part, is it not? It is the actual fact?

Mr. CLARKE. I would think so.

Mr. PECORA. To your personal knowledge?

Mr. CLARKE. Yes; I would say so.[54]

(iii) *Effect of " pulling the peg " after primary distribution.*—The pegging process operates to deceive the prospective investor. There is an artificial manipulation of price with a consequent misrepresentation of the true market for the securities offered. As soon as the bankers " pull the peg ", i.e., withdraw their support at

[52] Harley L. Clarke, Nov. 10, 1933, Chase Securities Corporation, pt. 6, p. 3177.
[53] Harley L. Clarke, supra, p. 3179.
[54] Harley L. Clarke, Nov. 10, 1933, Chase Securities Corporation, pt. 6, pp. 3181–3182.

the expiration of the period of primary distribution, there is a concomitant decline in the price of the bonds.

A typical instance of such decline is found in the offering of German 5½-percent bonds at 90 on June 12, 1930. A syndicate composed of 1,011 participant dealers in securities throughout the United States assisted in selling these bonds to the public.[55] Richard Whitney, president of the New York Stock Exchange, testified that pursuant to orders of J. P. Morgan & Co. he bought approximately $9,000,000 of the bonds in the market for the account of the syndicate at about the issue price over a period of 18 days. During this period, the syndicate succeeded in selling more than $98,000,000 of these bonds to the public at 90 or higher.[56] Following the withdrawal of support by the selling group, the bonds dropped from 90 to 86. At the time of the hearing on April 21, 1932, the bonds were quoted at 35.[57]

Kuhn, Loeb & Co., during the life of the syndicate, artificially maintained the market price of a $20,000,000 bond issue of the Mortgage Bank of Chile. At the expiration of the 60-day pegging period, the bonds promptly declined from 97 to 94.[58]

Thus the benefits accruing to the ultimate investor from this artificial price maintenance are negligible. Investors in bonds acquire them to hold. When the support of the syndicate is withdrawn at the expiration of 30 or 60 days, as the case may be, the price of the bonds is permitted to seek its real and natural level. Hence, the long-term investor receives no lasting benefit from the stabilizing process.

Mr. PECORA. So that one of the main purposes, if not the main purpose, of this operation is to support the market at the offering price for the 60-day period in order to enable distributors or the selling group to sell to the public at the offering price and not less, isn't that it?

Mr. BUTTENWIESER. Well, the ultimate investors will absorb the new offering.

Mr. PECORA. Now, do you know what happened to the market immediately after the expiration of the 60-day period in this particular instance?

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Mr. BUTTENWIESER. The market for these bonds temporarily, at the expiration of the syndicate or selling group, did decline somewhat.[59]

While the operations of the syndicate sustain the price for a brief period, thereby enabling the purchaser who changes his mind to unload without loss, the genuine investor is not aided by this operation.

Mr. PECORA. What protection does the ultimate investor get by reason of the operation of these trading syndicates?

Mr. HAYWARD. It prevents him from seeing the price of his bonds drop within a few days or a few weeks after the time he has purchased them.

Mr. PECORA. It prevents that effect for only the 60-day period, which usually measures the life of the trading syndicate.[60]

The bankers object to the characterization of these supporting operations as "manipulation", "pegging", or "rigging."

Mr. KAHN. I would use the words "aiding the market" to absorb the bonds which have been offered to investors until they are definitely placed in the hands of bona fide investors. * * * A bond issue is not placed to our satis-

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[55] Richard Whitney, Apr. 21, 1932, pt. 1, p. 245.
[56] Richard Whitney, supra, pp. 245–247.
[57] Richard Whitney, Mar. 1, 1933, National City, pt. 6, pp. 2204–2205.
[58] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1124.
[59] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1123.
[60] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1963.

faction or to the satisfaction of the corporation until it has found its level in the hands of ultimate investors. And that sometimes takes a little time, and sometimes you have overestimated the market value which is properly placeable upon those bonds, and sometimes conditions change.

We are not pegging, we are not supporting; we are trying to aid the distribution of bonds, which is our duty as agents for the corporation, and it is our duty toward investors to help them, if need be, to get those bonds placed that for one reason or another they might try to get rid of. * * * [61]

No matter how the operation is characterized, its effect is the same—it creates the appearance of a stable market where public demand is maintaining the price, whereas in fact the stability is an illusion created by the manipulative practices of the bankers.

(iv) *Pegging during secondary distribution.*—An instance of "pegging" after the completion of primary distribution, was found in connection with the flotation of $32,000,000 first-mortgage 6-percent convertible bonds of the Lautaro Nitrate Co., Ltd., by the National City Co. The contract between the National City Co. and the issuing corporation provided that the former was authorized to purchase $1,000,000 bonds for the account of Lautaro Nitrate Co., Ltd., for a period of approximately 1 year after the original distribution at the original issue price and to resell them for the corporation's account.

Ronald M. Byrnes, then an officer of the National City Co., endeavored to defend this provision on the ground that it vested the National City Co. with purchasing power which could be exercised in the interest of the bondholders.[62]

The National City Co. exercised this purchasing power to the limit prescribed in the agreement between October 1929 and December 1929. After the price rose it again disposed of these bonds to the public on behalf of the Lautaro Nitrate Co., Ltd.[63]

This operation of repurchasing the security for the account of the issuing corporation possesses the same objectionable features as the practice of pegging the market during primary distribution. In addition, pegging of the price for a substantial period after the sale of the bonds establishes a credit rating for the company which is wholly unrelated to its earnings and the true condition of its business. In the event of future borrowings by the company, the investing public is led to believe that the company is in sound condition by the fact that its bonds have maintained a steady quotation for a long period of time.

Mr. Byrnes. We buy bonds to sell, Senator Brookhart.

Senator Brookhart. Yes; and then when you bought them the second time, why, you bought them to maintain the market price?

Mr. Byrnes. Not to maintain the market, necessarily. That may be an effect of achieving an orderly market at any given moment; yes, it might. It certainly would contribute to that.

Senator Brookhart. Is that not what you do it for, then, to maintain that market value?

Mr. Byrnes. Well, that is perhaps an incidental effect. The primary thing is to have a purchasing power available in case one of these bondholders wants to sell, and at the moment we have no other purchasing power.

Senator Brookhart. It seems to me that the main purpose of a deal like that is to maintain the market. I cannot see that incidental part of it.

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[61] Otto H. Kahn, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1124.
[62] Ronald M. Byrnes, Mar. 2, 1933, National City Co., pt. 6, pp. 2309–2310.
[63] Ronald M. Byrnes, supra, p. 2316.

Mr. BYRNES. I would say, sir, from the standpoint of the bondholders themselves and the company it is to maintain the credit rating of the company in the market.

Senator BROOKHART. Well, the credit rating is to make the public believe that the stuff is really worth what you sold it at?

Mr. BYRNES. Yes, but there are always buyers and sellers. This is a particular buyer, the company that is particularly interested in maintaining an orderly market for its securities.[64]

A pegging process of this nature clearly indicates that the bankers are primarily concerned with the interest of the borrowing corporation, to the disadvantage and detriment of the investing public.

(v) *Pegging of comparable outstanding issues.*—In order to lend auxiliary support to the marketing of a new issue it has been the practice in the past to maintain the price of closely comparable outstanding issues at a level where the price of the contemplated new issue will not compare unfavorably with that of the old. Naturally the public is reluctant to purchase a new security when a previous security of the same issuer or a similar security of another issuer offers a higher yield at the current price with the same or greater margin of safety. Hence, it has been deemed essential by investment bankers to level out any discrepancies of this nature by stimulating the price of potentially rival issues.

(vi) *Undue emphasis on speedy distribution.*—The American system of marketing new issues is undoubtedly conducive to the development of intensive and high-pressure sales methods. There is a temptation for the selling group to resort to questionable practices in order to accelerate the sale of bonds, especially in view of the fact that the price is being artificially maintained for a comparatively short period. "Speed" is unduly emphasized in the process of distribution.

Mr. PECORA. Those securities sell very fast principally because the machinery that is employed to distribute and sell them is geared to a high rate of speed?

Mr. DILLON. I think there is some justification in that assumption. * * *[65]

In the instance of the Mortgage Bank of Chile $20,000,000 bond issue, brought out by Kuhn, Loeb & Co. and others, the contract of purchase was signed on June 25, 1925, the selling group was organized on June 26, 1925, and the entire issue was sold on that day.

Such haste in the disposal of a security is objectionable for the reason that it precludes a thorough study of the issue by the retail dealer, upon whom the investing public relies. The dealer who is given only a few hours to accept an allotment is in no position to appraise the merits of the bond. Moreover, a dealer may also be handicapped by the conciousness that if he delays his acceptance of an allotment he incurs the risk of removal from future offering lists. By the same token, if he rejects an allotment which he considers unsound or unattractive he may lose subsequent opportunities.

(vii) *Prospectuses.*—To aid in the selling of the issue, the bankers prepare prospectuses which purport to incorporate all the authentic and pertinent facts regarding the issue. These prospectuses in condensed form are widely advertised in the press and financial journals. The exposure at the subcommittee hearings of flagrant misrepresentations and concealments in these prospectuses upon which

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[64] Ronald M. Byrnes, supra, p. 2313.
[65] Clarence Dillon, Oct. 4, 1933, Dillon, Read & Co., pt. 4, p. 1623.

members of the investing public implicitly relied to their detriment, furnished one of the most important grounds for the passage of the Securities Act of 1933. A detailed discussion of the chicanery practiced by some investment bankers in connection with their prospectuses will be found in section 4, subsection (*d*) of this chapter.

The Securities Act, to prevent a recurrence of these gross frauds, promulgates a new standard of conduct for investment bankers in the primary marketing of securities, requiirng a complete, full, and accurate disclosure of all relevant facts.

(2) *Private offerings.*—Although syndication and public offering are customarily employed in the purchase and resale of an issue by investment bankers, securities are sometimes acquired by the bankers and sold directly to individuals at a fixed price, with no formal public offering.

(i) *The Morgan "preferred lists."*—J. P. Morgan & Co. and Drexel & Co. employed this method in connection with the distribution of the securities of United Corporation, Alleghany Corporation, Standard Brands, Johns-Mannville Corporation, and Niagara-Hudson Power Corporation. In each case, a portion of the stock purchased by the bankers was offered to a selected list of influential individuals.[66] As a result of these offerings, which received considerable publicity, the interest of the general public was captivated, and market levels materially above the price of the original offering were quickly established. Availing themselves of the opportunity afforded by the intense public interest, the bankers disposed of large blocks of their holdings at substantial profits, with entire immunity from the legal liability which would have accompanied a public offering and the issuance of prospectuses.

On January 28, 1929, J. P. Morgan & Co. contracted to purchase at $20 per share, 1,250,000 shares of the 3,500,000 shares of common stock of Alleghany Corporation, a corporation then about to be formed by O. P. and M. J. Van Sweringen for the purpose of purchasing and owning stock in various railway companies.[67]

On February 15, 1929, J. P. Morgan & Co. pursuant to the provisions of the agreement, took over these 1,250,000 shares of common stock at $20 per share. The balance of the authorized stock was issued to Vaness Co., General Securities Corporation, and the Van Swerinfens.

A "when-issued" market on the New York Stock Exchange was established in Alleghany Corporation stock from February 1, 1929, to February 15, 1929. The 1,250,000 shares purchased by J. P. Morgan & Co. (exclusive of 500,000 shares sold to the Guaranty Trust Co.) were privately offered to a select group of individuals at cost—$20 per share.[68] This "preferred list" included personages who at the time of the private offering held prominent governmental, political, and corporate positions.[69]

[66] A complete list of the individuals and the number of shares of each issue sold to them is contained in the record: Committee exhibit no. 51, June 9, 1933, J. P. Morgan & Co., pt. 2, pp. 885–904.

[67] George Whitney, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 133–135. Committee Exhibit No. 9, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 150–152.

[68] George Whitney, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 135–140.

[69] Committee exhibit no. 10, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 138–140.

For example, 2,000 shares were sold at $20 a share to John J. Raskob, Chairman of the National Democratic Committee, who acknowledged receipt in the following letter:

WHITEHALL, PALM BEACH.

DEAR GEORGE: Many thanks for your trouble and for so kindly remembering me. My check for $40,000 is enclosed herewith in payment for the Alleghany stock, which kindly have issued when ready, in the name of John J. Raskob, Wilmington, Del. I appreciate deeply the many courtesies shown me by you and your partners, and sincerely hope the future holds opportunities for me to reciprocate. The weather is fine and I am thoroughly enjoying golf and sunshine.

Best regards and good luck. JOHN.[70]

On the date of Raskob's letter, February 4, 1929, the high for Alleghany Corporation stock was 33⅛.[71] Alleghany Corporation common stock reached a peak of 57 about 5 months after the private offering at $20 per share was made.

Among others to whom allotments were offered at $20 per share were: Joseph Nutt, treasurer of the Republican National Committee—3,000 shares; Charles Francis Adams, Secretary of the Navy—1,000 shares; Edmund Machold, speaker of the Assembly of the State of New York and State chairman of the Republican Party in New York State—2,000 shares; Silas H. Strawn, president of the United States Chamber of Commerce and president of the American Bar Association—1,000 shares; William Woodin, president of American Car & Foundry Co. and later Secretary of the Treasury—1,000 shares.[72]

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Similarly, in connection with the common stock of Standard Brands, Inc., a number of influential individuals were recipients of the benefits of a private offering. J. P. Morgan & Co. contracted to purchase from Max C. Fleischmann and members of his family the stock ownership of Fleischmann Co. Simultaneously, negotiations were conducted for the formation of Standard Brands, Inc., which involved a combination of the Fleischmann Co., Royal Baking Powder Co., Chase & Sanborn Co., and E. W. Gillette Co., a Canadian company. The purchase of 430,000 shares of common stock of Fleischmann Co. from Max C. Fleischmann was conditioned upon the effectuation of this combination. When the combination was consummated, J. P. Morgan & Co. received 722,600 shares of the common stock of Standard Brands, Inc., in exchange for 430,000 shares of Fleischmann Co.[73]

The contract to purchase the Fleischmann stock was made on June 11, 1929, but did not become effective until September 5, 1929.[74] The price of Standard Brands, Inc., stock to J. P. Morgan & Co. was $32 a share. The shares of Standard Brands, Inc., were offered to a favored group at the same price. The stock was listed

[70] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 173, 174.
[71] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 174.
[72] The complete "preferred" list in the Alleghany Corporation stock is contained in the record: Committee Exhibit No. 10, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 138–140.
[73] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 197, 198, 221.
[74] George Whitney, supra, p. 191.

and the opening trades on September 6, 1929, were at 40⅞. Within 4 days thereafter the market price reached 43⅞.[75]

The "preferred list" in Standard Brands stock contained various names which did not appear on the "preferred list" in Alleghany Corporation stock. These included F. H. Ecker, president of the Metropolitan Life Insurance Co., which company was a heavy purchaser of securities for[76] Norman H. Davis, for Calvin Coolidge, and for Bernard M. Baruch, the financier.[77]

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The method of private offering was employed by J. P. Morgan & Co. in effecting distribution of United Corporation stock. United Corporation was incorporated by Drexel & Co., Bonbright & Co., and J. P. Morgan & Co. under the laws of Delaware on January 7, 1929,[78] United Corporation was a holding company for securities of public utility corporations.[79] The authorized capital stock was originally 1,000,000 shares of first preferred, which never were issued, 2,000,000 shares of preference stock, and 10,000,000 shares of common. The preference stock was entitled to a $3 annual dividend. All stock was without par value, and each share of any class was entitled to one vote.[80]

About January 11, 1929, United Corporation acquired from J. P. Morgan & Co. 350,957 shares of the common stock of Mohawk Hudson Power Corporation, 62,360 shares of the second preferred stock of Mohawk Hudson Power Corporation, 124,740 option warrants of Mahawk Hudson Power Corporation, 130,565 shares of the common stock of United Gas Improvement Co., 59,500 shares of the common stock of Public Service Corporation of New Jersey, and $700,801.10 in cash. In return for these acquisitions, United Corporation issued to J. P. Morgan & Co. 600,000 shares of its $3 cumulative preference stock, 800,000 shares of its common stock, and 714,200 option warrants.[81] Each of the option warrants issued by the corporation entitled the holder to subscribe at any time without limit in the future, to one share of common stock at $27.50 a share.[82]

In addition to the securities received by J. P. Morgan & Co. in the exchange above described, the bankers purchased 400,000 shares of common stock and 1,000,000 option warrants from United Corporation for $10,000,000 in cash. Bonbright Electric Corporation did likewise.[83]

In the agreement dated January 9, 1929, between J. P. Morgan & Co. and the United Corporation, the consideration allocated to the common stock was $22.50 per share, and to the option warrants $1 each.[84]

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[75] George Whitney, supra, p. 191. Committee Exhibit No. 14, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 222.
[76] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 192.
[77] The complete "preferred list" in Standard Brands, Inc., stock appears in the record in committee exhibit no. 14, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 220–221.
[78] George H. Howard, May 26, 1933, J. P. Morgan & Co., pt. 2, 1933, p. 308.
[79] George H. Howard, supra, p. 310.
[80] George H. Howard, supra, p. 311. A copy of the certificate of incorporation of the
[81] George H. Howard, supra, pp. 308–310. Exhibit A, May 26, 1933, J. P. Morgan & Co., pt. 2, p. 356.
[82] George H. Howard, supra, pp. 311, 329.
United Corporation is contained in committee exhibit no. 22, May 26, 1933, J. P. Morgan & Co., pt. 2, pp. 345–355.
[83] George H. Howard, supra, p. 329.
[84] George H. Howard, supra, pp. 333–334.

On January 11, 1929, J. P. Morgan & Co. issued to the press a release announcing the acquisition by the organizers of the United Corporation securities.[85] A subsequent release, dated January 14, 1929, was given to the press and to each purchaser of United Corporation securities.

There was no public offering of these securities, but, as in the instance of Alleghany Corporation, a private offering was made to a selected list of influential individuals, corporations, and institutions.[86] The list was prepared jointly by J. P. Morgan & Co. and Bonbright & Co. Within a week after the incorporation of United Corporation, these preferred clients were invited to subscribe to units consisting of one share of common and one share of preferred at $75 per unit. The 714,200 option warrants received by J. P. Morgan & Co. on the original exchange of securities with United Corporation, and the 1,000,000 option warrants obtained by J. P. Morgan & Co. as part of the cash transaction, were not included in the private offering.[87]

Public trading in the United Corporation units on a when-issued basis was conducted on the over-the-counter market. On January 17, 1929, the units were quoted at 92 bid and 94 asked.[88] The units were also traded in on a when-issued basis on the Philadelphia Stock Exchange; and on January 21, 1929, were quoted at $99 per unit.[88]

On July 23, 1929, J. P. Morgan & Co. sold 28,450 option warrants at an average price of $45.96; and during the succeeding 2 months further sales were made on the New York Stock Exchange at prices ranging from $40.53 to $47.01. A total of 200,000 option warrants, which had been acquired by J. P. Morgan & Co. for an allocated consideration of $1 each, were sold by the bankers between July 23, 1929, and September 20, 1929, for the aggregate sum of $8,490,045.74.[89] The remaining 1,514,200 option warrants were distributed on December 19, 1929, to the partners of J. P. Morgan & Co. at $1 each. The warrants could have been sold by the partners at a minimum price of $40 each during the summer of 1929.[89] On the basis of the minimum price between July 23, 1929, and September 20, 1929, the partners of J. P. Morgan & Co. were in a position to sell their warrants for a total exceeding $68,000,000.[90]

Although J. P. Morgan & Co. objected to the use of the phrase "public offering" in connection with the securities of United Corporation,[91] the bankers contemplated that the stock would be listed on the New York Stock Exchange. In fact, J. P. Morgan & Co. assisted in procuring the listing of United Corporation on the New York Stock Exchange.[92] Obviously, the publicity surrounding the acquisition by J. P. Morgan & Co. of the stock, which publicity was aided by press releases from the bankers, created a very active market in the stock when it was admitted to listing on the New York Stock Exchange.

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[85] George Whitney, May 31, 1933, J. P. Morgan & Co., pt. 2, p. 410.
[86] The complete "preferred list" of United Corporation subscribers is set forth in pt. 2, pp. 370–372 of the Morgan hearings.
[87] George Whitney, May 31, 1933, J. P. Morgan & Co., pt. 2, p. 377.
[88] George Whitney, supra, p. 378.
[89] George Whitney, supra, p. 388.
[90] George Whitney, supra, p. 411.
[91] George Whitney, supra, p. 402.
[92] George Whitney, supra, pp. 405–406.

In June 1927 J. P. Morgan & Co. acquired 400,000 shares of the common stock of Johns-Manville Corporation at 47½; 343,750 shares were disposed of to a selected list at 47½, and 56,250 were disposed of to a second selected list at 57½.[93]

The market quotations for Johns-Manville stock on the New York Curb Exchange during the week when the offerings were made to the individuals on the selected lists ranged between 78 and 84. On July 1, 1927, the date set for delivery and payment of the stock, it (the stock) closed at 79, representing a potential combined profit to the members of the selected lists of $12,037,500. The price of the stock mounted steadily in a continuous upward curve until it reached a peak of 242¾ in February 1929.

* * * * * * *

On August 19, 1929, J. P. Morgan & Co. sold to a selected list of purchasers 56,500 units of Niagara-Hudson Power Corporation common stock, each unit consisting of 1 share of common stock and 2 warrants, at $25 per unit.[94]

* * * * * * *

The bankers deny, "perhaps too vehemently", that they expect any direct consideration from the persons included in the "preferred lists."

Senator COUZENS. You said the only object was that these men you distributed the stock to would make money?

Mr. WHITNEY. I did not say our only object. I said we hoped they would.

Senator COUZENS. That was not the only object you had?

Mr. WHITNEY. No, sir.

Senator COUZENS. You hoped they would reciprocate?

Mr. WHITNEY. No; really.

Senator COUZENS. You did not give them this price so that they would reciprocate and keep on good terms?

Mr. WHITNEY. No; really. That is, of course, the suggestion that has been carried in the testimony yesterday and in the papers, but I can only tell you that that is not so.

Senator COUZENS. I never heard of anybody quite so altruistic in my life before.

Mr. WHITNEY. It is not a question of altruism; it is a question of doing a legitimate, straightforward security and banking business.

Senator COUZENS. I am not concerned about the illegitimacy of it, but I am concerned about the impression not going over that you only wanted these men to make a profit out of it. You had had business relations in the past with them and they were friends of yours, and you hoped it would continue by giving them an opportunity to make a profit; is not that true?

Mr. WHITNEY. When you put it that way, Senator Couzens, I would hate to be put in the position of stating that this was going to make them unfriendly, by giving it to them. Certainly not. It was a continuing of relations that were existent. But your first question rather implied that we expected some direct consideration.

Senator COUZENS. You would naturally get direct consideration by their making deposits with your concern, by giving you their underwritings, and the opportunity to sell their securities. That is perfectly obvious.

Mr. WHITNEY. I think if you will examine the list, Senator, you will find that many of them are purely personal friends; I mean, not people who would have anything to do with the influencing of business. You will find others with whom we have been associated in a great many lines for many years.

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[93] Committee Exhibit No. 15, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 254. The complete "preferred list" of Johns-Manville subscribers appears in pt. 2, pp. 882–884, of the Morgan hearings.

[94] Committee Exhibit No. 15, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 254. The complete "preferred list" of Niagara-Hudson Power Corporation subscribers appears in Committee Exhibit no. 37, June 1, 1933, pt. 2, p. 498, of the Morgan hearings.

If you have close association in business with a man you have mutual respect for each other, and you become friendly. Those are the kind of people. Whether it makes them feel more friendly or less friendly, I am not going to deny that that is one of the things. Some of them made money. I hope most of them did. I do not know anything about that. But your first question, which I denied perhaps too vehemently, was that we expected to get direct consideration.[95]

(ii) *Kuhn, Loeb & Co. "preferred lists."*—Kuhn, Loeb & Co. granted participations in syndicates to various influential persons, particularly executive officers of railroad corporations for which Kuhn, Loeb & Co acted as bankers, and officers of corporations which invested largely in securities.[96]

Mr. PECORA. I would say in casually glancing over this list that a large number if not a majority of the names appearing thereon are the names of men who were executive officers of various railroad corporations.

Mr. KAHN. Railroad and other corporations; yes.

Mr. PECORA. And most of the railroad corporations with which these men were affiliated are railroad corporations for which your firm did financing, are they not?

Mr. KAHN. Yes.

Mr. PECORA. Did your firm handle issues that found their way into the portfolio of large insurance companies?

Mr. KAHN. Yes, sir.

Mr. PECORA. I notice among the names on this list that of Mr. F. H. Ecker, president and director of the Metropolitan Life Insurance Co.

Mr. KAHN. Yes.

Mr. PECORA. That is one of the largest insurance companies in the country, isn't it?

Mr. KAHN. It is; yes.

Mr. PECORA. If not in the world?

Mr. KAHN. Yes.

Mr. PECORA. And has perhaps the largest cash resources of the entire country?

Mr. KAHN. I think so.

Mr. PECORA. And hence is the largest potential buyer of railroad bonds?

Mr. KAHN. I think so.

* * * * * * *

Mr. PECORA. Most of the corporations with which many of the men whose names appear on this list were affiliated and are affiliated are corporation clients of your firm, are they not?

Mr. KAHN. A client of our firm? Yes, sir.

Mr. PECORA. In other words, they are corporations who maintain deposit accounts with you, as well as corporations that engage your firms to do financing for them?

Mr. KAHN. Yes, sir.[97]

The motive behind the granting of these participations, according to Otto H. Kahn, was to maintain the good will of individuals upon whom Kuhn, Loeb & Co. relied for advice in financial matters. The participations were granted, however, whether the advice was followed or not.

Senator BARKLEY. Where in a given case you would call on Mr. Mitchell, or anybody else, for his suggestions or advice about the condition of the market, or the propriety of the occasion with reference to one of these issues, and his advice was negative, or his suggestion was that it was not a good time, in the event that you went ahead with it anyway, would you take him in in the investment, regardless of his advice?

Mr. KAHN. Oh, quite regardless of his advice. We would take him in, as I say, annually a couple of times, over a period of 5 years. Quite irrespective of

[95] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, pp. 172–173.

[96] A table showing the various issues in which these persons participated and the extent of their participations is contained in committee exhibit no. 18, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1262–1263.

[97] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1232–1233.

whether his advice was good, bad, or indifferent. We felt it was no more than reasonable to——

Senator BARKLEY. Your invitation was not based on their advice in any particular case, then?

Mr. KAHN. No.

Senator BARKLEY. But just as a sort of a continuing courtesy?

Mr. KAHN. A continuing courtesy; yes.

Mr. PECORA. And to maintain this spirit of good will that you referred to; is that right?

Mr. KAHN. Right.[98]

(iii) *National City Co. "preferred lists" in Boeing Airplane & Transport Corporation and United Aircraft & Transport, Inc.*—In October, 1928, the National City Co. made a private offering of units of the preferred and common stock of Boeing Airplane & Transport Corporation to a list of favored persons. The circumstances under which this offering was made clearly illuminate the motive underlying this type of offering.

The National City Co. acquired 90,000 shares of the 6 percent cumulative preferred stock and 45,000 shares of the common stock of Boeing Airplane & Transport Corporation, together with rights to purchase an additional 45,000 shares of common at $30 per share, all for the sum of $5,013,500.[99] There was considerable discussion within the National City organization as to whether the stock should be publicly or privately offered for sale, and the decision was finally reached in favor of a private offering.[1]

On October 22, 1928, Charles E. Mitchell, the chief executive officer of the National City Co., sent the following telegram to Joseph P. Ripley, a vice president of the company, who was in charge of the negotiations on the west coast:

> * * * All heartily approve purchase, but urge that instead of a public offering and general distribution through sales organization the distribution be limited as far as possible to our own officers, key men, directors and special friends, the principal reasons being that smaller group stockholders would enable us to more easily handle further desirable mergers and to some extent, at least, would take away the heavy speculation that would accompany in general a public offering on our part. At the same time I would hope that the distribution could be sufficiently broad to justify in due course a listing. * * *[2]

The conduct of the National City Co., following its decision to make a private offering of the stock, is consistent not with any tender regard for the interests of the investing public but rather with a well-conceived plan to excite public interest in the stock so that when it was listed on a public exchange the individuals on the preferred list would be in a position to realize a substantial profit. The success of the plan is manifested by the fact that on the first day of trading, November 2, 1928, the preferred stock opened at $60 per share and the common at $57 per share. At the opening quotations the units, consisting of 10 shares of preferred and 3 shares of common, had a market value of $771 per unit, representing a potential profit to the favored individuals of $181 per unit, or a potential profit to the entire group of $1,629,000.[3] The price of the stock continued to rise until January 1929, when the common was quoted in excess of $100 per share and the preferred in excess of

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[98] Otto H. Kahn, supra, p. 1235.
[99] Joseph P. Ripley, Mar. 2, 1933, National City, pt. 6, pp. 2326, 2328.
[1] Joseph P. Ripley, supra, p. 2326.
[2] Joseph P. Ripley, supra, p. 2327.
[3] Joseph P. Ripley, supra, p. 2335.

$75 per share. In January 1929 the name of the company was changed to United Aircraft & Transport, Inc., and under that name the common stock achieved a high of $160 per share in May 1929.[4]

On January 21, 1929, National City Co. offered to the public 150,000 shares of 6-percent cumulative preferred stock and 60,000 shares of common stock in units consisting of 10 shares of preferred stock and 4 shares of common stock, at the price of $1,000 per unit.[5] A few days later 13,000 shares of the common stock were offered by the National City Co. to a group of favored individuals, including officers of the National City Bank and National City Co., at $80 per share. Within 2 days after the offer was made to this favored group the common stock of United Aircraft & Transport Corporation was quoted at $96 per share;[6] and as heretofore indicated, the price continued to mount until it reached $160 per share in May 1929.

Mr. RIPLEY. Because one of the conditions of my negotiations with Mr. W. E. Boeing, starting in the early part of October, 1928, approximately a month before I received this telegram from Mr. Charles E. Mitchell—one of the conditions of the said negotiations was that the stocks of the Boeing Airplane & Transport should be listed in New York City on the New York Stock Exchange, if possible, and the New York curb market, if not possible, on the big board, as we call it.

Mr. SAPERSTEIN. Does that answer the question, Mr. Ripley?

Mr. RIPLEY. I am not through.

Mr. SAPERSTEIN. I beg your pardon.

Mr. RIPLEY. In addition to that, the desirability of having a quoted market on the stock was doubtless a consideration.

Mr. SAPERSTEIN. Why did you want a quoted market on the stock, if you were confining its sale to the officers and the key men, and those other persons who are mentioned in Mr. Mitchell's telegram?

Mr. RIPLEY. Are you asking why I wanted it?

Mr. SAPERSTEIN. Why did the National City Co. want it listed?

Mr. RIPLEY. I could not tell you what was in the minds of people at head office. I was obligated to Mr. Boeing to get it listed.

Mr. SAPERSTEIN. Did you know that an application was actually made for the listing of the stock?

Mr. RIPLEY. Yes, indeed.

Mr. SAPERSTEIN. You had arranged that?

Mr. RIPLEY. Certainly.

Mr. SAPERSTEIN. When you arranged it, you knew that the stock was going to be offered private only, and not to the public, did you not?

Mr. RIPLEY. My work in connection with making an application to list started before receiving any telegram from Mr. Mitchell to the effect that the offering was to be private.

Mr. SAPERSTEIN. When you received that telegram, you were made cognizant of the fact that it was to be private, and yet you went right ahead with your plans to have the stock listed, didn't you?

Mr. RIPLEY. Yes; having obligated myself to Mr. Boeing to do so.[7]

During the last week in October 1928, the National City Co. offered 90,000 shares of preferred and 27,000 shares of common stock of Boeing Airplane & Transport Corporation in units consisting of 10 shares of preferred and 3 shares of common, to a list of favored individuals at $590 per unit.[8]

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4 Joseph P. Ripley, supra, p. 2337.
5 Joseph P. Ripley, supra, p. 2338.
6 Joseph P. Ripley, supra, p. 2342.
7 Joseph P. Ripley, supra, pp. 2332–2333.
8 Joseph P. Ripley, supra, pp. 2326, 2329. A partial list of the individuals participating in this private offering and the extent of their participation appears in pt. 6, pp. 2334–2336 of the National City hearings.

Despite the fact that the National City Co., according to Ripley, did not feel justified in sponsoring aircraft stock because of its speculative nature, on November 1, 1928, newspaper advertisements appeared in large cities throughout the United States announcing that the National City Co. was sponsoring the issue of 90,000 shares of preferred stock and 27,000 shares of common stock of the Boeing Airplane & Transport Corporation.[9] The advertisements also stated that none of the shares would be available to the general public at that time because the units had been sold privately.[10]

On October 31, 1928, the National City Co. transmitted to the New York Curb Exchange an application for listing the stocks of Boeing Airplane & Transport Corporation. The application was prepared by an employee of the National City Co.[9] The sole explanation advanced for the discrepancy between the attitude of the National City Co. that the stock was too speculative to offer to the general public and the listing of the stock on a public market within a few days thereafter, was that Ripley had obligated himself to procure a listing with the head of Boeing Airplane & Transport Corporation.

When pressed to state the reason for not offering the issue publicly, Ripley stated that the National City Co. did not feel justified in sponsoring the aviation industry to the investing public.

Mr. SAPERSTEIN. * * * Mr. Ripley, does Mr. Mitchell's statement that "a smaller group of stockholders would enable us to more easily handle further desirable mergers" accord with your own idea as to the reason for not offering this issue publicly?

Mr. RIPLEY. You mean, the reason that moved the head office to arrive at that conclusion?

Mr. SAPERSTEIN. Yes.

Mr. RIPLEY. No; I think the real reason was that the National City Co. had not at that time come to the point where it felt justified in sponsoring the aviation industry to the investing public of this country.

Mr. SAPERSTEIN. But it had come to the point where it felt that it could safely and with profit offer an aviation issue to its own officers, directors, and special friends; is not that a fact?

Mr. RIPLEY. I want to give you two answers. In the first place, the motive, or the implied motive—implied by you—that the main purpose was to put through additional mergers or what not, does not hold water, because the great bulk of the stock, the common stock—and that was the voting stock—of Boeing Airplane & Transport Corporation was owned by Mr. W. E. Boeing and his associates. In other words, that group, quite regardless of any votes from this little amount or relatively little amount of common stock we sold, could have easily determined the course of action of Boeing Airplane & Transport and coming into any further mergers, or what not.

Next, I want to point out that in your question to me you have left out an important expression in Mr. Mitchell's telegram to me, namely, the expression "key men"—meaning, I believe, key men in the Boeing organization.

Mr. SAPERSTEIN. Mr. Ripley, I call your attention to the fact that I was not quibbling about anything; I was asking you whether your idea as to the reason that this issue was not publicly offered accorded with the ideas expressed by Mr. Mitchell in this telegram.

Mr. RIPLEY. I feel quite certain that the reason for adopting the so-called "private sale" method is outlined in this telegram, but it is twofold and includes the element of the speculative nature of the offering.[11]

(iv) *Significance of "preferred lists."*—The "preferred lists" strikingly illuminate the methods employed by bankers to extend

[9] Joseph P. Ripley, supra, p. 2328.
[10] Joseph P. Ripley, supra, p. 2332.
[11] Joseph P. Ripley, supra, p. 2327.

their influence and control over individuals in high places. The persons upon whom princely favors were bestowed in this manner, were officers and directors of banks, trust companies, insurance companies and other great financial institutions, executives of railroads, utilities, and industrial corporations, editors, lawyers, politicians, and public officials—in short, persons prominent in all the financial, industrial, and political walks of our national life. The granting of these preferential participations on the one hand and their acceptance on the other created a community of interest and similarity of viewpoint between donor and donee which augured well for their mutual welfare and ill for that of the public.

Where officials of financial institutions which invest heavily in securities accept such favors, it is plain that the temptation exists to reciprocate directly by exercising their power to purchase securities from the bankers on behalf of their institutions without regard to the nature of the risk. By virtue of the influence gained by the granting of favors to persons who hold multiple directorships in important corporations[12] the bankers are enabled to exercise substantial control over the affairs and the resources of those corporations. Public officials who consent to participate in "preferred lists" swiftly find themselves in a position where their usefulness is seriously impaired and they incur the danger of forfeiting the respect of the public.

Implicit in the bestowal of favors on this magnificent scale is a pervasive assumption of power and privilege. Implicit in the acceptance of such favors is a recognition of that power and privilege. The "preferred lists", with all their grave implications, cast a shadow over the entire financial scene.

(*b*) *Underwriting of offerings to stockholders.*—Offerings of additional issues by corporations to their stockholders are frequent in the case of stocks. The practice of permitting existing stockholders to subscribe pro rata to an additional issue is employed to protect such stockholders against dilution of their equity. Generally, preemptive rights are guaranteed to the stockholders by the company's charter, although in modern corporate practice the charter sometimes deprives stockholders of these rights. Convertible bonds are offered directly to stockholders in the same way.

When stockholders are entitled to subscribe proportionately to their holdings the new securities are usually offered at prices materially lower than the current market value.

In order to insure complete distribution of the new issue, an arrangement may be made whereby investment bankers undertake to purchase any portion of the issue which the stockholders fail to take at the same price. This is a true underwriting. As compensation for their undertaking the bankers receive a sum supposedly commensurate with the amount of stock they are called upon to take.

(1) *The Pennroad Corporation Underwriting.*—An instance of this type of underwriting is the transaction involving the voting trust certificates of the Pennroad Corporation. The Pennroad Corporation was organized in Delaware on April 24, 1929, at the instance of the Pennsylvania Railroad Co. The Pennroad Corpora-

[12] The record shows the interlocking directorates of individuals on the selected lists of J. P. Morgan & Co. See pt. 2, J. P. Morgan & Co., pp. 942–946.

tion was a holding company with power to invest its funds in the securities of any corporation or other agency engaged in the transportation of persons or property over land or water or by air, and with power to operate railroads.[13] The purpose of this corporation was described in a letter from the Pennsylvania Railroad Co. to its stockholders, as follows:

Your directors have given earnest consideration to recent developments in the field of transportation, and have reached the conclusion that it will be of material advantage to this company and its stockholders for the stockholders to unite in establishing a corporation so organized that it may make investments and take advantage of opportunities on a much broader basis than is possible under the limited powers of a railroad company. Your directors are of the opinion that such an independent instrumentality is needed to protect your interests and those of your company.[14]

The underlying reason for the organization of the Pennroad Corporation was to combat certain interests, primarily the Alleghany Corporation, the Baltimore & Ohio Railroad, and the Erie Railroad, which were invading the territory of the Pennsylvania Railroad Co.[15]

Kuhn, Loeb & Co., as bankers for the Pennsylvania Railroad Co., advised that the additional capital required to purchase properties necessary for the protection of the railroad, should be raised not by a bond issue or a preferred stock issue, which created fixed charges, but by the formation of the Pennroad Corporation and an offering of the stock to the stockholders of the Pennsylvania Railroad Co. The bankers also advised that no underwriting of the issue was necessary.[16]

The certificate of incorporation of the Pennroad Corporation authorized the issue of 10,000,000 shares of common stock without par value. The corporation offered 5,800,000 shares to stockholders of the Pennsylvania Railroad Co. at $15 per share. All the stock issued was placed in a voting trust, with W. W. Atterbury, Effingham B. Morris, and Jay Cook as voting trustees, for a period of 10 years, and voting trust certificates were delivered in respect of all stock purchased by stockholders.[17]

At the time of this offering, April 24, 1929, an aggreement was entered into between Kuhn, Loeb & Co. and the Pennroad Corporation wherein Kuhn, Loeb & Co. undertook to purchase 250,000 shares, or such part thereof as should be available after the termination of the offer to stockholders of Pennsylvania Railroad Co., upon condition that the stockholders should purchase at least 4,930,000 shares of the stock offered. In computing this 85 percent the Pennsylvania Railroad Co. reserved the right to sell 100,000 shares of this common stock at $15 per share to others than stockholders of the Pennsylvania Railroad Co. Kuhn, Loeb & Co. was also granted an option to purchase at any time before August 31, 1929, at $15 per share, any of the 5,800,000 shares which were not purchased by the stockholders or by others.[18]

Simutaneously, another agreement was made between Kuhn, Loeb & Co. and the Pennroad Corporation which provided that in con-

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[13] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1254.
[14] Committee Exhibit No. 19, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1240.
[15] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1246.
[16] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1247.
[17] Committee Exhibit No. 19, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1241.
[18] Committee Exhibit No. 21, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1272.

sideration of Kuhn, Loeb & Co. having acted in an advisory capacity and having given the organizers of the corporation the benefit of its experience and judgment in connection with the organization of the corporation, Kuhn, Loeb & Co. was granted an option to acquire 125,000 shares of common stock at $16 per share, 125,000 at $17 per share, 125,000 at $18 per share, and 125,000 at $19 per share, on or before July 1, 1932.[19]

The stockholders of the Pennsylvania Railroad Co. subscribed to 97 percent of the voting trust certificates of the Pennroad Corporation.[20]

Kuhn, Loeb & Co. made no public offering and was absolved from the obligation of fixing its name to any prospectus, thereby eliminating any element of legal liability on the part of Kuhn, Loeb & Co. in connection with the offering.

Mr. KAHN. * * * You may have observed, Mr. Pecora, that in this instance, in the first offering to the stockholders of 5,800,000 shares aggregating $87,000,000 in value, our name does not appear on the circular. And it did not appear on the circular deliberately, because we did not want in any way by the sponsorship of our name to influence the stockholders of the Pennsylvania Railroad, whether they desired or did not desire, to put up that money. We deliberately requested that our name be left out.

Mr. PECORA. Were you not willing to assume the responsibility for that particular issue or form of financing to the stockholders of the Pennsylvania Railroad Co.?

Mr. KAHN. We did not think that it was a matter in which in the first instance our name should appear, because that would have put upon us a responsibility that we should have had to exercise immediately, and we preferred that the stockholders should determine of their own choice whether it appealed to them to exchange equities for equities.[21]

Kuhn, Loeb & Co. exercised its option to purchase 125,000 shares at $16 on July 23, 1929, and exercised its option to purchase 125,000 shares at $17 on July 24, 1929. On the resale of these shares the firm realized a profit of $2,701,000.[22] Under its agreement, Kuhn, Loeb & Co. also took up, at $15 a share, 242,000 shares of the 5,800,000 shares offered to stockholders. The firm resold 25,000 shares to the Pennsylvania Railroad Co., at the latter's request, at $15 a share. On the remaining 217,000 shares of this lot, Kuhn, Loeb & Co. realized a profit of $1,188,000.[23] In addition, Kuhn, Loeb & Co. received the sum of $1,512,500 in December 1929 as its share of compensation for underwriting 3,025,000 shares of the Pennroad Corporation stock and derived a further profit of $69,924.08 in connection with its participation in an underwriting syndicate involving Pennroad Corporation stock. Between July 22, 1929, and December 11, 1929, Kuhn, Loeb & Co. received as compensation for its various activities in the Pennroad Corporation stock the sum of $5,472,245.55. In addition, Kuhn, Loeb & Co. received a commission of $327,397 in connection with the acquisition by the Pennroad Corporation of the stock of the Canton Co., and a commission of $40,000 in connection with the purchase by the Pennroad Corporation of certain shares of the New York, New Haven & Hartford Railway Co.[24]

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[19] Committee Exhibit No. 22, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1274.
[20] Otto H. Kahn, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1247.
[21] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1281.
[22] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1286, 1289.
[23] Otto H. Kahn, supra, pp. 1286–1287.
[24] Otto H. Kahn, supra, p. 1288.

The combined profits, commissions, and fees derived by Kuhn, Loeb & Co. as a result of its connection with the Pennroad Corporation from July 22, 1929, to December 11, 1929, aggregated the approximate sum of $5,840,000.

About $133,000,000 was raised by the Pennroad Corporation through the sale of its stock to the public. At the time of the hearings, the stock was selling at $3.50 per share, representing a shrinkage of about $106,000,000 in its market value since 1929.[25]

(c) *Offerings against options.*—Public offerings of securities are frequently made by investment bankers who have not purchased the securities, but merely hold an option for their purchase. When the public offering is made at a price which is predetermined by adding the profit or spread to the option price, the operation is identical with the sale and resale method of public offerings, except that the banker's risk is eliminated.

In such an operation, when the issue is subscribed for by the public, the banker is actually short the entire amount of the issue. He is then so situated that he may use his short position to manipulate the price by making purchases in the market against this short position. If the market declines below the option price, he may refuse to exercise the option and instead purchase the securities in the open market, thereby realizing a greater profit than he originally contemplated.

Where no public offering is made at a predetermined price, but the securities under option are sold in the open market by the banker, there is even a greater temptation to manipulate the market in order to realize a larger profit.

This type of operation possesses every objectionable feature of the practices of trading against options carried on by pool manipulators. It is no part of the legitimate business function of an investment banker.

4. Unsound Practices in Investment Banking

Many of the abuses in investment banking have resulted from the incompetence, negligence, irresponsibility, or cupidity of individuals in the profession. Such abuses can be eliminated only by the elimination of such persons from the field. Other abuses inhere in the American system and are, therefore, susceptible of remedial legislation. Occasionally a practice may be unearthed which partakes of the nature of both types.

(a) *Abuses arising out of the interrelationship of commercial and investment banking.*—A prolific source of evil has been the affiliated investment companies of large commercial banks. These affiliates have been employed as instrumentalities by commercial banks to speculate in their own stock, to participate in market operations designed to manipulate the price of securities, and to conduct other operations in which commercial banks are forbidden by law to engage.

Commercial banks did not hesitate to violate their fiduciary duty to depositors seeking disinterested investment counsel by referring such inquiries to their affiliates. The affiliates unloaded securities

[25] Otto H. Kahn, supra, p. 1288.

owned by them on unsuscepting investors and depositors. The activities of investment affiliates encouraged speculation by officers and directors of commercial banks and resulted in the payment of excessive compensation and profits to these officials.

A detailed discussion of the abuses flowing from the interrelationship of commercial and investment banking is contained in chapter III of this report.

(b) *Excessive compensation paid to investment bankers.*—As heretofore pointed out,[26] Kuhn, Loeb & Co. received more than 5½ million dollars in connection with its various activities in the sale of two stock issues of the Pennroad Corporation between July 1929 and December 1929. Among other compensation the firm received options exercisable at any time within 3 years to purchase 500,000 shares of stock which were exercised to the extent of 250,000 shares. On the resale of these shares the bankers made a profit of $2,701,000.

The specific services for which these options were given consisted of advice by the bankers against a bond or preferred stock issue and an assurance that no underwriting was necessary for a successful common-stock issue.

Mr. PECORA (interposing). When you say you gave the company all that advice you gave them, you mean you advised the company to issue an equity security like common stock instead of a fixed-charge security like a bond or preferred stock?

Mr. KAHN. Not only that, but we advised them to do without underwriting.

Mr. PECORA. Yes.

Mr. KAHN. If they had formed an underwriting the cost of that underwriting would have been a great deal more than this thing is. We urged them to accept our advice, which was a very heavy responsibility that it took, and not to form an underwriting syndicate, and by the acceptance of that advice they saved a great deal more than the figure which you have mentioned.

Mr. PECORA. But it was for giving that advice that you received a form of contingent compensation under which you actually realized within 6 or 8 months' time profits of over $5,000,000, didn't you?

Mr. KAHN. No one was more surprised than we were.

Mr. PECORA. You mean at the smallness of the profit you received or the magnitude of it?

Mr. KAHN. At the size which this contingent compensation assumed, solely through the action of the market and solely through the fact that at that time, which, as I said before, was a time of mania, people would buy securities at utterably unreasonable prices. We could not know that and we could not know how soon it would stop. We believed that it would last for a certain length of time to enable the Pennsylvania to make that issue at 15.[27]

Within 24 hours of the time when the options were first granted the stock was quoted on the open market at between $9 and $12 per share above the option price so that Kuhn, Loeb & Co. was in a position to profit by several millions of dollars.[28]

Henry H. Lee, President of the Pennroad Corporation, when asked to enumerate the specific services rendered by Kuhn, Loeb & Co. in connection with the financing of Pennroad Corporation, testified:

Mr. PECORA. * * * Will you enumerate to this committee, if you can, the specific services they rendered for which they received nearly $6,000,000 or were enabled to make nearly $6,000,000?

Mr. LEE. I do not think I can, Mr. Pecora.

Mr. PECORA. Do you think anybody can?

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[26] Sec. 3, subsec. (b) of this chapter.
[27] Otto H. Kahn, supra, p. 1290.
[28] Otto H. Kahn, supra, p. 1291.

Mr. LEE. I doubt it very much. On the other hand, it seems to me, too, that they took a certain amount of risk in what they undertook for us, and the tables might have been turned and they might have lost money or at least made very much less.

Mr. PECORA. Do you think they took a risk when they bought the stock from your company at a fixed price under options that they need not have exercised except at a time when the stock was selling in the open market for more than the option price; do you think they were taking a risk in that?

Mr. LEE. Mr. Pecora, I thought myself at the time that as the issue went to the stockholders of the Pennsylvania Railroad at 15, that if we could get options at 16, 17, 18, or 19 afterward, it was not such a bad thing for us.

Mr. PECORA. Do you realize that on April 25, 1929, the day after the incorporation of the Pennroad Corporation, its stock was selling at 25; not 15, 16, or 17 or 18; but at 25?

Mr. LEE. No one was more surprised than I was.

Mr. PECORA. But you know that is a fact?

Mr. LEE. That is true; yes. I have heard it testified to here.

Mr. PECORA. And in the light of that fact do you think they were taking any risk at all?

Mr. LEE. It would appear not. But, of course, later the price of the stock did recede considerably, even before it was actually issued.

Mr. PECORA. But it receded to a point where they were able to make only 5½ million dollars' profit on the stock they acquired under these options? That was quite a recession to them, was it not?

Mr. LEE. Not to them, but for the market.

Mr. PECORA. I am just asking you these questions, Mr. Lee, because you are the executive head of this big corporation that sold nearly $140,000,000 worth of its securities to the investing public, to find out really what services are rendered by bankers for which they receive such compensation as has been testified to here in the present instance. And you cannot enlighten us any further than you have on that, can you?

Mr. LEE. I do not think I can do so well as Mr. Otto Kahn.[29]

* * * * * * *

J. P. Morgan & Co. received 1,514,200 option warrants on United Corporation stock for which they paid $1 each. Within 60 days thereafter, J. P. Morgan & Co was in a position to sell these warrants in the market at a minimum price of $40 for a total profit of over $68,000,000.[30]

It is beyond belief that any form of service an investment banker can render, entitles him to so stupendous a profit.

(c) "*Finder's*" *fees.*—

Substantial commissions have been paid by bankers to persons who recommended investment banking business. These commissions are known as "finder's" fees.

In connection with the flotation by Kuhn, Loeb & Co. of five issues of guaranteed sinking-fund 6½-percent gold bonds of the Mortgage Bank of Chile totaling $90,000,000, a fee of one-half of 1 percent, or $450,000, was paid to the French firm of Louis Dreyfus & Co. for bringing the business to the attention of Kuhn, Loeb & Co. In addition, a "finder's" fee of $35,000 was paid to Norman H. Davis for putting Kuhn, Loeb & Co. in touch with the Mortgage Bank of Chile.[31]

Mr. PECORA. And was any fee paid Louis Dreyfus & Co. for finding the business for you?

Mr. KAHN. Yes.

Mr. PECORA. That is termed "finding." "Finding" is a term that is a familiar one in your business, is it not?

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[29] Henry H. Lee, July 6, 1933, Kuhn, Loeb & Co., pt. 3, p. 1498.
[30] George Whitney, May 31, 1933, J. P. Morgan & Co., pt. 2, p. 411.
[31] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1012–1013; also Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1125–1126, 1128.

Mr. KAHN. It is; yes.
Mr. PECORA. One who finds a financial operation for a bank is rewarded by the payment of a commission?
Mr. KAHN. Of a reasonable commission.
Mr. PECORA. And Louis Dreyfus & Co. received such a commission in connection with this Chilean financing?
Mr. KAHN. It did.
Mr. PECORA. Did anyone else receive any commission or compensation as a finder or a promoter of the negotiation?
Mr. KAHN. From us?
Mr. PECORA. You or the Guaranty Co.?
Mr. KAHN. From us; nobody else. From the Guaranty Co.; yes.
Mr. PECORA. Who?
Mr. KAHN. Mr. Norman Davis.
Mr. PECORA. How much did he receive?
Mr. KAHN. He received, for the first business which we did in the intermediaries' and negotiators' commission, $25,000.
Mr. PECORA. Did not your firm contribute $15,000 to that?
Mr. KAHN. My firm contributed nothing. The syndicate contributed, as part of the syndicate expenses, $15,000; and the Guaranty Co. contributed $10,000. Afterwards the second business was done and Mr. Davis received another fee of $10,000; so that his total fees received were $35,000.

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Senator BARKLEY. Was he acting in the capacity of an advisor as to this particular loan; or in what capacity was he compensated?
Mr. KAHN. He brought this particular loan to the attention of his friends, the Guaranty Co., and he brought also to their office a representative of the Mortgage Bank of Chile, and that was his first, and I assume, his controlling service. To the best of my recollection he assisted in one or two of the subsequent negotiations, when the details of the business were being determined; but his controlling service was as here reported.[32]

Kuhn, Loeb & Co. had an arrangement with Louis Dreyfus & Co. whereby Kuhn, Loeb & Co. agreed to pay a "finder's" fee on issues "found" in this country by the French firm, and whereby Louis Dreyfus & Co. agreed to pay a "finder's" fee on issues "found" in Europe by the American firm.[33]

The institution of "finders'" fees is undesirable for the reason that it encourages activities looking to the flotation of securities regardless of their soundness. It also involves additional expense, which is ultimately passed on to the investing public. In other recognized professions, the payment of fees for the solicitation of business is generally regarded as highly unethical.

(*d*) *Unsound and unfair financial and corporate structure.*—The investment banker plays a vital part in the determination of the capital structure of the issuing corporation and of the nature and terms of the security offered. He has a duty to protect the investor from unsound or unfair issues.

The investment bankers have recognized their duty in this respect. A pamphlet introduced into evidence by Otto H. Kahn contains the following excerpt:

Investors attach considerable importance to knowing that the mortgages, trust deeds, etc., and all legal steps relating to the issue of securities which they are asked to buy have been carefully examined by bankers of repute and experience and their counsel, with a view to safeguarding the interest of the holders of the bonds as distinguished from those of the railroads, the makers of the bonds.

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[32] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 2, pp. 1012–1014.
[33] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1127–1128.

The mortgages and trust deeds under which the securities are to be issued, before being put in final shape, are carefully gone over by the banker, and his advice is given with the view to creating the best and most salable instrument satisfactory both to the public and to the railroad company, and having due regard both for the protection of the investor and for the future financial requirements of the railroad. Such advice is frequently, especially in the case of large refunding mortgages which are meant to be the principal means of raising money for the railroads for years to come, of very great utility. It is likewise greatly valued by the investor who has come to rely upon the tried and tested thoroughness and competence of experienced and highly reputed bankers to protect the interests of the investing public in respect of not only the intrinsic goodness of a security for which they become sponsors, but also in respect of the provision of the mortgage or trust deed appertaining to such security.

4. The bankers' dual obligation to the investing public, on the one hand, and, on the other, to the corporation whom he serves constitutes a protection to both.

The leading bankers could not maintain their position as such if they did not have the confidence of the investing public and a large following amongst investors, large and small, both here and abroad.

Careful analysis, continuous and watchful scrutiny, in respect of securities issued by him and of the companies concerned, are essential functions of the banker. In buying securities and offering them for sale, he gives public notice, so to speak, that he has examined into and satisfied himself as to their safety and merit.

The banker does not safeguard merely the technical and, to the best of his ability, the intrinsic soundness of the securities he issues; it is alike his duty and to his own self-interest to protect and stand behind the securities for which he is recognized as sponsor, just as it is his duty and to his own self-interest to satisfy himself by careful investigation as to the soundness of such securities, because the banker whose clients suffer loss through following his advice will very soon lose his reputation and the confidence and patronage of his clients.[34]

The record discloses many instances where investment bankers were derelict in the performance of this fundamental duty to the investing public.

(1) *Perpetual option warrants.*—In shaping the financial structure of corporations, investment bankers have devised the perpetual option warrant, which entitles the holder at any time without limit in the future to purchase from the corporation its common stock at a fixed price.[35]

United Corporation, a Delaware corporation, issued a million such warrants to J. P. Morgan & Co., each entitling the holder to subscribe in perpetuity to the common stock at $27.50 per share. George H. Howard, president of the United Corporation, when interrogated as to the advantages of perpetual warrants, testified:

Mr. PECORA. What do you conceive to be the advantages to a corporation in issuing option warrants that are unlimited as to time?

Mr. HOWARD. I suppose that probably is some advantage to the corporation to have those options in the hands of various people who, if the company succeeds and the stock takes a price, pay that much cash into the company, converting their options and thereby giving that company that much additional cash capital.

Mr. PECORA. If the company succeeds at any time after it is launched, isn't that success sufficient inducement to the investing public to buy its shares?

Mr. HOWARD. It may be.

Mr. PECORA. And under such circumstances the public would buy the shares at a figure that would correspond to value at the time?

Mr. HOWARD. They would.

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[34] Committee exhibit no. 1, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1049.
[35] George Whitney, May 31, 1933, J. P. Morgan & Co., pt. 2, p. 388.

Mr. PECORA. Now, these option warrants entitle the holders at any time in the future to purchase the common shares of the company for a fixed price of $27.50 regardless of how much more than that the value of the stock might be?

Mr. HOWARD. That is true.

Mr. PECORA. What are the advantages to a corporation in having option warrants issued of that character?

Mr. HOWARD. Only the advantage that I have suggested to you.

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Mr. PECORA. Let us assume that the United Corporation's common shares at some time subsequent to January 1929 reached a market value of $50 a share. Anyone holding any of these option warrants could immediately demand the issuance to him by the company of shares of that common stock having a market value of $50 a share for $27.50 a share?

Mr. HOWARD. Yes, sir.

Mr. PECORA. Is that right?

Mr. HOWARD. That is right.

Mr. PECORA. Then that is not an advantage to the corporation, is it?

Mr. HOWARD. Well, suppose at that time, Mr. Pecora, that the assets, the real asset value of that share, was $27.50 or something else. I should think it would all depend upon what the real value of that thing was at that time.

Mr. PECORA. It would depend on the market value, wouldn't it? You would not expect the holder of a large block of option warrants to come in and ask for the issuance of common stock in exchange for those option warrants when the common stock was selling for less than $27.50?

Mr. HOWARD. No.

Mr. PECORA. And pay $27.50 to the company for that stock, would you?

Mr. HOWARD. No.

Mr. PECORA. But it is easy to conceive that a large holder of these option warrants would avail himself of his right under those option warrants to have the common stock of the company issued to him at $27.50 when it had reached a market value considerably in excess of $27.50, is it not?

Mr. HOWARD. Quite true.[36]

The advantage attributed to these perpetual option warrants by Howard is neither real nor apparent.

George Whitney, of the firm of J. P. Morgan & Co., conceded that his firm would not employ the perpetual warrant again.

Senator COUZENS. Just what did you hope to gain by that, rather than issuing limited option warrants? Limited as to time?

Mr. WHITNEY. Well, I think it is quite obvious, Senator Couzens, that on the face of it a perpetual warrant, such as that kind, sounds as if it were a more attractive piece of paper to have. I think that experience since—not from the point of view as Mr. Pecora suggested, as to the disadvantage of the company—but I think that our experience since as to a certain inflexibility that it brings about in the future conduct of the company would probably make us, if we had the decision to make again, not make it perpetual. * * *

Senator ADAMS. These warrants would affect the stockholder rather than the company, would they not? That is, the effect would be upon the stockholder of the company rather than upon the company itself, if you could distinguish between the two?

Mr. WHITNEY. Well, that would be the only person we ever considered could be affected. I never thought that there was a question about their affecting the company. The question of the minority stockholders having the right, at whatever the price of the stock might be at the time, to come in and subscribe to a share at 27½, the question might be raised. That is why we took such infinite pains on every piece of paper that we brought out, everybody we talked to about it, we put them on notice of the fact that those option rights were outstanding to the matter of 3,900,000 shares of stock.

Senator ADAMS. But the fact that the distributed share of stock was, say, $50 a share, if someone else holding an option warrant could buy a share for 27½, why, other stockholders had a slight increase [sic!] in value of their stock, did they not?

[36] George H. Howard, May 26, 1933, J. P. Morgan & Co., pt. 2, pp. 329–331.

Mr. WHITNEY. It was always a question on these 3,900,000 shares that they had the right to come in and share in the future stockholdings of the company. But, on the other hand, everybody who bought a share of stock was fully on notice that that privilege existed. So he has bought with the entire knowledge of the situation.

Of course, if today something could happen—during the average period since the formation of this company, it would have been over the average very much to the advantage of the stockholder if everybody had exercised this privilege, but as Mr. Pecora pointed out the other day, people are not apt to exercise such a privilege when the stock is selling substantially below.[37]

The exercise of all options results in dilution of the value of outstanding stock. Hence the purchaser of shares on the market may find his stock instantly devaluated by the exercise of options at prices below the market. On the other hand, it is impossible to prognosticate the value of the stock at some remote date in the future, and correspondingly impossible to determine at the time of issuance whether the corporation is receiving adequate consideration for them and fixing a fair price for their exercise.

(2) *Voting trusts.*—A voting-trust agreement is an agreement which cumulates in the hands of a person or persons the shares of several owners of stock in trust for the purpose of voting them in order to control corporate business and affairs. The agreement confers upon the voting trustees the right to vote the stock transferred to them for such purpose, irrevocably, for a definite period. The stock transferred under such agreement is canceled, and trust certificates are issued by the trustees to the shareholders. The right to vote is thus separated from the beneficial ownership of the stock. This device has been employed for purposes detrimental to the interests of the real owner of the shares.

In the case of the Corporation Securities Co. of Chicago, immediately after the organization of the company on October 5, 1929, and before any public offering of the common stock was made, the directors of the company created a voting trust which covered a substantial block of the common stock. Samuel Insull, Samuel Insull, Jr., and Harold L. Stuart, president of Halsey, Stuart & Co., were designated as voting trustees. When interrogated as to the purpose of this voting trust, Mr. Stuart testified:

Mr. PECORA. And the purpose of it was to enable the three voting trustees, you, Mr. Samuel Insull, Sr., and Mr. Samuel Insull, Jr., without necessarily investing a single dollar of your own money in the corporation, to retain the management and control of it through the creation of that voting trust, attaching to over a million shares of stock? Isn't that right?

Mr. STUART. Well, of course we actually owned shares.

Mr. PECORA. But you need not have owned any shares at all in order to have obtained that control through the medium of that voting trust.

Mr. STUART. I presume a voting trust could be created without the trustees owning stock.

Mr. PECORA. Under the terms of this voting trust and the manner in which it was created, it was made possible for you and the other two trustees to control the company without owning a single share of the stock.

Mr. STUART. But we actually did.

Mr. PECORA. But, I say, it was made possible by this voting trust.

Mr. STUART. Perhaps it was.

Mr. PECORA. And the directors and officers were all persons that were connected with either the Insull companies or Halsey, Stuart & Co., weren't they?

Mr. STUART. That is my recollection.[38]

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[37] George Whitney, May 31, 1933, J. P. Morgan & Co., pt. 2, pp. 385-386.
[38] Harold L. Stuart, Feb. 17, 1933, Insull, pt. 5, p. 1644.

Mr. PECORA (continuing). And it is a device that is often resorted to in order to obtain control of the operation and management of a corporation at a minimum of actual investment.

Mr. STUART. Yes——[39]

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Similarly, a voting trust agreement was executed between General Theatres Equipment, Inc., and Albert H. Wiggin, Harley L. Clarke, and Frank O. Watts, as trustees, covering the Fox Film Corporation class A and class B common stock. Concerning this trust Harley L. Clarke testified:

Mr. PECORA. Can you not give the committee a reason advanced by the bankers for wanting this voting trust?

Mr. CLARKE. I do not think they had any other reason than the usual reason.

Mr. PECORA. What is the usual reason?

Mr. CLARKE. To be able to dominate the management of the company if they thought it necessary.[40]

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In the case of the Pennroad Corporation, the stockholders of Pennsylvania Railroad Co. were offered 5,800,000 shares of newly issued common stock of the Pennroad Corporation in the form of voting-trust certificates. In the circular sent to the stockholders of the Pennsylvania Railroad Co. it was stated:

The wide diversification of the ownership of your company's stock, not only in this country but abroad, indicates that there will be a correspondingly wide distribution of the stock of the new corporation. Accordingly, in furtherance of the purpose for which the corporation has been organized and in order to insure continuity of management, all the stock now being issued will be placed in a voting trust under which Messrs. W. W. Atterbury, Effingham B. Morris, and Jay Cooke have consented to act as voting trustees. The voting trust will be for a period of 10 years and will vest in the voting trustee the entire voting power in respect of the stock deposited thereunder. Voting-trust certificates will be delivered in respect of all stock purchased pursuant to the present offering.[41]

The purchasers of these certificates who paid approximately $130,000,000 in the aggregate acquired no voice in the election of officers or directors or in the selection of trustees.

Mr. PECORA. Now, as a matter of fact, the purchasers of these voting-trust certificates paid something like $130,000,000 in the aggregate, did they not, for those certificates?

Mr. KAHN. They did; yes.

Mr. PECORA. And they bought them under circumstances, terms, and conditions which deprived them of any voice even in the election of officers or directors, did they not?

Mr. KAHN. It would seem so; yes.

Mr. PECORA. On principle, do you approve of that method of financing a corporation?

Mr. KAHN. On principle, Mr. Pecora, I have the utmost faith in the working of public opinion. I have relatively little faith in supervision, and I do not generally approve any paternalistic attitude on the part of corporation managers or anybody else. I do think, speaking now as a principle, that when you ask people to go into a concern with you and you take their money, I do generally think as a principle that nothing ought to be done to interfere with the right to exercise their vote; and I also say that occasions may arise where the continuity of management is of such importance that for the time being, and with the knowledge of the people who put up their money, a voting trust is justifiable. When you get into a situation having a definite, well-defined pur-

[39] Harold L. Stuart, supra, p. 1643.
[40] Harley L. Clarke, Nov. 27, 1933, Chase Securities Corporation, pt. 8, p. 3836.
[41] Committee Exhibit No. 19, June 29, 1933, Kuhn, Loeb & Co., pt. 3, p. 1241.

pose, requiring continuity of management, it may be right to have a voting trust. Ordinarily speaking, I do not believe in depriving people of the right to have their say.

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Mr. KAHN. My answer to your question, of course, is that I would like to point out that this was done in 1929; and I think anything that was done in 1929 should be judged by a different standard from that which prevailed before, which is prevailing now, and which I hope will always prevail after our experience. But the instances, the things for which 1929 and the spirit of 1929 were responsible, are legion; and in the light of hindsight they are simply inexplicable.

Mr. PECORA. Would you go so far as to say, in the light of this hindsight, that such things should be made impossible by law, if necessary?

Mr. KAHN. Unless there is a really good, sound, legitimate, and generally useful reason why a certain transaction should be carried to its destined and logical end by a continuity of management—unless that is so, I think all things of that kind ought to be eliminated. I think affiliates, investment trusts—by which common voting power is given to a small class of stock—are inventions of the devil and ought to be done away with.

Mr. PECORA. Those devils have come from around the vicinity of Wall Street, have they not?

Mr. KAHN. All over the country. They are not only created in Wall Street. I have got quite some painful experience of the same kind of thing that was done outside of Wall Street. But I do think, and I think it is one of the things which I venture the hope will come from the deliberations of your committee, that all these things will be eliminated and not be permitted to occur again, unless good reason can be shown to you why in specific instances the continuity of management should be secured.[41a]

(3) *Provisions for substitution of collateral—Kreuger & Toll Co.*—The investment bankers were responsible for the provisions in the Kreuger & Toll bond indentures which occasioned tremendous losses to the American investing public. In 1929, under the leadership of Lee, Higginson & Co., a syndicate composed of that firm, Clark Dodge & Co., Brown Bros. & Co., Guaranty Co. of New York, National City Co. of New York, Union Trust Co. of Pittsburgh, and Dillon, Read & Co., purchased $26,500,000 of the $50,000,000, 5 percent secured gold debentures of Kreuger & Toll Co. The price to the syndicate was 96 less 3½ percent.[42] The bonds bought by the American syndicate were sold to the American public through the orthodox syndication method.[43]

The indenture agreement covering the $50,000,000, 5 percent secured gold debentures of Kreuger & Toll Co., dated March 1, 1929, provided for the deposit with the trustee or depositary of certain bonds specifically designated as security for the debentures.

The agreement further provided that Kreuger & Toll Co. might substitute for the bonds deposited other securities of the following character and description (called "eligible" securities):

(1) Bonds or notes issued or guaranteed by any sovereign State, or any political subdivision thereof, including any municipality, having authority to issue or guarantee bonds or notes and having a population in excess of 300,000.

(2) Bonds or notes issued or guaranteed by any mortgage banking institution or institutions, society or societies (in which the company may but need

[41a] Otto H. Kahn, June 20, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1255–1256.

[42] Donald Durant, June 11, 1933, Krueger & Toll, pt. 4, pp. 1149–1151. The record contains a detailed statement of the issues of Kreuger & Toll Co., International Match Co., and Swedish American Investment Corporation, offered in the United States, aggregating $255,832,000, pt. 4, Kreuger & Toll, pp. 1152–1154.

[43] Donald Durant, supra, pp. 1148–1149.

not have a partial or controlling interest), and secured by mortgage on agricultural or city property or entitled by special law to priority on such property.

(3) Shares in railroad or other companies, a minimum dividend on which is guaranteed by any sovereign State."

Under the debenture agreement Kreuger & Toll Co. had at all times the right to withdraw any portion of the eligible securities deposited and to substitute for any portion thereof other eligible securities, or cash, provided that such withdrawals did not impair the required ratio of 120 percent between the par value and income of the eligible securities on deposit and the principal amount and interest payable on all outstanding debentures.[44]

The agreement further provided that in any case in which the trustee or depositary desired proof as to whether any securities tendered by Kreuger & Toll for deposit were eligible securities, or any fact in respect of the required ratio of principal or the required ratio of income, the trustee or the depositary might rely upon a certificate of the company stating that such securities were eligible securities.[45] The trustee or the depository would be fully protected in relying upon such certificate, but had the right in its discretion to require from the company advice of counsel or proof that the securities so tendered for deposit under the agreement were eligible securities.[46]

In brief, the Kreuger & Toll 5-percent gold debentures were specifically secured by a pledge of foreign government bonds and bonds guaranteed by foreign governments, which at the time of the issue in 1929 had a par value of over $60,000,000, as compared with the $50,000,000 par value of the secured debentures. Under the provisions of the indenture agreement Kreuger & Toll could substitute for the pledged bonds other eligible bonds, provided the ratio were not disturbed.

At the time the bonds were sold, the collateral, aggregating at par somewhat more than $60,000,000, had a probable market value at least the equivalent to the amount of the bonds sold to the public. With few exceptions, the bonds comprising the original collateral were regarded as fundamentally sound investments, and the income derived from them was in excess of the sum needed to pay the interest on the debentures.[47]

The four vital deficiencies in the substitution provisions were that the basis of substitution of collateral was merely par value rather than market value; that the ratio of 120 percent of income was required to exist only at the time of substitution and for no period thereafter; that there was no limitation upon the nature of the government whose securities were substituted, except that the population it governed had to exceed 300,000; that the certificate of the trustee as to the eligibility of the securities being substituted was sufficient in the first instance. These deficiencies were pointed out by Dr. Max Winkler, an expert in foreign bonds.

Senator FLETCHER. But they allowed the substitution of bonds or securities at par instead of at market value?

Dr. WINKLER. That is correct.

Senator FLETCHER. Is that unusual in a debenture of this kind?

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[44] Pt. 4, Kreuger & Toll, p. 1280.
[45] Pt. 4, Kreuger & Toll, p. 1281.
[46] Pt. 4, Kreuger & Toll, p. 1282.
[47] Dr. Max Winkler, Jan. 12, 1933, Kreuger & Toll, pt. 4, p. 1307.

Dr. WINKLER. It would be except for the additional provision in this case that substitution must not, at the time the substitution is made, disturb the ratio. What happens immediately afterwards no one can tell, but at the time of substitution a ratio of 120 percent with respect to both par value and income must be maintained.

Senator COUZENS. Was that ratio based on par or on actual value?

Dr. WINKLER. The ratio was based on par.[48]

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Mr. MARRINAN. And further, with respect to the matter of eligibility, in the examination yesterday reference was made, perhaps not in well-chosen words, to the possibility of substituting bonds of a minor political subdivision in China. Was there any basis for stating or holding out such a possibility?

Dr. WINKLER. I believe there was if I understand the prospectus correctly, because eligilibity is confined to any bond of a political subdivision, regardless of locality, which has a population of more than 300,000 inhabitants.

Mr. MARRINAN. Would it have been possible, Dr. Winkler, under this substitution provision of the indenture to convert obligations, sound obligations in the pledged collateral, into issues which possessed no inherent merit or intrinsic value whatsoever?

Dr. WINKLER. Not entirely; because the substituted bonds had to be of a type which would not disturb the ratio to which we alluded awhile ago.

Senator COUZENS. And who would be the judge of that?

Dr. WINKLER. The Kreuger & Toll Co., if I understand the prospectus correctly.

Senator COUZENS. In other words, Kreuger served on all sides of the question.

Dr. WINKLER. It would seem so.

Senator FLETCHER. The trustee had nothing to say about that.

Dr. WINKLER. The trustee had the right to ask the company to furnish proof as to eligibility, and the company would merely have to send a certificate to the trustee advising the trustee that the substituted bonds were eligible.[49]

After the disposal of these bonds to the American public, Ivar Kreuger, the dominant figure in Kreuger & Toll Co., engineered a series of substitutions, replacing the original collateral with securities distinctly inferior in quality. Typical of such substitution was the replacement in 1930 of French Government bonds having a high investment standing, with Yugoslavian bonds possessing a much lower rating.[50]

Had there been no substitutions, the value of the original pledged collateral at the time of the hearings, January 12, 1933, would have been at least $24,500,000, with an annual income of $1,681,500. The substituted collateral at the time of the hearings was worth about $9,750,000, with an annual income of $628,350.[51]

Although it was the continuing duty of the investment bankers sponsoring the issue to see that the conditions and convenants of the indenture agreement were fulfilled, and although the trustee was charged with the duty of seeing that the collateral substituted for the original pledged securities were of the required nature and character, both the original sponsors and the trustee were flagrantly derelict in the performance of their duty. They made no inquiry concerning the compliance by Ivar Kreuger with the provisions of the indenture agreement governing the substitution of collateral.

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[48] Dr. Max Winkler, supra, p. 1309.
[49] Dr. Max Winkler, supra, p. 1308.
[50] Dr. Max Winkler, supra, pp. 1309–1310. A complete list of the substitutions is contained in the record, pt. 4, Kreuger & Toll, pp. 1174–1175. The status of the collateral as of Jan. 5, 1933, appears in the record at p. 1183.
[51] Dr. Max Winkler, supra, p. 1812.

Donald Durant, a member of Lee, Higginson & Co., the sponsors of the issue, was the only American director of Kreuger & Toll Co., but failed to attend any of the meetings of the Board.[52]

Senator COSTIGAN. Is it your opinion that the director is under no obligations to attend directors' meetings and participate with other directors in the discussion of its affairs?
Mr. DURANT. I think he should do it whenever possible.
Senator FLETCHER. How many American directors were there of Kreuger & Toll?
Mr. DURANT. Only one.
Senator COSTIGAN. You were the only one?
Mr. DURANT. Yes, sir.
Senator COSTIGAN. Were you at all sensitive over the fact that your name was being held out to the public as a director of Kreuger & Toll without attendance at directors' meetings by you?
Mr. DURANT. Senator, I did not know that it was being held out to the public in any such sense.
Senator COSTIGAN. Was your name not known generally to be that of a director?
Mr. DURANT. It was known, but I do not know that it meant anything except that I was a director.
Senator COSTIGAN. In other words, you do not think the investing public ought to draw any inference from the fact that the names of distinguished financiers are associated with concerns in which they seek to make investments, or as directors of those concerns?
Mr. DURANT. Well, the fact that I was a director did not show the public that I was much closer to it than I already was, as a member of Lee, Higginson & Co.
Senator COSTIGAN. Did that duality of representation embarrass you in any respect?
Mr. DURANT. No, sir.
Senator COSTIGAN. In considering, for example, the question of the substitution clause in the indenture?
Mr. DURANT. I do not feel that it did.[53]

Dr. Winkler testified that in his opinion Lee, Higginson & Co. were remiss in their duty to the public throughout the Kreuger & Toll flotation. He stated:

Dr. WINKLER. It seems to me that where substitutions are permitted it is perhaps the duty of those who distribute the bonds to the public to see to it that when substitutions are made the bonds put in place of the withdrawn bonds are at least as sound intrinsically as the bonds taken out. If I recall correctly, Lee, Higginson & Co. have been floating securities for many years, and I doubt as to whether they would have offered directly to the investing public securities that were put in place of certain other bonds that the Kreuger Co. took out. Therefore, I believe it was to some extent their duty to see to it that when good bonds are taken out at least equal bonds are put in place of them.

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Senator COUZENS. Do you not think there was some other responsibility on the part of Lee, Higginson & Co. in the matter outside of an examination or consideration of the indenture and the securities deposited with it?
Dr. WINKLER. I think that Lee, Higginson & Co. should have made it their business to obtain information from time to time as to substitutions of collateral, regardless of how serious or how inconsequential such substitutions may have been.[54]

The gross profit realized by Lee, Higginson & Co. in the syndication of this Kreuger & Toll issue was $365,000.[55]

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[52] Donald Durant, Jan. 11, 1933, Kreuger & Toll, pt. 4, p. 1183.
[53] Donald Durant, supra, pp. 1190–1191.
[54] Dr. Max Winkler, Jan. 12, 1933, Kreuger & Toll, pt. 4, pp. 1313–1314.
[55] Donald Durant, Jan. 11, 1933, Kreuger & Toll, pt. 4, p. 1151.

(4) *Circumvention of preemptive rights of stockholders.*—The preemptive right of stockholders to subscribe to additional issues of stock was designed to protect the property interest of the stockholder in the corporate assets. The stockholder is entitled to maintain his pro rata interest in the corporate enterprise as it progresses. Where the corporation has earned more than a mere return on its capital, the stockholder is generally granted an opportunity to retain his proportionate share by subscribing to any new issues of stock before they are offered to the public. The preemptive right also safeguards the stockholder's voting rights. It is his protection against dilution of his equity.

The laws of some States provide that the stockholder shall have no preemptive right unless specifically granted to him by the articles of incorporation, or that he may be deprived of this right by appropriate provisions in the articles of incorporation. In the instance of Sinclair Consolidated Oil Corporation, a New York corporation organized on September 23, 1919, the articles of incorporation deprived the stockholders of their preemptive right.[56] Consequently, a group of individuals, headed by Harry F. Sinclair, chairman of the executive committee of the corporation, was able to purchase from the company 1,130,000 shares of stock which they resold on the New York Stock Exchange in a few months at a profit of over $12,000,000. The stockholders, who were not "insiders", were denied any opportunity to share in this profit.[57]

When additional stock of American Commercial Alcohol Corporation was issued, the preemptive rights of stockholders were circumvented by a complex plan involving the issuance of new stock for property, which, under the Delaware law, could be accomplished without first offering the new stock to stockholders.[58]

Many unsound practices as to capital structure emanate from the diversity of incorporation laws in the various States. The superior flexibility of the incorporation laws of a particular State encourages incorporation under the laws of such State.

(e) *Abuses in foreign issues.*—The record of the activities of investment bankers in the flotation of foreign securities is one of the most scandalous chapters in the history of American investment banking. The sale of these foreign issues was characterized by practices and abuses which were violative of the most elementary principles of business ethics.

As early as 1927, Thomas W. Lamont, a member of J. P. Morgan & Co., in an address before the Pan American Conference, sounded a warning note concerning the flotation of foreign bonds. In that address he stated:

> From the point of view of the American investor it is obviously necessary to scan the situation with increasing circumspection and to avoid rash or excessive lending. I have in mind the reports that I have recently heard of American bankers and firms competing on almost a violent scale for the purpose of obtaining loans in various foreign money markets overseas.
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> Naturally it is a tempting thing for certain of the European Governments to find a horde of American bankers sitting on their doorsteps offering them

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[56] Committee Exhibit No. 117, Nov. 9, 1933, Chase Securities Corporation, pt. 6, p. 3122.

[57] For a detailed discussion of this operation see ch. I of this report, sec. 8, subsec. c.

[58] For a detailed discussion of this operation see ch. I of this report, sec. 8, subsec. a.

money. It is rather demoralizing for municipalities and corporations in the same countries to have money pressed upon them. That sort of competition tends to insecurity and unsound practice. The American investor is an intelligent individual and can be relied upon to discriminate. Yet, in the first instance, such discrimination is the province of the banker who buys the goods rather than of the investor to whom he sells them.

I may be accused of special pleading in uttering this warning, yet a warning needs to be given against indiscriminate lending and indiscriminate borrowing.[59]

Despite warnings such as these concerning the precarious nature of foreign flotations, American investment bankers continued to unload foreign issues upon the American investing public.

Far from exercising discrimination in relation to these issues, the bankers failed to check adequately the information furnished by foreign officials; ignored bad debt records and bad moral risks; disregarded political disturbances and upheavals; failed to examine, or examined only perfunctorily, economic conditions in foreign countries; failed to determine whether the proposed uses of the proceeds of loan issues were genuinely constructive; failed to ascertain whether the proceeds of loan issues were applied toward the purposes specified in the loan contracts; failed to ascertain whether revenues pledged for the service of loans were collected and properly deposited in accordance with the agreements; and generally indulged in practices of doubtful propriety in the promotion of foreign loans and in the sale of foreign securities to the American public.

(1) *Bond issues of the Republic of Peru.*—In 1927 National City Co., the securities affiliate of the National City Bank of New York, together with the investment banking houses of J. & W. Seligman & Co., E. H. Rollins & Sons, Graham Parsons & Co., F. J. Lisman & Co., and Ames Emerich & Co., undertook to float the first of three bond issues for the Republic of Peru. On March 1, 1927, these houses offered to the public $15,000,000 of 7 percent sinking fund gold bonds of the Republic of Peru, due in 1959, commonly known as the "tobacco loan."[60]

The bonds were offered at 96½. The bankers received a gross spread of 5.03 points. At the time of the hearing on February 27, 1933, the bonds were quoted between 7 and 8, less than 3 points above the spread received by the bankers.[61] The financial history of the Republic of Peru which had been under examination by the bankers for years prior to the offering, was of such a nature that even a casual regard for the interests of the American investor would have led the bankers to shun this financing.

On December 9, 1921, C. W. Calvin, a representative of the National City Co. in Peru, wrote to J. T. Cosby, vice president of the National City Bank, describing conditions in Peru as follows:

* * * In the meantime the conditions of Government finances is positively distressing. Treasury obligations are almost impossible to collect. Government officials and employees are months in arrears in their salaries, and, as one business man expressed it, the Government treasury is "flat on its back and gasping for breath." With the export trade continuing small, customs revenues are not of a large amount, and, unless some sort of loan is forthcoming in the near future, I do not see how the Government can continue functioning on the basis of its present income.[62]

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[59] Thomas W. Lamont, Dec. 18, 1931, Hearings before the Committee on Finance, pt. 1, p. 25.
[60] Hugh B. Baker, Feb. 27, 1933, National City, pt. 6, p. 2051.
[61] Hugh B. Baker, supra, p. 2052.
[62] Hugh B. Baker, supra, p. 2053.

Victor Schoepperle, a vice president of the National City Co., had devoted most of his time since 1919 to the company's foreign financing. In a memorandum dated April 2, 1923, Schoepperle said:

As reasons for our declining the business, we cited the history of Peruvian credit, the political situation in Peru, and our feeling that the moral risk was not satisfactory. * * *.[63]

Hugh B. Baker, president of the National City Co., admitted that the memorandum offered no encouragement for a loan to Peru.

Mr. PECORA. On the whole Mr. Schoepperle's report as embodied in this memorandum was against financing any Peruvian credits, wasn't it?
Mr. BAKER. Yes; at that time.
Mr. PECORA. Because it was considered a bad risk; isn't that so?
Mr. BAKER. I assume that must have been his reason there.
Mr. PECORA. Do you know whether that memorandum was considered by the executive officers of your company when in the early part of 1927 the company gave its consent to the flotation of this $15,000,000 issue?
Mr. BAKER. I am quite sure that that was discussed, although, as I say, the specific memorandum I do not recall. But certainly we went back into all those matters.
Mr. PECORA. Well, now, if this memorandum was discussed there was nothing in it, was there, that encouraged the officers in floating this loan?
Mr. BAKER. Certainly not at that particular time.[64]

Another memorandum dated May 8, 1923, was found in the files of the National City Co., wherein the following statement appears:

As far as the attitude of the City Co. is concerned in connection with this financing, it may be mentioned that the history of Peruvian credit, the political situation in Peru, and the company's feeling regarding the moral risk have hitherto caused them to avoid Peruvian financing. Moreover, while the tobacco monopoly may be profitable, it appears very doubtful whether the railways will be profitable for a long time to come, and the Government appears to be determined to use all the tobacco monopoly's profits for railroad construction.[65]

In a cable to National City Co. on about July 12, 1923, Schoepperle adverted to the carelessness of Peru in the fulfillment of its contractual obligations:

Peru has been careless in the fulfillment of contractual obligations. City of Lima 5-percent loan coupons, due January 1, 1922, were not paid until the following May 1922. The Peruvian 5-percent gold bonds of 1920, due in January 1922, were paid in September 1922, and those due in July 1922 were paid in October of 1922. The London Times, in its issue of March 30, 1922, alluded to Peru's "frequent unobservance of her undertakings to the Peruvian Corporation, her broken pledges over the Chimbote concession, and her flagrant disregard of guarantees given to the North Western Railway of Peru.[66]

Regarding the difficulty of Peru in balancing its budget, Schoepperle testified:

Mr. PECORA. Will you look at that table and tell us if it is not the fact that during that period the Government of Peru had succeeded in balancing its budget only for 3 years; that is, on only three occasions during that 10-year period?

* * * * * * *

Mr. SCHOEPPERLE. I think I would prefer to accept the statement that you made in the first instance, that during 3 of those years there appears to have been, according to these tables, a surplus of revenues over the expenditures, and for the balance of the period under discussion there appears to have been a deficit.[67]

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[63] Hugh B. Baker, supra, p. 2054.
[64] Hugh B. Baker, supra, pp. 2054–2055.
[65] Hugh B. Baker, supra, p. 2055.
[66] Hugh B. Baker, supra, p. 2058.
[67] Victor Schoepperle, Feb. 27, 1933, National City, pt. 6, p. 2060.

Baker endeavored in his testimony to minimize the damaging effect of these and other memoranda unfavorable to the financing by suggesting that Peruvian conditions may have improved by 1927.

Mr. PECORA. You have observed that in the communications I have read into the record from your files on the Peruvian loan studies, hazards were pointed out and perils were referred to, making a Peruvian loan a risky and hazardous thing? You have recognized that, have you not?

Mr. BAKER. Yes; extending back there to the early days.

Mr. PECORA. Also as late as 1925?

Mr. BAKER. Yes. There were some reports.

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Mr. PECORA. And you have noticed that your files referring to the credit history of Peru show a pretty bad history?

Mr. BAKER. That was a bad history; but, of course, we would take into consideration improvements that are being made during that period and approaching that period of this loan of 1927, which was 2 years later than this, that if the economic situation and the political situation, and so forth, in Peru had sufficiently improved, our opinion as to what we would regard a good credit in 1927 might have been an entirely different thing in 1923 or 1924 or 1925.[68]

Nevertheless, in a memorandum prepared by Schoepperle between December 1, 1925, and March 1927 it was stated:

Peru bad-debt record adverse moral and political risk. Bad internal-debt situation. Budgetary and trade position about as satisfactory as Chile in past 3 years. Natural resources more varied. On economy showing Peru should go ahead rapidly in next 10 years.[69]

In March 1927 when the tobacco loan was publicly offered the National City Co. issued a prospectus describing the loan in which no information was vouchsafed regarding the bad-debt record of Peru.

Mr. PECORA. Do you find any mention in it (the prospectus) whatsoever of the bad credit record of Peru which is embodied in the information I have read into the record from your files?

Mr. BAKER. I should have to read this over, Mr. Pecora. [After perusing document.] No; I do not see anything. It is a secured loan. I do not see any statements in there.

Mr. PECORA. No statement or information was given to the American investing public in your circular corresponding to the information that your company possessed in writing among its files concerning the bad debt record of Peru and its being a bad moral and political risk?

Mr. BAKER. No, sir.[70]

The $15,000,000 loan was quickly absorbed by the public. Almost immediately negotiations went forward for the flotation of additional loans to Peru on a vast scale.

On December 21, 1927, an issue of $50,000,000 Peruvian Government 6-percent bonds was offered to the public at 91½ by a syndicate composed of National City Co., J. & W. Seligman & Co., Blyth, Witter & Co., the Guaranty Co. of New York, F. J. Lisman & Co., and Central Union Trust Co. The gross spread to the bankers was 5 points.[71]

Between the sale of the $15,000,000 issue and the offering of the $50,000,000 issue, conditions in Peru failed to improve, as indicated in a letter from J. H. Durrell, a vice president and overseas man-

[68] Hugh B. Baker, Feb. 27, 1933, National City, pt. 6, pp. 2063–2064.
[69] Hugh B. Baker, supra, p. 2065.
[70] Hugh B. Baker, supra, pp. 2067–2068.
[71] Hugh B. Baker, supra, p. 2070.

ager of the National City Bank, to Charles E. Mitchell, dated July 27, 1927.

As I see it, there are two factors that will long retard the economic importance of Peru. First, its population of 5,500,000 is largely Indian, two-thirds of whom reside east of the Andes, and a majority consume almost no manufactured products. Second, its principal sources of wealth, the mines and oil wells, are nearly all foreign-owned, and excepting for wages and taxes, no part of the value of their production remains in the country. Added to this, the sugar plantations are in the hands of a few families, a majority of whom reside and invest their profits abroad. Also, for political reasons, the present Government has deported some 400 prominent wealthy conservative families, but allows them to continue to receive and to make use of abroad the income from their Peruvian properties. As a whole, I have no great faith in any material betterment of Peru's economic condition in the near future.

The country's political situation is equally uncertain. President Leguia, while not having the absolute power possessed by General Gomez in Venezuela, is the last word in all things political, and usually the first word as well. * * * Unfortunately, his health is bad, and it is reported that he must undergo a serious operation soon.[72]

The prospectus on this $50,000,000 loan contained the following statement:

The Republic of Peru is the third largest country in South America, with an area of approximately 550,000 square miles. It has a population estimated at 6,000,000.[72a]

The President of the National City Co. was examined with reference to the omission from the prospectus of the unfavorable factors set forth in Durrell's letter to Mitchell.

Mr. PECORA. * * * Why wasn't that detailed information given in this circular along with the statement that the population of Peru was 6,000,000?

Mr. BAKER. I cannot answer that.

Mr. PECORA. Did you think it would have had a bad effect on the flotation of these bonds if the advices contained in Mr. Durrell's letter of July 27, 1927, had been given to the investing public through the medium of a circular?

Mr. BAKER. It might have; yes.[73]

* * * * * * *

Mr. PECORA. Yes. Do you think that the public here would have subscribed at 91½ for these bonds if they had been given the information that was given to your company by its overseas manager and vice president, that "there are two factors that will long retard the economic importance of Peru"?

* * * * * * *

Mr. BAKER. I doubt if they would.

Mr. PECORA. And do you think that the public would have subscribed to these bonds at 91½ if they had been told in the circular that Mr. Durrell in July 1927 advised the company that "Peru's political situation is equally uncertain. I have no great faith in any material betterment of Peru's economic condition in the near future"?

Mr. BAKER. I doubt if they would.[74]

In October 1928 a third Peruvian issue in the sum of $25,000,000 was offered to the American public at 91 by a syndicate composed of National City Co., J. & W. Seligman & Co., Blyth, Witter & Co., Guaranty Co. of New York, F. J. Lisman & Co., and Central Union Trust Co. The gross spread to the bankers was 5 points.[75]

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[72] Hugh B. Baker, supra, p. 2071.
[72a] Ibid., p. 2075.
[73] Hugh B. Baker, supra, pp. 2075–2076.
[74] Hugh B. Baker, supra, p. 2076.
[75] Hugh B. Baker, supra, p. 2078.

Prior to this third loan the bankers received additional information indicating that the condition of Peru made the bonds an investment of the most hazardous type. Ralph Dalton, vice president of the Foundation Co. in a report to Victor Schoepperle of the National City Co., dated January 12, 1928, stated:

The present low value of Peruvian money is due primarily to the fact that the balance of international payments is unfavorable to Peru, although the commercial scales show a favorable balance, and this is apparent at a glance when one considers that metals and minerals, oils, bring into the country only a part of the real value as shown by the customhouse statistics, for the reason that the production of these articles is largely in the hands of foreign companies which sell exchange only sufficient to cover their operating costs, and many other articles leave a part of their value abroad.[76]

On March 4, 1928, in a report drawn by Frederick R. Kent, a director of the Bankers Trust Co. of New York, the taxation system of Peru was critically examined and adverted to as a "hodge-podge."

Mr. PECORA (reading). That the taxable income of the Peruvian people, including foreign organizations, is not sufficient to warrant an increase in public works, of sanitation, irrigation, highway building, nor railroad building, except in those cases where an immediate return will arise from an increased income and where foreign loans are used for the purpose of foreign exchange in sufficient sums to meet the debt charge.

* * * * * * *

As I had the feeling that the whole taxation system is a hodge-podge, I asked Mr. Larranaga of the Caja whether he could have prepared for me in the Caja, statements showing what form of taxes were too costly to collect to make them worth while, which were merely hit-or-miss forms of taxation, and what recommendations would seem to be advisable based on the actual experience of collection. He told me that it was impossible to answer such a question and that he could not do it and that no one in the government could do it and that possibly at the end of two years, if an expert were brought down from the States he could go over the books of the Caja in connection with its collections, that they might get the answer.[77]

In a letter written on August 25, 1928, by the manager of the Lima Branch of the National City Bank to the New York office, it was stated:

Economic conditions.—Business continues to be extremely dull. Although there has been more activity in the cotton market during the past month, important growers estimate that the crop will be 25 percent below normal and probably a bit more. Our collection department reports that collections are becoming increasingly difficult. At every hand one hears complaints regarding slow sales and scarcity of money. Prices of securities and real estate are at extremely low levels, and new building operations have naturally been curtailed considerably.

* * * * * * *

Government conditions.—Financial condition of Government. Continues very tight. We understand that practically all of the Government dependencies are in arrears as regards salaries paid to employees. One of the members of the American Naval Mission informs us that for the first time in years they have been unable to secure their daily allowance of some Lp 4/500. from the Treasury. Although the Treasury has called upon a number of the banks to effect the discount of some of its paper, we have received no such requests of late.[78]

In a cablegram from the Lima Branch to the New York office, dated September 14, 1928, it was stated:

[76] Hugh B. Baker, supra, p. 2078.
[77] Victor Schoepperle, supra, pp. 2108–2109.
[78] Victor Schoepperle, supra, p. 2110.

We have assumed (*a*) no further national loan can be safely issued and (*b*) integrity Republic's finances threatened until floating debt problem solved. Stop.[79]

On October 8, 1928, in a memorandum addressed to Durrell, an assistant vice president of the company, it was stated:

Economic conditions in the country leave considerable to be desired. The last cotton crop was a short one on account of lack of water for proper irrigation, * * *.[80]

In a prospectus issued with this $25,000,000 loan, no reference was made to the previous bad debt record of Peru or to the disturbing economic conditions in the country. Like its predecessors, this issue was abosrbed by the public upon the basis of inadequate information. All three issues went into default in 1931. During 1933 the bonds were quoted as low as 4⅝.

(2) *Bond issues of the State of Minas Geraes, Brazil.*—On March 19, 1928, the National City Co. floated $8,500,000 6½-percent bonds for the State of Minas Geraes, Brazil. The bonds were offered to the public at 97½ by a syndicate comprising National City Co., Kissel, Kinnicutt & Co., and J. H. Schroeder Banking Corporation. The bankers' spread was 4.333 points. The debt record of Minas Geraes was hardly calculated to inspire confidence. Previously the State had issued bonds which had been disposed of in the Paris market. Upon maturity Minas Geraes refused to pay these bonds in gold francs as required by the terms of the indenture. A decision adverse to the State was rendered in the French courts. Minas Geraes appealed the decision, and pending the appeal a settlement was worked out with the bondholders.[81]

On September 1, 1928, another issue of $8,000,000 6½ percent bonds, series A of 1929, was offered to the public by the same syndicate at 87. The spread to the bankers was 4.67 points.[82]

In connection with the issue of September 1929, a prospectus was prepared stating:

The proceeds of this loan will be utilized for purposes designed to increase the economic productivity of the State.[82a]

And in a letter from the president of the State incorporated in the prospectus it was stated:

The proceeds of the loan will be utilized as provided in law No. 1061 of August 16, 1929, for all or some of the following-mentioned purposes: Purchase of additional equipment for the South Minas Railway and the Paracatu Railway, the further development of the Electric Light & Power system of Bello Horizonte, the State capital, advances to the Banco de Credito Real of Minas Geraes * * * for the purpose of increasing its facilities for making agricultural and mortgage loans, for loans to the municipality of the capital, and to other municipal corporations of the State, and for any other productive undertakings duly authorized by law.[83]

Between $3,000,000 and $4,000,000 of the proceeds of this $8,000,000 loan, instead of being used as represented in the prospectus—to increase the economic productivity of the State of Minas Geraes—were used to repay short-term loans or advances previously made to the state.[84]

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[79] Victor Schoepperle, supra, p. 2112.
[80] Victor Schoepperle, supra, p. 2113.
[81] Ronald M. Byrnes, Feb. 28, 1933, National City, pt. 6, pp. 2126–2132.
[82] Ronald M. Byrnes, supra, p. 2133.
[82a] Ibid., p. 2135.
[83] Ronald M. Byrnes, supra, pp. 2133–2134.
[84] Ronald M. Byrnes, supra, p. 2135.

In a cable dated June 22, 1929, from the branch manager of the National City Bank in Rio de Janeiro to a vice president of National City Co. it was stated with regard to the prospectus:

As regards authority for redemption of short-term advances out of proceeds, Government assures us that such advances served purposes covered by said two laws, and counsel therefore holds that you can obtain necessary protection by including in purpose clause statement such as "part of proceeds will be applied to reimburse Government for expenditures already made in connection with works covered by said laws." [85]

Despite this suggestion no mention was made in the prospectus concerning the proposal to devote from 40 to 50 percent of the proceeds of the loan to the discharge of antecedent obligations of the State.

Mr. PECORA. How would a person receiving that prospectus and reading it acquire any knowledge from the prospectus itself as to the provisions of the laws referred to there?

Mr. TRAIN. They are very generally summarized here under the purposes of the loan.

Mr. PECORA. Are they summarized in a fashion which would be certain to convey to the average reader of the circular or prospectus the information or knowledge that a substantial part of the proceeds of this second loan was to be used to pay these short-term unsecured advances?

Mr. TRAIN. No.[86]

On June 12, 1927, George F. Train, a member of the foreign department of National City Co., wrote to R. M. Byrnes, a vice president of the company, concerning the State's previous handling of its external loans:

The 1911 contract was concluded in Brazil, and apparently the same thing happened. I am unable to confirm this as I have as yet no photostats of the bonds, but the laxness of the State authorities borders on the fantastic. The 1916 bonds were admittedly signed by the then Secretary of Finance in Paris, who carelessly overlooked the wording not being in accordance with the contract. It would be hard to find anywhere a sadder confession of inefficiency and ineptitude than that displayed by the various State officials on the several occasions.

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The foregoing recital serves to show the complete ignorance, carelessness and negligence of the former State officials in respect to external long-term borrowing. It is hard to believe that there was not some collusion between the officials and Perier & Co., but whether that was the case or not, the latter seem to me to have given sufficient evidence of their bad faith.[87]

On April 27, 1928, Train, in a letter to Squires, wrote:

I regret to say that the reaction here in regard to how the State has handled the details of this transaction is generally unfavorable, and there is a considerable degree of uneasiness on the part of all concerned over the question of the State's willingness to meet its obligations.[88]

Despite these unflattering opinions regarding the State's method of managing its finances, the prospectus published in connection with each issue contained the following assertion:

Prudent and careful management of the State's finances has been characteristic of successive administrations in Minas Geraes.[89]

Such a representation, in view of the adverse opinions held by officials of the National City Company, appears to have been deliberate. In a letter to Train dated September 14, 1927, a member of the

[85] George F. Train, Feb. 28, 1933, National City, pt. 6, p. 2165.
[86] George F. Train, supra, p. 2166.
[87] George F. Train, supra, p. 2155.
[88] George F. Train, supra, p. 2152.
[89] George F. Train, supra, p. 2155.

foreign department of the company, to whom a draft of the first prospectus was submitted for suggestions, called attention to the fact that this portion of the prospectus might be subjected to criticism:

Prudent and careful administration of the State's finances has been axiomatic with successive administrations in Minas Geraes. I am not trying to criticise, and no doubt I am too much saturated with material dealing with the French issues of the State, but in view of the extremely loose way in which the external debt of the State was managed, do you think the statement quoted above would be subjected to criticism?[90]

Apparently recognizing the force of the question propounded in the letter, the draftsman displaced the word "axiomatic" with the word "characteristic" in the final draft of the prospectus. The effect of this hair-splitting modification on the mind of the prospective investor was the same. The impression intended to be conveyed was that the State of Minas Geraes was careful in the administration of its finances—a view not shared by the officials of National City Co.

Officials of the National City Co. attempted to defend the prospectus upon the tenuous ground that the language referred to the "internal" finances, as counterdistinguished from the "external" finances of Minas Geraes.

Mr. Pecora. Was it your intention merely to refer to the management of the internal finances when you had this statement incorporated in the prospectus?

Mr. Train. That was my intention.

Mr. Pecora. Why didn't you say so in the prospectus then?

Mr. Train. Well, of course, it would rest on an interpretation of the word "finances." It would have been more accurate had I said the "State's budget" or "budgetary position."

Mr. Pecora. But if you wanted to make a favorable comment on the administration of the internal finances of the State, would it not have been extremely simple to have inserted the word "finances"?

Mr. Train. I think it would have been more accurate.[91]

The State of Minas Geraes defaulted on both issues on March 1, 1932. At the time of the Senate hearings the bonds were quoted around 21 or 22.[92]

(3) *Bond issues of the Republic of Cuba.*—The governmental authorities of the Republic of Cuba had contemplated undertaking a series of improvements on the island, the most ambitious of which was the building of a central highway from one end of the island to the other, connecting with all towns and ports along the coast. Through the medium of this central highway, the Cuban Government hoped to establish better transfer facilities for the sugar products and other sources of wealth of Cuba which had previously been inaccessible, thereby giving an impetus to commerce in Cuba, while furnishing employment over a period of years to many Cubans who were suffering from the general trade depression.[93]

The cost of these improvements was originally estimated at 325 million dollars. As economic conditions changed for the worse, however, this extensive program was progressively and substantially diminished.[94]

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[90] George F. Train, supra, p. 2157.
[91] George F. Train, supra, p. 2159.
[92] George F. Train, supra, pp. 2169–2170.
[93] Shepard Morgan, Oct. 23, 1933, Chase Securities Corporation, pt. 5, p. 2549.
[94] Shepard Morgan, supra, p. 2550.

On July 15, 1925, the Republic of Cuba enacted the public-works law which provided for a comprehensive program of public improvements and developments on the island. The law created special revenues both of a temporary and permanent character. It was estimated that these special revenues would yield 16 to 18 million dollars per annum, 90 percent of which would be set aside for servicing the indebtedness incurred in making these improvements. Substantial income from special revenues, including a tax on traffic and locomotion of vehicles and a tax on gasoline, would be derived from the increase of motor-vehicle traffic and gasoline consumption resulting from the road improvements effected.[95]

The public-works law originally provided that the temporary special revenues created to meet the carrying charges on the indebtedness incurred in the construction of these public works were to be collected for a period of 5 years. Thereafter, the law was amended to extend the existence of these temporary special revenues for a period of 10 years.[96]

At the time of the passage of the public-works law Gerardo Machado was President of Cuba.[97]

The preliminary expenses to cover studies and surveys were paid by the Cuban Government out of the current special revenues created by the public-works law of 1925.[96]

Competitive bidding was required on the initial $10,000,000 loan to Cuba, and the Chase National Bank in conjunction with the banking firm of Blair & Co. were the successful bidders.[98]

On February 19, 1927, Chase National Bank and Blair & Co. entered into a contract with the Republic of Cuba for the extension of a $10,000,000 credit, which was the initial step in financing the public-works program. The agreement empowered the Republic to issue deferred-payment work certificates to contractors in the maximum sum of $10,000,000. Chase National Bank and Blair & Co. agreed to purchase these certificates from the contractors during the period between July 1, 1927, and June 30, 1930. The certificates bore interest at the rate of 6 percent and constituted a first lien on the special revenues created by the public-works law. The aggregate amount of certificates actually issued under this agreement was about $4,250,000.[4]

In 1928 the financing of the public-works program entered upon its second phase. The Chase National Bank successfully bid for further financing of the Public Works Program. On June 22, 1928, the bank agreed to furnish Cuba with a revolving credit of $60,000,000, inclusive of the $10,000,000 credit established in February 1927.[5]

By the terms of the agreement, whenever the bankers should have advanced the sum of $10,000,000 against deferred-payment work certificates issued to construction contractors, the certificates were to be

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[95] Shepard Morgan, supra, pp. 2548–2549.
[96] Shepard Morgan, supra, p. 2551.
[97] Shepard Morgan, supra, p. 2547.
[98] Shepard Morgan, supra, p. 2552.

Footnotes and references 99, 1, 2, and 3 are omitted from this print.

[4] Shepard Morgan, supra, pp. 2552–2553.
[5] Shepard Morgan, Oct. 24, 1933, Chase Securities Corporation, pt. 5, pp. 2659–2660.

convertible into public-works $5\frac{1}{2}$-percent serial certificates in the same principal amount. Thereupon the credit would be restored for a further sum of $10,000,000. In this manner the credit was to revolve until the aggregate principal amount of $60,000,000 had been advanced.

A syndicate was formed to handle the credit comprising: Chase Securities Corporation and Chase National Bank, with a joint participation of $13\frac{1}{3}$ million dollars; Blair & Co., Inc., with a participation of $13\frac{1}{3}$ million dollars; Equitable Trust Co., with a participation of $13\frac{1}{3}$ million dollars; and Continental National Bank & Trust Co., Chicago, with a participation of $10,000,000.[6]

The syndicate offered to the American public two lots of the $5\frac{1}{2}$-percent serial certificates each in the sum of $10,000,000. The first lot was offered on October 24, 1928, at $99\frac{3}{4}$ and accrued interest, $6,250,000 to mature on December 31, 1931, and $3,750,000 to mature on June 30, 1932.[7]

The second lot was offered on January 29, 1929, at 100 and accrued interest, $2,500,000 to mature on June 30, 1932, $6,250,000 to mature on December 31, 1932, and $1,250,000 to mature on June 30, 1933.[8]

Serial certificates having a face value of $30,000,000 were retained by the members of the syndicate in proportion to their respective participations. All but $5,000,000 of the certificates retained by the syndicate matured subsequent to the certificates sold to the public.[9]

Prospectuses were issued in connection with both public offerings. The first prospectus dated October 24, 1928, stated:

> During the 5 fiscal years ended June 30, 1927, the ordinary revenues of the Government exceeded the ordinary expenditures by over $22,500,000.[10]

The prospectus dated January 29, 1929, which accompanied the second offering contained the statement:

> During the 6 fiscal years ended June 30, 1928, the ordinary revenues of the Government exceeded the ordinary expenditures by over $23,000,000.[11]

These representations were remarkably at variance with later statements contained in an application made on July 21, 1930, to list Cuban bonds on the New York Stock Exchange. The listing application showed that for the 4 fiscal years ending June 30, 1928, the expenditures of the Cuban Government exceeded the revenues by about $4,000,000. The explanation offered to the Senate subcommittee for the statements contained in the prospectuses was that those statements emanated from the Cuban Secretary of the Treasury.[12]

* * * * * * *

The loan agreement contained the following clause:

> * * * In order to give effect to such guaranty and security the Republic will set aside in a special account in each fiscal year 90 percent of such revenues or the necessary part thereof as and when collected in such year until the amount so set aside shall equal the amount payable in each year, for principal

[6] Shepard Morgan, supra, pp. 2659–2661.
[7] Shepard Morgan, supra, p. 2661.
[8] Shepard Morgan, supra, p. 2663.
[9] Shepard Morgan, supra, p. 2688.
[10] Shepard Morgan, supra, p. 2682.
[11] Shepard Morgan, supra, p. 2665.
[12] Shepard Morgan, supra, p. 2665.

or, as the case may be, for interest and/or commissions or compensation when and as the same shall be payable pursuant to the terms of the work certificates and the serial certificates and the provisions of the existing agreement and this agreement.[13]

In the prospectus accompanying the public offering made in October 1928 it was stated:

They (the serial certificates) are expressly secured by a first preferential lien and a charge to the extent required for payment of principal and interest in each fiscal year on 90 percent of the normal revenues collected from certain banks as provided by the Cuban public-works law of July 25, 1925. The Republic agrees to set aside in a special account for each such fiscal year 90 percent of the collections from the pledged revenues until the amount so set aside shall equal the amount required in each year for the payment of principal and interest on these serial certificates.[14]

Within 4 months after the Chase Securities Corporation and its associates had sold to the public the second issue of $10,000,000 serial certificates, it became apparent that the Cuban Government would not be able to carry on the public-works program, take care of its budgetary requirements, and meet the serial certificates as they matured. According to a report dated May 21, 1929, prepared by a Chase official:

The Government, however, consider that they will not be able to carry on the public works that they have in mind, take care of their budgetary requirements, and at the same time meet the serial certificates at their respective maturities. They estimate, to take care of their budget, they will desire to transfer $9,000,000 per year, at least for a while, from the estimated $18,000,000 of collections under the public-works law.[15]

Thus, practically in the wake of the public distribution of the serial certificates, the Cuban Government contemplated the diversion to budgetary purposes of 50 percent of the $18,000,000 estimated special revenues created by the public-works law, although those revenues were required by the loan agreement to be segregated to meet the expense of the public-works program.

Despite the provisions of the agreement and the representation in the prospectus there was never an actual segregation or earmarking by the Cuban Government of the revenues pledged, and they were freely commingled with the general funds of the Government. In a letter dated December 23, 1931, Louis S. Rosenthall, a second vice president of the Chase Bank, wrote to Shepard Morgan:

As you know, there has actually been no segregation of special funds in the treasury, and the Government from time to time has been compelled to use all funds in evidence to meet budgetary and other pressing payments. It has only been with the greatest difficulty that the Government has been able to return funds "borrowed" from the special public-works funds.[16]

Endeavoring to justify the failure of the Government to segregate the special revenues, and the failure of the bankers to insist upon such segregation, Mr. Morgan testified as follows:

Mr. PECORA. * * * You learned through this letter and through the telephone conversation that, according to this letter, Mr. Rosenthall had with you on the morning of December 23, 1931, if you did not learn it sooner, that the Government of Cuba had not lived up to those provisions of its loan agreements that were just read into the record by Mr. Williams?

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[13] Shepard Morgan, Oct. 25, 1933, Chase Securities Corporation, pt. 5, p. 2700.
[14] Committee Exhibit No. 44, Oct. 24, 1933, Chase Securities Corporation, pt. 5, p. 2702.
[15] Shepard Morgan, Oct. 25, 1933, Chase Securities Corporation, pt. 5, p. 2690.
[16] Committee Exhibit No. 47, Oct. 25, 1933, Chase Securities Corporation, pt. 5, p. 2701.

Mr. MORGAN. I did not learn any such thing.
Mr. PECORA Didn't you?
Mr. MORGAN. No. What the loan agreement says is that these public-works revenues will be set aside in a special account.
Mr. PECORA All right What do you think that meant?
Mr. MORGAN. I know what it meant.
Mr. PECORA. What did it mean?
Mr MORGAN. It meant that it was set up as a fund, not earmarked currency, in a strong box——
Mr. PECORA. Merely an accounting fund?
Mr. MORGAN. Yes.
Mr. PECORA. And commingled with funds generally?
Mr. MORGAN. Quite. As a cash matter; yes.
Mr. PECORA. I thought you said yesterday and the day before that those funds were earmarked. Are funds earmarked when they are commingled with general funds?
Mr. MORGAN. They are when they are set up in a special account.
Mr. PECORA. Is that what you regard as earmarking funds—merely because a bookkeeping entry is made about them?
Mr. MORGAN. When their purpose is satisfied. We were advised by our lawyers that Cuba had lived up to this agreement, and it was for that reason, Mr. Pecora, that I went to Habana in the subsequent January to arrange a—shall I say, a perfection of this program—whereby the funds should be actually paid over as received, instead of set up in a separate account.

Senator COUZENS. It seems a good thing, to me, that the Chase has gone out of the securities business.[17]

* * * * * * *

Mr. PECORA. Did you mean to tell the American investing public that these serial certificates were offered with this prospectus, that the Cuban Government had merely set up on its books as a special account 90 percent of these revenues to be derived from the public-works fund created by the law of 1925, or did you mean to tell the public that those funds were actually being set aside or segregated or put in a special fund in order to meet payment of servicing charges on these serial certificates? What did you mean to tell the public about that?
Mr. MORGAN. A reference to the contract would show that.
Mr. PECORA. The contract was not given to the public in this prospectus, was it?
Mr. MORGAN. It was published.
Mr. PECORA. Are you saying that seriously, Mr. Morgan, that the contract was public?
Mr. MORGAN. I said it was published.
Mr. PECORA. Do you mean to tell the committee by that statement that the American investing public had available to it the terms of this contract merely because it was a matter of public record down in Habana, Cuba?
Mr. MORGAN. Mr. Williams tells me——
Mr. PECORA. Now, please answer my question with regard to what you meant in the answer you made a moment ago. Do not tell me what Mr. Williams said about that, please.
Mr. MORGAN. If application had been made to us, we would have been glad to furnish the contract. It was a matter of public record in Cuba.
Mr. PECORA. Is that what you meant when you said this was a public contract?
Mr. MORGAN. A published contract.
Mr. PECORA. Is that what you meant?
Mr. MORGAN. Quite.[18]

Apparently the bankers did not consider the investor justified in relying upon the prospectus, but imposed upon him the burden of examining the contract. An examination of the contract, however,

[17] Shepard Morgan, Oct. 25, 1933, Chase Securities Corporation, pt. 5, pp. 2701–2702.
[18] Shepard Morgan, supra, pp. 2702–2703.

would have enlightened him little, since with respect to the obligation imposed on the Government to segregate the pledged revenues the contract contained a "weakness."

Mr. PECORA. Tell us, please, Mr. Morgan, how you understood that the Government was to set aside in a special account 90 percent of the collections from the pledged revenues until the amount so set aside should equal the amount required in each year for the payment of principal and interest on the serial certificates if, as a matter of fact, these "pledged moneys", so called, were commingled with general accounts and funds? You can make your answer to that as a banker, as a lawyer, or in any other role that you wish to assume.

Mr. MORGAN. As a practical matter, Mr. Pecora, I have thought that that was a weakness in the contract; and I went to Habana a month after the receipt of this letter and made an arrangement with the Cuban Government whereby that was amended—not the contract was amended, but the arrangement was amended.[19]

* * * * * * *

On October 24, 1929, the participating banks concluded to refrain from financing any further issues of certificates and laid plans to refund the serial certificates already in the hands of the public and the bankers by means of a long-term bond issue and a short-term banking credit.[20]

On February 26, 1930, the bankers entered into an agreement[21] with Cuba for the issuance of $40,000,000 15-year 5½-percent bonds, which the bankers agreed to purchase at 95, with an option to purchase an additional $40,000,000 bonds. The agreement further provided for the extension of a $20,000,000 credit by the bankers to the Cuban Government for 1 year at 5½ percent.[22] Out of the funds thus made available, the Cuban Government agreed to repurchase from the bankers at par the $30,000,000 serial certificates held by them and also to redeem at par the original $10,000,000 deferred-payment work certificates held by the bankers. As security for the payment of the $20,000,000 credit, Cuba agreed to hold in portfolio the $40,000,000 bonds not purchased by the bankers and to apply the proceeds of the sale of those bonds, as and when sold, to the payment of the credit.[23]

No provision was made in the contract for the repurchase of any part of the $20,000,000 serial certificates held by the public.

A selling group of more than 600 banks and investment dealers throughout the United States, Europe, and Cuba helped to dispose of the entire $40,000,000 bond issue to the public at 98.

Out of the proceeds, the bankers received payment of their $30,000,000 serial certificates, as well as the original $10,000,000 deferred-payment work certificates. As heretofore stated, the certificates held by the bankers, except for a small portion thereof, matured subsequent to those held by the public. Nevertheless, the bankers' certificates were paid first:

Mr. PECORA. Now, let us see if this isn't another side of that picture: At the time this agreement, providing for the issue of $80,000,000 of bonds, was entered into, February 26, 1930, between the Republic of Cuba and the Chase

[19] Shepard Morgan, supra, p. 2704.
[20] Committee Exhibit No. 48, Oct. 25, 1933, Chase Securities Corporation, pt. 5, pp. 2706–2707.
[21] This agreement is printed in full in the minutes of the hearings before the Senate Committee on Finance under S. Res. No. 19, 72d Cong., pt. 5, p. 1998.
[22] Shepard Morgan, Oct. 26, 1933, Chase Securities Corporation, pt. 6, p. 2767.
[23] Shepard Morgan, Oct. 26, 1933, Chase Securities Corporation, pt. 6, p. 2767.

National Bank, the Chase National Bank and its banking associates in the original group held in their portfolios the $30,000,000 worth of serial certificates that had been issued under the prior agreement of June 1928.

Mr. WILLIAMS. That is true.

Mr. PECORA. The Chase National Bank and its banking associates also held at that time $10,000,000 of the original deferred payment public-works certificates that had been issued in 1927.

Mr. WILLIAMS. That is true; aggregating, as I said, a total of $40,000,000.

Mr. PECORA. That made a total of $40,000,000. The maturities of the $30,000,000 of serial certificates held by the bankers in February of 1930 were later than the maturities of the $20,000,000 of the same serial certificates which had been issued in 1928 and were sold to the public by the Chase National Bank and its banking associates.

Mr. WILLIAMS. Yes; and in exchange for them the bank took bonds having a maturity 15 years later.

Mr. PECORA. All right. Under this agreement of February 26, 1930, the Cuban Government issued $40,000,000 of 15-year bonds bearing 5½ percent?

Mr. WILLIAMS. Which were purchased——

Mr. PECORA (interposing). What was that?

Mr. WILLIAMS. Which were purchased by the bankers at 95——

Mr. PECORA (interposing). Well, I am going to give you the whole story, and if I do not you may supply any omissions.

Mr. WILLIAMS. All right.

Mr. PECORA. And the Chase National Bank and its banking associates of that banking group took over those $40,000,000 of bonds from the Cuban Government, paying the Government 95 percent of their par value, and sold them to the public at 98?

Mr. WILLIAMS. Later; yes.

Mr. PECORA. Yes; later.

Mr. WILLIAMS. Yes.

Mr. PECORA. So that whatever moneys the Chase National Bank and its banking associates laid out in the purchase of those $40,000,000 of refunding bonds, they afterward got back in increased measure by selling those same bonds to the public at 98. That is correct, isn't it?

Mr. WILLIAMS. In increased measure, if that spread of 3 points was sufficient to cover their expenses; yes.

Mr. PECORA. Well, so far as the public was concerned, they paid 98 to the Chase National Bank and its associates for those bonds, which the Chase National Bank and its associates got from the Government of Cuba at 95. That is what I mean by the term "in increased measure."

Mr. WILLIAMS. The public paid 98 and accrued interest.[24]

The excuse offered by the bankers for this subjection of the public interest to their own bordered on the fantastic.

Mr. PECORA. And out of the proceeds derived from the sale of this first $40,000,000 of 15-year bonds this arrangement provided in substance that the $30,000,000 worth of serial certificates held by the bankers and which did not mature until after the $20,000,000 of certificates sold to the public were first to be paid?

Mr. MORGAN. That is correct. But I should like to call your attention to the fact that the certificates already in the hands of the public remained as a first lien. Future financing was to operate as a second lien.

Mr. PECORA. But payment is better than a first, second, or third lien all put together, isn't it?

Mr. MORGAN (continuing). And at the same time the banks put up a supplemental $20,000,000.

Mr. PECORA. But, I say, payment is better than a first, second, third, or even a tenth lien, isn't it?

Mr. MORGAN (continuing). Under precisely the same terms.

Mr. PECORA. But, I say, payment of certificates is better than a lien for their payment, isn't it? It is better than a dozen liens for future payment, isn't it?

[24] A. M. Williams, Oct. 25, 1933, Chase Securities Corporation, pt. 5, pp. 2736–2737.

Mr. MORGAN. Not necessarily.

Mr. PECORA. Why, do you mean to say that you would rather have a lien than actual payment?

Mr. MORGAN. If they are good, and when earning me 6 percent or 5½ percent and are repaid, I think they are good. It is a good investment, Mr. Pecora.[25]

The $20,000,000 serial certificates held by the public were ultimately paid, but not before the bankers had procured payment for themselves.

* * * * * * *

In connection with the public offering of the $40,000,000 bond issue, a prospectus was issued by the original group. The prospectus omitted any reference to the revenues and expenditures of the Republic of Cuba. For the fiscal year ending June 30, 1929, the revenues were $79,325,000 and the expenditures $86,765,000, leaving a deficit of $7,440,000.[26]

Mr. PECORA. Now, the question I asked you was this, in substance. As a banker do you not think that the public, when it was invited to subscribe for these Republic of Cuba bonds, was entitled to know what the facts were with regard to the revenues and the expenditures of the Republic of Cuba for the preceding fiscal year?

Mr. MORGAN. I am disposed to think that that, taken by itself, would have given a misleading impression.

Mr. PECORA. It would have informed the public that the expenditures exceeded the revenues by nearly 10 percent, would it not?

Mr. MORGAN. Yes; but at the same time——

Mr. PECORA. And that fact would not have favorably impressed any prospective purchaser of these bonds, would it?

Mr. MORGAN. At the same time, if I had been drawing the circular, I would have stated, for the sake of the information to the public, that the debt of Cuba had come down during that same year by a little better than $6,000,000; that is to say, practically offsetting this deficit figure.

Mr. PECORA. What was the answer? I did not get the first part of it.

The CHAIRMAN. The debt had been reduced $6,000,000.

Mr. PECORA. The reduction of the debt does not counteract the fact that the expenditures exceeded the revenues by nearly 10 percent of the revenues for the preceding fiscal year, does it?

Mr. MORGAN. I should think it was perhaps even a more material fact, from the standpoint of the bondholder, than the current revenues and expenditures of the Republic.

Mr. PECORA. Was the reduction of the debt referred to in this prospectus?

Mr. MORGAN. Yes.

Mr. PECORA. Then, why was not the fact referred to in the prospectus that the expenditures exceeded the revenues by nearly 10 percent for the preceding fiscal year?

Mr. MORGAN. I have stated that to my best knowledge, Mr. Pecora.[27]

The omission was at variance with the practice followed when the previous prospectuses were drawn.

Mr. PECORA. Why did you, then, in the circulars or the prospectuses which were issued in October 1928 and in January 1929, when the $20,000,000 worth of serial certificates were offered to the public, make mention of the expenditures and the revenues of the Republic of Cuba?

Mr. MORGAN. It was then regarded as a material fact.

Mr. PECORA. When did it cease to be a material fact? Or, let me put it this way: Did it cease to be a material fact when the expenditures exceeded the revenues by nearly 10 percent?

Mr. MORGAN. No; but it would have required a much longer prospectus, Mr. Pecora, in order to have set up the picture with complete accuracy.[28]

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[25] Shepard Morgan, Oct. 25, 1933, Chase Securities Corporation, pt. 5, pp. 2711–2712.
[26] Shepard Morgan, supra, pp. 2716–2717.
[27] Shepard Morgan, supra, 2717–2718.
[28] Shepard Morgan, supra, p. 2718.

The prospectus referred to the $20,000,000 public-works certificates held by the public, but failed to mention the $30,000,000 serial certificates and the $10,000,000 deferred-payment work certificates held by the banks.

The total funded debt of the Republic as of the end of the fiscal year, June 30, 1929, was $87,174,200, exclusive of $20,000,000 public works 5½-percent serial certificates outstanding, of which $77,660,000 was external. Floating indebtedness as of the same date amounted to approximately $5,000,000.[29]

The Chase officials endeavored to justify this omission on the ground that the $30,000,000 serial certificates and the $10,000,000 deferred-payment work certificates were not "outstanding" as part of the total funded debt of Cuba, because they were held by the bankers and not by the public.

Mr. PECORA. Yes; now, on that date, June 30, 1929, weren't there outstanding as obligations owing by the Republic of Cuba $30,000,000 of serial certificates and the $10,000,000 of deferred-payment public-works certificates which were held and owned by the Chase National Bank and its associates in this financing?

Mr. MORGAN. There were certain serial certificates in existence, but not outstanding. They were in the hands of the bankers, and——

Mr. PECORA (interposing). Well, weren't they outstanding obligations of the Republic of Cuba?

Mr. MORGAN. Yes; but you are using the word "outstanding" in two different senses.

Mr. PECORA. I am using them as representing obligations due and owing by the Cuban Government.

* * * * * * *

Mr. MORGAN. They were unquestionably obligations owed by the Republic of Cuba, but——

Mr. PECORA (interposing). That is, the $30,000,000 of serial certificates.

Mr. MORGAN (continuing). But not outstanding in the sense of a debt to the public.

Mr. PECORA. They were outstanding so far as the Republic of Cuba was concerned, weren't they?

Mr. MORGAN. They were in existence.

Mr. PECORA. As obligations of the Republic of Cuba?

Mr. MORGAN. In existence as obligations of the Republic of Cuba, quite so.

Mr. PECORA. All right. And forming a part of the indebtedness of the Republic of Cuba?

Mr. MORGAN. Quite so.[30]

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No exposition of fine-spun theory could obliterate the ultimate fact that the certificates held in portfolio by the bankers were outstanding obligations of Cuba.

Mr. MORGAN. The fact was that at the conclusion of this operation, without allowing for retirements that had been made in the meantime, the total funded debt of the Republic of Cuba——

Senator COUZENS. Never mind the funded debt.

Mr. MORGAN. The total amount outstanding, if you would like to have me say that, the total amount outstanding in the hands of the public——

Senator COUZENS. Never mind "in the hands of the public." You always put something in so that we can't get a clear picture.

Mr. MORGAN. The total amount outstanding?

Senator COUZENS. Yes.

Mr. MORGAN (continuing). Was approximately $87,000,000, plus $20,000,000, plus $40,000,000.

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[29] Committee Exhibit No. 54, Oct. 26, 1933, Chase Securities Corporation, pt. 6, p. 2744.
[30] Shepard, Morgan, Oct. 26, 1933, Chase Securities Corporation, pt. 6, pp. 2744–2745.

Senator COUZENS. Now we are getting a correct answer. That is what we have been trying to get all morning, and I don't see why we could not get it straight without all this——

Mr. WILLIAMS. Senator, let me say that there is not the slightest question that to all legal intents and purposes in June 1929 these certificates which had been issued up to that date and which were held in the portfolio of the Chase Bank and its associates were outstanding obligations of the Cuban Republic, just as much as any other security.

Senator COUZENS. Why didn't Mr. Morgan tell us that in the first place?

Mr. WILLIAMS. Perhaps he was confused on the legal consequences of the issuance of those securities.[31]

It was contended that sufficient disclosure of the bankers' $30,000,000 serial certificates and $10,000,000 deferred-payment work certificates was made in the following portion of the prospectus.

PURPOSE OF THE ISSUE

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The public works 5½-percent sinking-fund gold bonds and said $20,000,000 credit are for the purposes of refunding or paying indebtedness of the Republic incurred for work completed and accepted in accordance with the provisions of the public-works law.[32]

This statement is silent with respect to the fact that there were $40,000,000 of obligation in the hands of the bankers in addition to the amount of funded debt set forth in the prospectus.

Mr. PECORA. The $20,000,000 of serial certificates actually at the time in the possession of the banking group were not taken into account in stating the indebtedness of the Republic of Cuba in this prospectus; were they?

Mr. MORGAN. Except as they were referred to in the preceding sentence.

Mr. PECORA. What reference is made to them in the preceding sentence?

Mr. MORGAN. That the purpose of the $40,000,000 issue was to refund or pay indebtedness.

Mr. PECORA. What is there in that statement which would inform the public that the $20,000,000 credit which was to be refunded by means of this bond issue was not part of the $87,174,200 indebtedness set forth in the prospectus?

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Mr. WILLIAMS. May I say that I think there is some point to Mr. Pecora's criticism of the phraseology of the circular. It might have been more clearly stated. But at the time the circular was put out it was stated that the debt was eighty-seven and odd million dollars. Then there was a bond issue of $40,000,000, making a total of $127,000,000. There was no change in the total indebtedness of Cuba by reason of the issue of the $40,000,000 of bonds, because $40,000,000 of existing obligations were retired through this operation.

Mr. PECORA. But, Mr. Williams, the statement in the prospectus of the indebtedness and its reference to that portion of the indebtedness which was to be retired by means of this bond issue, does not indicate one way or other whether the portion of the indebtedness that was to be retired through this bond issue was included in the amount stated in the prospectus as being the indebtedness.

Mr. WILLIAMS. No; the statement said that the proceeds of the bonds were to be used to reduce or retire indebtedness.

Mr. PECORA. But it does not say whether that indebtedness was already included in the statement of what the indebtedness was as set forth in the prospectus; isn't that so, Mr. Williams?

Mr. WILLIAMS. I think that is a fair criticism.[33]

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[31] Shepard Morgan, supra, p. 2751.

[32] Committee Exhibit No. 54, Oct. 26, 1933, Chase Securities Corporation, pt. 6, p. 2744.

[33] Shepard Morgan, Oct. 26, 1933, Chase Securities Corporation, pt. 6, pp. 2753, 2755.

The total gross commissions paid to the Chase National Bank and its associates by the Republic of Cuba in connection with the financing under the 1927 and 1928 agreements, the bank credit of 1930, and additional advances in June 1932, December 1932, and June 1933, aggregated $1,638,393.02. The profits of the managing group and the selling groups from the public sale of the first and second $10,000,000 issues of serial certificates were $1,690,399.70. The net commissions and profits to the original and selling groups from the sale and distribution of these securities to the public totaled $3,091,023.56.[34]

From time to time questions have been raised both in Cuba and the United States concerning the legality and binding effect of the Public Works obligations. It was not within the province of the investigation conducted by the Senate subcommittee to determine either the validity or the illegality of these obligations and nothing contained in this report should be construed as expressive of any opinion on the subject. Strictly legal questions aside, however, it is abundantly clear that a sum in excess of $60,000,000, loaned by American investors and bankers to the Cuban Government and employed by the latter in its public-works program, still remains unpaid as to principal, with interest arrearages accumulating since June 30, 1933.

(4) *Bond issues of the city of Rio de Janeiro.*—On October 6, 1921, Dillon, Read & Co. underwrote an issue of $12,000,000 8 percent sinking fund gold bonds of the city of Rio de Janeiro, Brazil. Dillon, Read & Co. paid 89 and interest for the bonds and sold them to the public at 97¾.

At that time the firm of Imbrie & Co. held an irrevocable option on all financing for the city of Rio de Janeiro. Dillon, Read & Co. paid $120,000 to the receiver of Imbrie & Co. for a transfer of this option.[35]

The primary purpose of this $12,000,000 loan was to demolish Castle Hill, a large mound in the slums of Rio where approximately 5,000 people lived, then to level the land, and sell it to the public. Fundamentally, it was a scheme of real estate development. The proceeds of the sale of the land were to be used to retire the bonds, but the city reserved the right to use part of the land for municipal or federal purposes.[36]

Of the total loan, $4,000,000 was allocated to this demolition project; $1,500,000 to the erection of a municipal slaughter house; and $1,500,000 to the purchase of such municipal bonds as the city would select, the bonds so purchased to be held as collateral security for the payment of the new bonds issued. Although the agreement between Dillon, Read & Co. and the city was dated as of October 1, 1931, it was not actually executed until October 31, 1931. Meanwhile, the bonds were offered to the American public on October 7, 1931.[37] According to Robert O. Hayward, a member of the firm of Dillon, Read & Co., the bonds were offered by virtue of an option agreement dated September 3, 1921. The option agreement con-

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[34] Shepard Morgan, supra, pp. 2796–2798.
[35] Robert O. Hayward, Oct. 11, 1933, Dillon, Read & Co., pt. 4, p. 1893.
[36] Ibid., p. 1898.
[37] Ibid., pp. 1899, 1900.

tained no commitment as to the purposes for which the proceeds of the loan were to be used. Hayward contended that the omission was not material because the purpose of an issue of government or municipal bonds is " the least important of the details." [38]

Kennedy & Co. was selected as the contractor by Dillon, Read & Co. and nominated in the contract without public bidding. Hayward admitted that a corporation composed of the members of Clarence Dillon's family owned a 45-percent interest in Kennedy & Co.[39]

Although the proceeds of the sale of lots created by the demolition of Castle Hill were to be set aside and applied toward the retirement of the bonds, no engineering estimate of the length of time necessary to complete the enterprise was obtained by the bankers, no date was specified in the contract with Kennedy & Co. for completion of the work, and no effort was made to determine when the sale of lots could be commenced.[40]

As late as 1931, after the original $5,000,000 had been consumed in the demolition project, and after an additional $1,500,000 originally intended for the construction of a slaughter house had likewise been consumed, together with other funds borrowed by the city, lots had been sold with a net return of only $230,000.[41]

Out of the $1,500,000 provided for the Municipal Slaughter House, $1,020,000 was paid to Kennedy & Co., the contractors, and $480,000 was diverted to other purposes.

The sum of $1,500,000 was left on deposit with Dillon, Read & Co., under the following provision of the agreement:

> The obligor agrees that the bankers shall retain $1,500,000 out of the payment to be made by them under article 3, section 2, of the main agreement, such amount to be used by them in the purchase of such foreign obligations of the obligor (other than bonds issued hereunder) as may be designated by the Perfecto of the obligor.[42]
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> * * * * * * *
>
> The obligor covenants and agrees that such bonds or other evidences of indebtedness issued by the obligor (but not including the bonds issued hereunder), as are purchased or acquired by the use of any part of the proceeds of this loan, shall be delivered to and deposited with the bankers, to be held by the bankers as security for the fulfillment by the obligor of its obligations hereunder, and under the bonds issued hereunder.[43]

The Perfecto (mayor) designated for purchase the bonds of an issue designated as the 1919 Imbrie loan, which matured in 1922. Since the bonds of this series had only a few months to run and were held in large blocks by a few individuals who did not desire to sell, Dillon, Read & Co. succeeded in purchasing only $20,000 par value of those bonds. Pursuant to instructions from the perfecto of Rio, Dillon, Read & Co. turned over $1,000,000 of the balance to the Equitable Trust Co., trustees under the Imbrie loan, and this money was used to satisfy and discharge bonds of the Imbrie loan when they matured.[44] No mention was made in the prospectus of

[38] Ibid., p. 1905.
[39] Ibid., pp. 1897, 1908, 2130.
[40] Ibid., pp. 1910–1911.
[41] Ibid., pp. 1908, 1909, 1918, 1920.
[42] Ibid., pp. 1925, 1940, 1946.
[43] Ibid., p. 1926.
[44] Ibid., p. 1920.

the loan floated by Dillon, Read & Co. that any part of the proceeds was to be used for the retirement, payment, or redemption of the existing bonds of the city of Rio de Janeiro. On the contrary, it was specifically provided in the loan agreement that any bonds purchased could be held as additional security for the bonds of the new loan, and by the discharge of the bonds of the previous loan the new bondholders were deprived of this security.[45]

The loan contract also provided that a deposit of not less than $250,000 would be maintained with Dillon, Read & Co. as a reserve for servicing the bonds. Part of this fund was employed on March 31, 1931, to make up a sinking fund payment.[46] On October 1, 1931, in order to enable the municipality to meet the interest payment due on the bonds, $239,518 was drawn out of this deposit account leaving a balance of $7,000. Although the city later increased the deposit to $37,000 it was never restored to the figure required by the contract. No disclosure was made to the bondholders of the circumstances regarding these payments out of the reserve fund.[47]

(5) *Bond issues of the Republic of Brazil.*—On the 16th day of May, 1921, Dillon, Read & Co. offered as part of a contemplated $50,000,000 loan a series of $25,000,000 8 percent bonds of the Brazilian Government.[48] This was the first Brazilian external loan floated in the United States.[49] The loan contracts were executed on June 2, 1921, and dated as of May 27, 1921. Dillon, Read & Co. received an option on the issuance of $25,000,000 additional bonds, which option was executed on September 14, 1921, and dated as of May 28, 1921.[50]

The first issue of $25,000,000 was taken over by the bankers at 90 and offered to the American public at 97½.[51]

The second issue was taken over by the bankers at 90 and sold to the public at 98½.[52]

According to Hayward, the difference of 1 point in the offering price between the two issues, which were identical, was due to the fact that the money market was a little better at the time of the second issue and that the bankers always seek to dispose of an issue at the highest price obtainable in the market; that is, "all that the traffic will bear." [53]

A trading account was organized to aid in the disposal of the bonds, and within a period of a week or 10 days all the bonds were sold to the public.[54] Each $25,000,000 issue was offered publicly on the basis of the options held by Dillon, Read & Co., and were practically disposed of before Dillon, Read & Co. actually executed the loan contracts with Brazil.

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[45] Ibid., p. 1927.
[46] Ibid., p. 1931.
[47] Ibid., pp. 1934–1936.
[48] Ibid., p. 1949.
[49] Ibid., p. 1952.
[50] Ibid., p. 1954.
[51] Ibid., p. 1959.
[52] Ibid., p. 1960.
[53] Ibid., pp. 1960–1961.
[54] Ibid., pp. 1961, 1967.

In the prospectuses offering these bonds to the public, it was stated:

The proceeds of this loan are to be employed in part for the purchase in the United States of materials required by the Government.[55]

Although Dillon, Read & Co. were advised that the proceeds of the loan were to be used "in the development services and works of reproducing character, purchases of material with preference in the United States, under equality of conditions, and to support exchange", the circular failed to disclose these purposes.

On December 1, 1931, a default occurred in the payment of interest on the bonds. The Brazilian Government, in contravention of the terms of the loan agreement, did not segregate the proceeds from taxes pledged to secure the loan; but according to Hayward, a funding plan was devised whereby Brazilian currency is set aside semiannually in the Bank of Brazil to be used eventually for the retirement of script which is paid to the bondholders in the meanwhile.[56]

The total gross profits accruing to Dillon, Read & Co., and the Eastern Trust Co. (a corporation owned wholly by Dillon, Read & Co.) on the first issue of $25,000,000 was $501,366.89, and on the second issue of $25,000,000, $910,598.03, a total on both issues of $1,411,964.92. The total gross profit of the underwriters and the selling syndicates on the first issue was $1,242,454.33, and on the second issue $1,545,903.34, a total on both issues of $2,788,357.67.[57]

On June 1, 1922, Dillion, Read & Co. secured an option from Brazil for the purchase of $25,000,000 United States of Brazil Central Railway electrification bonds. The bonds were acquired by Dillon, Read & Co. at 91 and were publicly offered on June 5, 1922, at 96½. The gross profit to Dillon, Read & Co. on this flotation was $381,284.74. The total profit of the originating group and all other syndicates was $1,038,998.62.[58]

According to an advertisement published in the New York Times on or about June 25, 1922:

The proceeds of the loan are to be used to provide for the electrification of the suburban division of the railway, which is owned by the Government of Brazil and is without bonded debt.[59]

According to the prospectus:

The proceeds of the loan are to be used in part to provide for the electrification of the suburban division of the railway, which is owned by the Government of Brazil and is without bonded debt.[60]

During the negotiations for the loan, it was disclosed to Dillon, Read & Co. that only $8,000,000 of the $25,000,000 would be used for permanent railway improvement—electrification of the road—and $17,000,000 would be used for the purchase or replacement of equipment. Neither the advertisement nor the prospectus disclosed that approximately two-thirds of the proceeds of the loan were to be used for the general expenses of the road.[61]

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[55] Committee exhibit no. 29, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 2033.
[56] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1970.
[57] Ibid., pp. 1966–1967.
[58] Ibid., pp. 1977–1978.
[59] Ibid., p. 1979; also p. 2036.
[60] Ibid., pp. 1979, 1936–1937, 2037.
[61] Ibid., pp. 1981–1982.

Although the issue was sold in 1922, down to the time of the hearing before the Senate subcommitee, on October 12, 1933, not only had no part of the road been electrified, but the contract for electrification had never been let. Nevertheless, all the proceeds of the loan were consumed.[62]

The terms of the loan contract provided:

SEC. 2. The obligor covenants that it will create and, at all times while any of the bonds shall be outstanding, maintain with the bankers a deposit of not less than $500,000. * * *[63]

On May 1, 1931, $392,052.50 was withdrawn from this deposit account covering the interest due on June 1, 1931. This withdrawal was never fully replaced by the Brazilian Government.[64]

When the Government failed to make the remittance of funds necessary to meet the interest payment due June 1, 1931, Dillon, Read & Co. knew that such failure evidenced at least a temporary embarrassment on the part of the Government.

In a cable from Dillon, Read & Co. to the Brazilian Minister of Finance, dated May 2, 1931, it was stated:

We released yesterday announcement funds in hand for 7's and 8's June 1 payments which had decided effect in strengthening Brazilian bonds and general confidence in your situation.[65]

The announcement referred to presented a misleading picture of the situation to the public.

Senator COUZENS. They knew the contract was in default, and they issued a statement which boosted the price of the bonds.

Mr. PECORA. I was coming to that.

Mr. HAYWARD. The contract at that time was not in default.

Mr. PECORA. It might not have been in technical default, but it was in practical default, was it not?

Mr. HAYWARD. Not at that time. There was an obligation to replenish that fund.

Mr. PECORA. And that obligation had not been lived up to by the Government, had it?

Mr. HAYWARD. The fund had not been drawn on on that date.

Mr. PECORA. The fund was drawn down May 1, according to your own records. Nearly four-fifths of this fund was drawn down on May 1, out of this so-called "deposit account" of $500,000.

Mr. HAYWARD. This was one day after that and as I have said, the interest payment date was June 1.

Mr. PECORA. Was it ever replenished or replaced?

Mr. HAYWARD. As I said, it is still not completely replenished.

Mr. PECORA. To what extent has it ever been replenished since May 1, 1931?

Mr. HAYWARD. It was replaced by a transfer from other funds, other accounts on August 12, 1931, to the extent of $213,659.80.[66]

Dillon, Read & Co. realized that the public would assume that the interest payment had been made from funds remitted by Brazil. This fact is evidenced by a communication from Dillon, Read & Co. to the Consul General of Brazil under date of November 9, 1931, in which it was stated:

As you are undoubtedly aware, the loan contracts are a matter of public record and are open to inspection by any holders of Brazilian Government bonds. Should the holders of such bonds shortly form protective committees, we have no doubt that the attorneys for these protective committees will wish

[62] Ibid., p. 1984.
[63] Ibid., pp., 1987, 2044; see also pp. 1945, 2026.
[64] Ibid., p. 1987.
[65] Robert O. Hayward, Oct. 12, 1933, Dillon, Read & Co., pt. 4, p. 1989.
[66] Robert O. Hayward, supra, p. 1989.

to make complete examination of the situation, inspecting the contracts of the Brazilian Government covering its loans abroad, and the fact that the Government is in default also in regard to these important clauses of the contract is bound to impress them most unfavorably. We were under no obligation to acceded to the request of the Minister of Finance in April that part of these funds should be used for the payment of interest. No public announcement to the effect that these funds had been so used was made by us, and the holders of Brazilian Government covering its loans abroad, and the fact that the Govern-acceded to the request of the Minister of Fnance in April that part of these funds that date was met by funds remitted from Brazil.[67]

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On October 15, 1927, Dillon, Read & Co. purchased $41,500,000 Brazilian Government 6½ percent sinking fund gold bonds due October 15, 1957. Rothschild, Baring & Schroeder, London bankers, purchased a similar amount for distribution in Europe. Dillon, Read & Co. acquired these bonds at 88 and offered them to the public at 92½. The profit realized by Dillon, Read & Co. was $598,789.69, and the total profit of all the groups in the syndication of this issue was $1,750,117.24.[68]

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Previously, Dillon, Read & Co. had floated issues aggregating $145,000,000 for the United States of Brazil.[69] The new issue was sold to the American public approximately 5 years after the flotation of the railway electrification loan, and, in the interim, the Brazilian Government had not electrified the road or even let the contract for electrification. These bonds, like all Brazilian bonds, are in default and are being serviced by a refunding plan devised by the Brazilian Government. Out of $186,000,000 Brazilian bonds sold by Dillon, Read & Co. to the American public, there were outstanding at the time of the hearing, October 12, 1933, a net total of $144,000,000 which are in default.[70]

(6) *Bond issues of the Mortgage Bank of Chile.*—Between June 25, 1925, and June 26, 1929, Kuhn, Loeb & Co., in conjunction with the Guaranty Co. of New York, floated $90,000,000 guaranteed sinking fund gold bonds of the Mortgage Bank of Chile. There were 4 issues of $20,000,000 each and 1 issue of $10,000,000.[71]

The Mortgage Bank of Chile (Caja de Credito Hipotecario)—a public corporation similar to our Federal land banks—made first-mortgage loans and sold bonds against these loans to the Chilean public.[72]

During the negotiations Kuhn, Loeb & Co., considering the responsibility of the Mortgage Bank of Chile insufficient, refused to undertake the flotation unless the issue were guaranteed by the Chilean Government.[73] Accordingly, the payment of the $90,000,000 bonds was guaranteed by the then existing Chilean Government, which had but recently come into power.[74]

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[67] Ibid, pp. 1991–1992.
[68] Robert O. Hayward, supra, p. 2008.
[69] Robert O. Hayward, supra, pp. 1993–1994.
[70] Robert O. Hayward, supra, p. 1974.
[71] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1016.
[72] Committee Exhibit No. 9, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1020–1022.
[73] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1023.
[74] Committee Exhibit No. 9, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1020–1021.

Mr. PECORA. The Government had come into power in September of 1924, which was a Government that obtained its power through a show of force. It was a revolutionary Government, wasn't it?

Mr. BUTTENWIESER. I believe so.[75]

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Mr. PECORA. At the time of this issue of $20,000,000 for the Mortgage Bank of Chile, what kind of government existed in Chile?

Mr. KAHN. At that particular time—and I am now speaking subject to correction, but at that particular time they had what in Chile they called an election—no; they had what here we call an election; they had a new deal, and a new government came in. They did not come in by the peaceful means which characterizes the situation in this country; they came in with a moderate degree of violence.[76]

In a cable dated June 22, 1925, from Manuel Foster, representing Kuhn, Loeb & Co. in Chile, to Kuhn, Loeb & Co., in New York, it was stated:

Answering questions your cable 19th instant: First president was duly elected under constitution, but present cabinet was appointed by former military council and practically confirmed by the president. Constitutionally they have no authority to recognize debts unless by law enacted by Congress. But in this case their decrees as proceeding from a de facto government recognized by the country and respected by all the citizens are valid and binding upon the Republic.[77]

In reply, Kuhn, Loeb & Co. cabled:

Is it not correct to refer to council as governing council which we prefer instead of military council?[78]

At that time the American Government had not recognized the de facto government guaranteeing the bonds.[79]

In the prospectus the Government was referred to not as a " military council ", but as a " governing council." [80] The body described as the " governing council " was composed of military and naval officers. The first military council held power until January 1925, when it was ousted by a similar council composed of younger officers. The latter group functioned under its own laws and decrees rather than under the laws passed by a popular assembly or congress. There was no election held until after the first issue of $20,000 had been offered.[81]

In view of these circumstances, the guaranty of the government was of doubtful validity and little value. The guaranty was obtained from a government which was functioning without a constitution, without a congress, and before a popular election had been held. Although the guaranty was not repudiated by the Chilean Government, it was obvious that the instability of the Government, with its resultant effect upon the business and finance of the nation, was a vital factor to be considered in determining the security and soundness of the issue.

The first issue of $20,000,000 6½-percent bonds was purchased by a syndicate comprising Kuhn, Loeb & Co., the Guaranty Co. of New York, and Lehman Bros. The price to the bankers was 93, and the

[75] Benjamin J. Buttenwieser, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1024.
[76] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1016.
[77] Benjamin J. Buttenwieser, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1031.
[78] Benjamin J. Buttenwieser, supra, p. 1031.
[79] Committee Exhibit No. 9, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1020–1023.
[80] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1101.
[81] Benjamin J. Buttenwieser, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1031.

bonds were offered to the public at 97⅜.[82] The profit to the originating group, exclusive of the $100,000 commission paid as a "finder's" fee to Louis Dreyfus & Co., was $247,127.20.[83]

In July 1926 Kuhn, Loeb & Co floated the second issue of $20,000,000 6¾-percent Mortgage Bank of Chile bonds. The price to the originating group was 95⅝, and the bonds were offered to the public at 99¼.[84] The gross profit to the originating group in connection with this issue was $824,850.[85]

This issue was floated in spite of the fact that during the early part of 1926 a depression occurred in the nitrate industry, the principal resource of Chile.[86] B. Atterbury, representing the Guaranty Co. of New York in Santiago, Chile, had apprised his company that the nitrate situation, the figures on Government finances, and the general commercial feeling were not encouraging.[87]

The third issue of $10,000,000 5-year 6-percent notes was floated in December 1926. Prior to the flotation of this issue no independent investigation was made by the bankers of political and economic conditions in Chile. The bankers purchased these notes at 95½ and offered them to the public at 98¾, with accrued interest, [88] realizing thereon a gross profit of $325,000.[89]

The fourth issue of $20,000,000 6 percent bonds was brought out on April 30, 1928, with Kuhn, Loeb & Co., the Guaranty Co. of New York, National City Co., and Lehman Bros. as the originating group. The price to the bankers was 92, and the price to the public was 95¾.[90] The gross profit to the bankers on this issue was $863,000.[91]

The fifth issue of $20,000,000 6 percent bonds was offered on June 26, 1929. The price to the bankers was 89½, and the price to the public was 92 and accrued interest. On this issue the originating group sustained a loss of $33,518.32.[92]

The Mortgage Bank of Chile defaulted on all the bonds in July 1931, and the Chilean Government defaulted on its guaranty.[93] At the time of the hearings, June 28, 1933, the bonds were quoted at 14.[94]

5. Regulation Under the Securities Act of 1933

The evidence presented to the Senate subcommittee regarding the practices prevalent in the investment banking business laid the foundation for the Securities Act of 1933.

Broadly speaking, the Act imposes upon the seller of a new security the duty to make fair, complete, and adequate disclosure to the investor, with appropriate penalties for violations of that duty. This constitutes no radical departure from established principles of

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[82] Benjamin J. Buttenwieser, June 28, 1933, Kuhn, Loeb & Co., pt. 3, p. 1108.
[83] Benjamin J. Buttenwieser, supra, p. 1117.
[84] Benjamin J. Buttenwieser, supra, p. 1130.
[85] Benjamin J. Buttenwieser, supra, p. 1136.
[86] Benjamin J. Buttenwieser, supra, p. 1180.
[87] Benjamin J. Buttenwieser, supra, p. 1182.
[88] Benjamin J. Buttenwieser, supra, p. 1139.
[89] Benjamin J. Buttenwieser, supra, p. 1141.
[90] Benjamin J. Buttenwieser, supra, p. 1142.
[91] Benjamin J. Buttenwieser, supra, p. 1145.
[92] Benjamin J. Buttenwieser, supra, p. 1148.
[93] Benjamin J. Buttenwieser, supra, p. 1091.
[94] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 1016.

business conduct. On the contrary, the Act translates into positive law certain elementary percepts to which investment bankers have rendered lip service on many occasions.

Mr. WHITNEY. The bonds that we sell are sold under certain very definite representations by the company from whom we have purchased the bonds and are reselling to the public. We have always endeavored, I think successfully, to have the greatest possible publicity in all matters connected with our security issues. In other words, to make the fullest kind of disclosure to the public of the security, the character of the company, the type of business they do, and all those other matters which are of interest to a prospective buyer. * * *[95]

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Mr. KAHN. * * * For if the private banker does render, as I believe he does, services which are necessarily better rendered by him than by a corporate entity, then I say let him go ahead. But impose upon him the strictest requirements of disclosure as to what he offers. * * *[96]

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Mr. DILLON. * * *
I want to say at the outset that I am in sympathy with the principles of the securities bill. I do not think it has gone far enough in the question of publicity. I think I have elaborated on that before. I think the publicity should be continuing and not only at the time of the issue.[97]

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Mr. PECORA. Do you approve heartily of the principle of a full disclosure of material facts?
Mr. ALDRICH. Absolutely.
Mr. PECORA. In the offering of securities to the investing public?
Mr. ALDRICH. Absolutely.
Mr. PECORA. And that is the essential principle of the Securities Act of 1933 as you understand it?
Mr. ALDRICH. That is correct.[98]

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The Securities Act of 1933, as amended by the Securities Exchange Act of 1934, is applicable to all securities except those designated as "exempted" by the terms of the act. "Exempted" securities include securities issued or guaranteed by the United States, by any State or political subdivision of a State, by any public instrumentality of one or more States, or by any Federal public instrumentality. Likewise in the exempted class are securities issued or guaranteed by any national bank or by any State banking institution subject to supervision by a State banking commissioner. Other securities exempted are short-term commercial paper; securities issued by certain types of nonprofit corporations, or by certain types of building and loan associations; securities issued by a common carrier subject to the jurisdiction of the Interstate Commerce Commission; certificates issued with the approval of a court by a receiver or trustee in bankruptcy, or in connection with a reorganization; and insurance policies subject to the supervision of a State insurance commissioner.[99]

The act affects only new offerings of securities sold through the use of the mails or other instrumentalities of interstate transportation or communication. It is not concerned with the ordinary re-

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[95] George Whitney, June 2, 1933, J. P. Morgan & Co., pt. 2, p. 556.
[96] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1317.
[97] Clarence Dillon, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2111.
[98] Winthrop W. Aldrich, Dec. 6, 1933, Chase Securities Corporation, pt. 8, p. 4122.
[99] Securities Act of 1933, sec. 3.

distribution of securities, and hence, broker's transactions, executed upon customer's orders on any exchange or in the open market, are not governed by this act.[1] Transactions by any person other than an issuer, underwriter, or dealer, which do not involve a public offering, are exempt from the 1933 act.

Persons whose transactions fall within the scope of the act are: (a) the issuer, defined to mean every person who issues or proposes to issue any security; (b) the underwriter, defined to mean any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or has a direct or indirect participation in any such undertaking, or in the underwriting of any such undertaking; and (c) the dealer, defined to mean any person who engages as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.[2]

Unless a registration statement is in effect as to an unexempted security, it is unlawful for any person to use the mails or any instrumentalities of transportation or communication in interstate commerce, to sell or offer to buy such security; or to carry or cause to be carried through the mails or in interstate commerce, by any means of transportation, any such security for the purpose of sale or for delivery after sale.[1]

It is likewise unlawful for any person, directly or indirectly, to use the mails or any means or instruments of transportation or communication in interstate commerce, to carry or transmit any prospectus relating to a registered security, unless the prospectus conforms with the requirements of the act; or to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus conforming with the act's requirements.[3]

Any security may be registered with the Commission under the terms of the act, provided a registration statement is first filed.[4] The registration statement, because of its importance as a source of information to the prospective buyer, has been designed to reach items of distribution profits, watered values, and hidden interests that usually have not been revealed. Together with other information, there must be filed a balance sheet which gives an intelligent, comprehensive idea of the assets and liabilities of the issuer, and a profit and loss statement which gives a fair picture of its operations for the preceding three years, certified by an independent public accountant. To avoid evasion, the act enumerates definite statements which must be filed, one form for foreign government issues and another for all other issues.[5]

To eradicate the evils attendant upon advertisements and prospectuses, the act requires that the prospectus include the same statements made in the registration statement, except that it need not include certain documentary exhibits.[6]

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[1] Securities Act of 1933, sec. 4. Such transactions, of course, are now regulated under the Securities Exchange Act of 1934.
[2] Securities Act of 1933, sec. 2 (4) (11) (12).
[3] Securities Act of 1933, sec. 5.
[4] Securities Act of 1933, sec. 6.
[5] Securities Act of 1933, sec. 7, schedules A and B.
[6] Securities Act of 1933, sec. 10.

In order to combat the abuses of highly geared selling organizations, with the resultant speedy disposal of issues before the public has had opportunity to adequately appraise their value, the act provides for a waiting period of 20 days after filing the required information before securities can be sold. This period affords opportunity for the Commission to determine whether the application conforms with the act. In the case of foreign government issues, this waiting period is 7 days. The registration is not deemed effective until the expiration of these examination periods, pending which the securities fall within the prohibitions relating to nonregistered securities.[7]

The Securities Exchange Act of 1934 relaxes the standard for determining what constitutes reasonable investigation and reasonable ground for belief in connection with an issue from that imposed on a fiduciary to that required of a prudent man in the management of his own property.[8]

The Securities Act of 1933 placed in the administration and enforcement of the provisions of the act with the Federal Trade Commission. With the passage of the Securities Exchange Act of 1934, the administration of the Securities Act of 1933 was transferred to the Securities and Exchange Commission created by the Securities Exchange Act of 1934. The Securities and Exchange Commission now has complete jurisdiction over the primary and secondary distribution of securities and over all transactions in securities.[9]

Neither by the Securities Act of 1933 nor by the Securities Exchange Act of 1934 does the Federal Government undertake to approve or guarantee the present soundness or the future value of any security. The investor must still, in the final analysis, select the security which he deems appropriate for investment. The purposes of the Securities Act of 1933 are to make available to him complete and truthful information from which he may intelligently appraise the value of a security, and to safeguard against the negligent and fraudulent practices perpetrated upon him in the past by incompetent and unscrupulous bankers, underwriters, dealers and issuers.

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[7] Securities Act of 1933, sec. 8.
[8] Securities Exchange Act of 1934, sec. 206 (e).
[9] Securities Exchange Act of 1934, sec. 210.

CHAPTER III.—COMMERCIAL BANKING PRACTICES

The close interrelationship of commercial banking with securities speculation, by virtue of the extension of credit by commercial banks for those purposes, and the participation by commercial banks in the investment-banking field, necessitates an analysis of the practices of these banks, although commercial banking practices per se was not within the field of the inquiry. The investigation of commercial banking was confined to the relationship of commercial banking to securities speculation and to investment banking, the activities and practices of private bankers, and a special inquiry into group banking as conducted in Detroit, Mich., and Cleveland, Ohio, with its resultant disastrous failures and losses.

1. The Nature of Commercial Banking

The primary function of commercial banking is to furnish short-term credits for financing the production and distribution of consumable goods. By their nature, such loans should be self-liquidating. A sharp line of demarcation should exist between the function of the commercial banker and the investment banker. Long-term capital financing for the production of "durable goods", such as machinery, railroad equipment, building material, and construction work in general, is the proper field of the investment banker, since such loans are not self-liquidating within the prescribed limits of short-term commercial banking operations.[1]

As was stated by Winthrop W. Aldrich, president of the Chase National Bank:

> * * * This experience as a bank official, coupled with the testimony which was presented to your committee in February of this year had convinced me that many of the abuses in the banking situation had arisen from failure to discern that commercial banking and investment banking are two fields of activity essentially different in nature. I came to believe that while it was essential that there should be coordination between these two types of banking, such coordination could best be protected from abuse and thus enhanced in usefulness through absolute separation of interest between the two fields.
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> The commercial bank's credit function is very definitely governed by its responsibility to meet its deposit liabilities on demand. It must not seek excessive profits by taking undue credit risks and it cannot wisely tie up its funds in long-term credits however safe they may be. Its primary credit function is performed by lending money for short periods to finance self-liquidating commercial transactions, largely in the movement of goods and crops through the various stages of production and distribution; and in the making of short-term loans against good collateral. The commercial bank cannot safely make loans to a borrower who lacks capital of his own or who cannot in the normal course of his business repay the loan within a reasonable period of time. It is within this framework that the commercial bank renders sound and constructive service to the industry, trade, and agriculture of the country.

[1] Clarence Dillon, Oct. 18, 1933, Dillon, Read & Co., pt. 4, pp. 2109–2110.

The investment banker also renders necessary and effective service to the industry, trade, and agriculture of the country. He does it by meeting long-term needs, providing funds for plant and equipment or for permanent working capital. He does, and should, take speculative risks of a sort unsuitable to the commercial bank in providing capital funds for new and promising enterprises, even though the major volume of his transactions is naturally to be found in providing additional capital for industries well established and less uncertain in their prospects. With every new issue, moreover, he takes the risk that the public may not readily absorb the new securities which he brings out and that his own capital may be tied up for a long period of time. This last distinction between investment and commercial banking emphasizes the wisdom of the legislation forbidding investment bankers from taking deposits.[2]

2. Commercial Banks and Securities Speculation

The role played by commercial banks in securities speculation, particularly during the speculative period from 1926 to 1929, and the legislative regulation of these activities, has already been detailed in this report. It is generally conceded that the flow of credit of the commercial banks in the form of brokers' loans, the financing of syndicate or pool operations in securities, and loans on securities as collateral, accentuated the speculative excesses during the boom period. The consequent disastrous results affected not only the investing public, but these banking institutions, whose capital was substantially impaired by the collapse and shrinkage of values of securities into which banks had frozen a large part of their funds. The indulgence by commercial bankers in these security loans involved their institutions in such huge losses as to directly cause their banks to close, as was the case with the group-banking holding companies of Detroit and Cleveland.[3]

3. Commercial Banking and Investment Banking

Commercial banks not only played a vital part in securities transactions by the extension of credit to carry on these activities, but directly engaged, in circumvention of the law, through the medium of their investment affiliates, in securities and other transactions prohibited to commercial banks. This participation of commercial banks in the investment-banking field ultimately resulted in such gross abuses and malpractices, and occasioned such losses to the banking institutions and the investing public, that the banking act of 1933 was passed divorcing commercial banking from investment-banking institutions.

(A) INVESTMENT AFFILIATES

(1) *Organization.*—(*i*) *National City Bank of New York and National City Co.*—The National City Bank of New York was organized in 1812. The National City Co., the investment affiliate of the National City Bank of New York, was organized under the laws of the State of New York on July 5, 1911. The certificate of incorporation of the National City Co. granted to it extensive busi-

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[2] Statement of Winthrop W. Aldrich, Nov. 29, 1933, Chase Securities Corporation, pt. 8, pp. 3977, 3979.
[3] For a detailed discussion of the bank credit and securities speculation, see ch. I, sec. 5, of this report. For a detailed discussion of group banking, see sec. 6 of this chapter.

ness powers and capacities, authorizing the acquisition of any kind of property and the conduct of any business and the doing of whatever might be incident thereto. The only limitation upon its business activities was that the certificate of incorporation did not authorize the business of banking, of a money corporation, railroad or transportation or educational corporation.[4] The certificate of incorporation provided that the directors of the corporation need not be stockholders, and further provided:

> No transaction entered into by the company shall be affected by the fact that the directors of the company were personally interested in it, and every director of the company is hereby relieved from any disability that might otherwise prevent his contracting with the company for the benefit of himself or any firm, association, or corporation in which he may be in anywise interested.[5]

The capital stock of the company was fixed at $10,000,000, but there was no limitation on the capital it might accumulate.[6]

Prior to the incorporation of the National City Co., on June 1, 1911, an agreement was entered into between the National City Bank of New York and James Stillman, Frank A. Vanderlip, and Stephen S. Palmer, trustees, and Henry A. C. Taylor, Cleveland H. Dodge, William Rockefeller, Moses Taylor Pyne, J. P. Morgan, and other subscribers who were shareholders of the bank. These trustees were all officers of the National City Bank, Stillman being chairman of the board of directors, Vanderlip its president, and Palmer a director. The preamble to the agreement recites:

> Opportunities and facilities for making desirable investments, other than those which are possible in the ordinary course of the banking business, are, from time to time, presented to the officers of the bank, which they desire to make available to the shareholders of the bank.[6]

The avowed purpose for the formation of the National City Co. was, therefore, to permit the bank to make investments not within the scope of the bank's power.

The articles of agreement provided for the organization of the National City Co. Since the National City Bank was forbidden from owning stock in the investment company, the law was circumvented by having the officers and shareholders of the bank own all the stock of the investment company. Each shareholder of the National City Bank was accorded a beneficial interest, through the three trustees, in the capital stock of the investment company to the extent of two-fifths of the par value of his capital stock in the bank, provided he exercised his right by accepting the terms of the agreement.

The par value of the capital stock of the National City Bank was $25,000,000, and two-fifths, or $10,000,000, was the par value of the stock of the investment company.

The trustee agreement provided, in order to facilitate participation by the shareholders of the National City Bank in the beneficial interests in the investment company, that the trustees would recommend to the directors of the bank the declaration of a special dividend of 40 percent on the capital stock of the bank, or $10.000.000, the exact amount of the capital stock of the company. The sub-

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[4] Opinion by Frederick W. Lehmann, Solicitor General of the United States, Nov. 6, 1911, rendered to the Attorney General of the United States, pt. 6, National City, p. 2036.
[5] Supra, pp. 2036–2037.
[6] Supra, p. 2037.

scribers, shareholders of the bank, agreed to apply this dividend to the payment of the stock of the investment company, and to assign this special dividend to the trustees to enable the trustees to organize the investment company.

The stock of the investment company was issued to the trustees and was held by them in trust for the shareholders. The beneficial interest in the company stock was transferable only by the transfer of the stock of the bank. Every sale or transfer of stock of the bank by a subscriber or his successor included his beneficial interest in the capital stock of the investment company.

The number of stockholders of the investment company was limited to three, the three trustees. A vacancy in the number of trustees could only be filled by the remaining trustees selecting an officer or director of the bank, making the trustees a self-perpetuating body. Any trustee who ceased to be an officer or director of the bank ceased to be a trustee. Since only officers or directors of the bank could act as trustees, only officers or directors of the bank could ever be stockholders of the company.

The agreement further provided that the trustees and such other persons as they might designate, who were officers or directors of the bank, shall constitute the first board of directors of the company, and that no one shall be a director of the company who was not also an officer or director of the bank.

The certificate of incorporation of the National City Co. provided for five directors. Since there were only three stockholders, the certificate of incorporation provided that directors of the company need not be stockholders of the company.

The agreement prohibited the transfer of beneficial interests in the company without a transfer of the corresponding shares of the bank, and, conversely, prohibited the transfer of shares in the bank without a transfer of the corresponding beneficial interest in the company.

The agreement required the payment of company dividends to the shareholders of the bank whose certificates of bank shares were properly endorsed that they were subject to the agreement, and provided that payment of the dividends might be made by the trustee to the bank.

The National City Co. was, therefore, in substance, not an independently organized company, but in truth and in fact was organized by the National City Bank, its officers and shareholders acting as such. Only shareholders of the bank were permitted an interest in the company and only in proportion to their holdings in the bank. This constitution of interest in the company had to continue to the end, for no person could ever have an interest in the company without an interest in the bank, and no person lose his interest in the company without losing his interest in the bank. No person could be an officer or director of the company unless he was an officer or director of the bank.

The bank, by the declaration of a dividend, furnished the entire capital of the company. All the stock of the company was held by the trustees and voted by them. These trustees were not elected by the incorporators of the company nor by its stockholders. They were nominated by the agreement between the bank, its officers, and shareholders, made before the company came into existence. These trustees could not be removed, nor could their successors be elected or determined by any power or interest of the company. The trustees, nominated by the agreement, perpetuated themselves. They appointed their own successors. The only power outside the trustees which could make a change in their membership was the shareholding body of the bank, which could refuse to continue a trustee as an officer or director of the bank, ipso facto eliminating him as a trustee of the company.[7]

At the time of the hearings held before our subcommittee, the trustees of the National City Co. were Beekman Winthrop, Percy A. Rockefeller, and James A. Stillman. The board of directors of the company was composed of 27 members, who under the agreement were appointed or substituted by the individual members of the board of directors of the bank, not as members of the board of directors of the bank but as individuals of a board delegated to elect trustees.

Under the trustee agreement, the fiction was indulged in of a differentiation between the board of directors of the bank and the members of the board of directors of the bank, who are designated and delegated to the power of trustee appointment and removal. It was claimed that the members of the board of directors of the National City Bank, when they acted in the designation of a trustee of the National City Co., dissassociated themselves from their relationship to the National City Bank as its directors.[8]

At no time since the National City Co. was organized have the shareholders had any voice in the designation of the trustees who held their stock for them, except as they had the right to appoint individuals as members of the board of directors, who constituted the designating body of the trustees.[9]

The trustees of the National City Co. kept no minutes of their proceedings and never reported to the stockholders of the company, for whom they acted as trustees.[10]

(ii) *Chase National Bank and Chase Securities Corporation.*—Chase Securities Corporation was organized on March 21, 1917. Its original capital was $2,500,000 and was, in effect, a 25-percent security dividend from the Chase National Bank to its stockholders.[11]

The shares of the Chase Securities Corporation were issued directly to the stockholders of the Chase National Bank, each stockholder becoming a shareholder of record in the Securities Corporation. The certificates of stock, both of the bank and of the Securities Corporation, made out in the names of the respective stockholders, were deposited with the Bankers Trust Co., which issued a receipt covering the same number of shares in each institution. The "stockholder" of the Chase National Bank and the Chase Securities Corporation held this receipt. When the Bankers Trust Co. receipt was transferred, an authorization on the back of the receipt appointed the Bankers Trust Co., the attorney of the holder, to endorse the respective stock certificates of the bank and the Securities Corporation which it held to the transferee of the receipt. Each stockholder

[7] Supra, pp. 2030–2042.
[8] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, p. 1780.
[9] Charles E. Mitchell, supra, pp. 1781–1782.
[10] Charles E. Mitchell, supra, p. 1783.
[11] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2281, 2283–2284, 2287.

in each institution remained such of record, and the stock was voted directly. This arrangement maintained a parity of ownership and preserved the ownership of all of the capital stock of the Chase Securities Corporation by the stockholders of the Chase National Bank. Although originally the stock of the Securities Corporation was issued jointly with the stock of the bank, subsequently, on January 15, 1930, the mechanics were changed so that the receipt form was abandoned, and instead, on the reverse side of each piece of paper representing the stock certificate of the bank was printed the stock certificate of the Securities Corporation.[12] The instrument of transfer provided for a transfer of the interest in the shares of stock in both institutions.[13] Under this arrangement the stockholder of the Chase National Bank could not transfer his stock in the bank without at the same time transferring his stock in the Securities Corporation.[14] By purchasing and accepting the security in the Chase National Bank, the stockholder was deemed to have consented to the terms of the agreement forbidding the transfer of the bank stock without the simultaneous transfer of the Securities Corporation stock. The stockholders of the Chase National Bank always had the same pro rata equity in the Securities Corporation.[15]

The original capitalization of the Chase Securities Corporation of 100,000 no-par-value stock was intermittently increased, and was either sold pro rata to stockholders or used to effect various mergers with institutions upon an exchange-of-stock basis, until June 30, 1933, when the total outstanding shares of capital stock of the Chase Securities Corporation was 7,400,000. This total included the split-up of Chase Securities Corporation stock on July 1, 1921, on a 5-to-1 basis, at which time the par value of the Chase National Bank stock was reduced from $100 to $20.[16]

Since the stock of the affiliate was inextricably bound up with the bank stock, there was a similar increase in the capital stock of the Chase National Bank with every increase in the stock of the affiliate.[17]

The original cash capitalization of the Chase Securities Corporation was increased from its original $2,500,000 and no surplus, to a total capital, not including stock dividends, of $115,371,352.65 capital and surplus, of which approximately $95,000,000 was capital and $13,000,000 surplus.[18]

On May 16, 1933, the charter of the Chase Securities Corporation was amended so as to eliminate from its activities the business of distributing securities to the public. The Chase Harris Forbes Corporation, a wholly owned subsidiary of the Chase Securities Corporation, engaging exclusively in the securities business, was placed in the process of liquidation, and the corporate name of Chase Securities Corporation was changed to Chase Corporation. The securities business of the Chase National Bank's affiliates was terminated; and although the Chase Securities Corporation under its new name,

[12] Committee exhibit no. 2, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2340-2353.
[13] Eldon Bisbee, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2288-2289.
[14] Eldon Bisbee, supra, p. 2290.
[15] Eldon Bisbee, supra, p. 2291.
[16] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, p. 2373.
[17] Committee exhibit no. 6, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2355.
[18] A detailed recital of each increase in capitalization, the purpose thereof, and the allocation to capital and surplus, is contained in the record. See testimony of Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2365-2383, and Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2281.

Chase Corporation, continued, by identity of stock ownership, to be affiliated with the Chase National Bank, its activities were limited to holding and administering its remaining investments.[19] The par value of the stock was changed from no par value to $1.[20]

From June 1, 1917, when the securities affiliate was created, to the end of 1925, the net profits earned by the Chase Securities Corporation aggregated $11,170,819.29, out of which sum cash dividends aggregating $4,150,000 were paid. From November 22, 1925, to June 30, 1933, the net profits of the affiliate were $29,911,136.90, out of which cash dividends aggregating $17,757,500 were paid. Thus, the total aggregate net profit from June 1, 1917, to June 30, 1933, was $41,081,956.19, out of which total cash dividends of $21,907,500 were paid.[21]

(2) *Circumvention of the law.*—Admittedly, the investment affiliates were organized at the instance of the banking institutions to enable the banks to engage in businesses and operations that were prohibited to such banks. Mr. Eldon Bisbee, a member of the law firm of Rushmore, Bisbee & Stern, who attended to the organization of the Chase Securities Corporation, stated:

Mr. PECORA. In other words, it was considered desirable to have all of the capital stock of the Chase Securities Corporation held at all times by the stockholders of the Chase National Bank?

Mr. BISBEE. That was a part of the unanimous agreement on the part of the stockholders of the bank when the Securities Co. was organized.

Mr. PECORA. Mr. Bisbee, will you tell the committee the reasons for that? What were considered to be the advantages to the institution of such an arrangement?

Mr. BISBEE. I will do my best, Mr. Pecora. Perhaps the business reasons might be better explained by someone else; but a bank as such may not engage in the securities business; that is, as the securities business is generally understood. Banks are restricted in the nature and quality of investments that they may make; and it was considered advisable at that time to have a corporation owned by the same stockholders in exactly the same percentages, that might undertake business which the bank could not undertake, and not only thereby make money for the stockholders by undertaking that business but thereby enhance the goodwill of the bank itself by enlarging the circle of its operations.

Mr. PECORA. Or to depreciate the value of that goodwill in the event that the business of the Securities Corporation proved unprofitable?

Mr. BISBEE. Proved unsuccessful; exactly.[22]

Senator COUZENS. Did the creation of the Chase Securities Co. enable you to loan money to the Chase Securities Co. and thereby effect a benefit that you could not do direct through the Chase National?

Mr. WIGGIN. I think so.

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Senator COUZENS. You could not purchase common stock?

Mr. WIGGIN. No, sir.

Senator COUZENS. You could loan on it as a security, but you could not purchase it direct, although you could purchase bonds?

Mr. WIGGIN. Correct.

Senator COUZENS. So that if you wanted to control the corporation by the purchase of common stock you could not do it through the National Bank, but you could do it through the Securities Co.?

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[19] Committee exhibit no. 8, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2206–2207.

[20] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, p. 2383.

[21] Committee exhibit no. 8, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2388–2389, contains in tabulated form the various increases of capital stock, cash capital and surplus, total capital, yearly net profits, reserves provided for losses, and the cash dividend payments on Chase Securities Corporation stock from June 1, 1917, to June 30, 1933.

[22] Eldon Bisbee, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2288.

Mr. WIGGIN. The Securities Co. could purchase it; yes.

Senator COUZENS. So, in turn, you could lend the bank's money to enable them to do it?

Mr. WIGGIN. Lend it to the Securities Co.?

Senator COUZENS. Yes.

Mr. WIGGIN. Yes; we could.[23]

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Mr. BISBEE. The bank did not control it.

Senator COUZENS. Did not control what?

Mr. BISBEE. Anything that the Securities Co.——

Senator COUZENS. Certainly it did. They were identical stockholders.

Mr. BISBEE. The stockholders controlled them, but not the bank.

Senator COUZENS. Oh, that is just a bandying of words, because, as a matter of fact, it was under the same control, and this device was created for that purpose. I am not being critical, but I am saying that it provided this device.

Mr. BISBEE. It did not own the Securities Corporation.

Senator COUZENS. Oh, yes, it did. No matter how you may phrase it, it was the same stockholders and the same management, and the control of the Securities Co. was in the bank.

Mr. BISBEE. There were 89,000 stockholders.

Senator COUZENS. Yes; but the bank could furnish the money to purchase common stock and control the corporation through the Securities Co. which it could not do direct. I am not charging that you did that.

Senator ADAMS. That is merely one of many things which the Securities Co. enabled it to do that the bank could not otherwise do.

Senator COUZENS. Certainly.

Senator ADAMS. That is the purpose of the Securities Co.[24]

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Mr. PECORA. Mr. Wiggin, in the statement made to the committee during this hearing by Mr. Bisbee, he said in substance, among other things, when he was referring to the organization of the Chase Securities Corporation in 1917, that at that time a national bank could not under the law engage in the business of issuing and selling securities. I believe that is a fair paraphrasing of your statement, Mr. Bisbee, is it not?

Mr. BISBEE. Generally, yes.

Mr. PECORA. Let me ask you, Mr. Wiggin: In view of that statement of Mr. Bisbee's, was it the purpose and intention at the time of the creation of the Chase Securities Corporation to organize that corporation among other reasons for the purpose of enabling the Chase National Bank, through the conduct and operation of the Chase Securities Corporation, to do things which the bank itself could not directly do under the law?

Mr. WIGGIN. That would not be a correct statement.

Mr. PECORA. What do you understand, then, to be the reason for the statement made by Mr. Bisbee when referring to the creation of the Chase Securities Corporation in 1917 that the bank could not engage in the securities business as such?

Mr. WIGGIN. It did not enable the bank to engage in the securities business.

Mr. PECORA. Not directly, of course, but did it not in effect, through the medium of the capital set-up of the Chase Securities Corporation, enable the bank to utilize its funds either in whole or in part for the purpose of the business conducted by the Chase Securities Corporation, which was an investment or securities business?

Mr. WIGGIN. Well, it enabled the Chase Securities Corporation to do a securities business.

Mr. PECORA. And the Chase Securities Corporation was organized as an affiliate of the Chase National Bank in such fashion that the identity of the stockholders of the Chase Securities Corporation was the same as the stockholders of the Chase National Bank and in equal proportion?

Mr. WIGGIN. That is correct.

Mr. PECORA. Was that not done in order to do indirectly that which the bank could not do directly? Is that not a fair conclusion, Mr. Wiggin?

Mr. WIGGIN. Well, it was done to give those same stockholders the benefit of what we thought would be a profitable business.

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[23] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2291–2292.
[24] Eldon Bisbee, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2292.

Mr. PECORA. And that profitable business was the investment or securities business, was it not?
Mr. WIGGIN. Yes, sir.
Mr. PECORA. And the stockholders of the bank would not have had the opportunity or advantage of engaging in that business except through the set-up of an organization like the Chase Securities Corporation?
Mr. WIGGIN. That is correct.[25]

On November 6, 1911, a short time after the formation of the National City Co., an opinion was rendered to the Attorney General of the United States by Frederick W. Lehmann, at that time Solicitor General of the United States, in which, after analyzing the corporate structure of the National City Co., its connection with the National City Bank of New York, and the banking laws applicable to the situation, Solicitor General Lehmann concluded that both the bank and the investment company, whether considered as affiliated or unrelated, were in violation of the law. Solicitor General Lehmann concluded that the investment company was not independently organized, but was organized by the bank, its officers and shareholders acting as such; that the National City Co., considered by itself and apart from its relation to the National City Bank, was also in violation of the law, since its charter from the State of New York expressly prohibited it from the business of banking; and that the charter could not confer the power to engage in the business of national banking, which could only be conferred by the laws of the United States. The opinion stated that the National City Co. in its holding of national bank stocks was an usurpation of Federal authority and in violation of Federal law. The opinion not only attacked the creation of the National City Co. upon a legal basis, but almost prophetically pointed out the abuses and danger that would arise from the inter-relationship of investment affiliates with large commercial banks.[26]

4. ABUSES

(a) *Abuses arising out of investment affiliates.*—The creation of investment affiliates by commercial banks was undesirable not only because these affiliates circumvented the law but because these affiliates created conditions and situations which were detrimental both to the investing public and to the banking institutions. Possessed with this instrumentality that enabled these banking institutions to conduct a business and indulge in practices which governmental authority through legislative enactment had forbidden to commercial banks, these banking institutions, infected with speculative fervor, indulged in practices and transactions which had the direst consequences.

(1) *Violation of fiduciary duty to depositors and investors.*—Commercial banks found a fertile field among its depositors for purchasers of security issues which their investment affiliates were sponsoring. These banks, violating their fiduciary duty to depositors seeking disinterested investment counsel from their bankers, referred these depositors to the affiliates for advice. These depositors were then sold securities in which the affiliates had a pecuniary interest.

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[25] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2297–2298.
[26] Opinion of Frederick W. Lehmann, Solicitor General of the United States, Nov. 6, 1911, rendered to the Attorney General of the United States, pt. 6, National City, pp. 2030–2042.

Hugh B. Baker, president of the National City Co., testified:

Mr. PECORA. Now, Mr. Baker, do you know that frequently depositors of a bank seek the advice of officers of their bank with respect to making investments?

Mr. BAKER. Yes, sir.

Mr. PECORA. And in order for a bank to give that kind of advice disinterestedly it should not be interested in pushing any particular security, should it?

Mr. BAKER. Well, I think it is distinctly to the advantage of a bank if it has the benefit of the study of securities which our organization, we thought, was able to give.

Mr. PECORA. Isn't every well-organized and functioning bank possessed of certain facilities for informing its clients of security issues generally—I mean the soundness of security issues generally?

Mr. BAKER. It is, but, of course, that is in the matter of degree. There is a tremendous amount of study and research work required in the development of issues of securities and then in following their progress afterward.

Mr. PECORA. Mr. Baker, you would not hesitate to say, would you, that the advice which a bank gives to a depositor, in response to the depositor's request for such advice concerning investments, should be wholly unselfish and disinterested on the part of the bank and should be designed to serve the depositor's interests?

Mr. BAKER. It should certainly serve the depositor's interests all the time.

Mr. PECORA. And do you think that a bank which has an affiliation with an investment company, sponsoring its own issues or the issues of others, is in a position to give that kind of unselfish and disinterested advice to a depositor seeking such advice?

Mr. BAKER. I think so.

Mr. PECORA. Do you recognize that to such a bank and its officers and employees there is the temptation of favoring the securities in which its affiliate is interested?

Mr. BAKER. That may be true, but the——

Mr. PECORA (interposing). Well, it is true, isn't it?

Mr. BAKER. But the point is, as I see it, that where the investment house has the facilities to determine the value of securities, that is a distinct advantage to have.

Mr. PECORA. But the investment house has not given the same consideration to all securities offered to the public as it has to those in which it is particularly interested, has it?

Mr. BAKER. That is right.

Mr. PECORA. So that a bank with that kind of investment affiliate, functioning even through the bank's own branches, is in the position of having the affiliate particularly interested in certain issues of which it has made a special study and of having the temptation always present to advise a depositor seeking its advice for investment purposes to invest in the securities which its investment affiliate is sponsoring.

Mr. BAKER. There is no doubt about that, and yet——

Mr. PECORA (interposing). And to that extent isn't there always lurking the danger that the depositor seeking disinterested advice won't get it?

Mr. BAKER. That depends upon the ability of the investment banking house in its research work, and in its investment in securities it recommends, to try to keep on hand a diversified list that will fit all classes of investors.

Mr. PECORA. Mr. Baker, do you still think it is good banking practice for a bank to have itself so interwoven with an investment affiliate, as the National City Bank is with the National City Co.?

Mr. BAKER. Yes, sir.

Mr. PECORA. You do?

Mr. BAKER. Yes, sir.[77]

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Mr. BAKER. A customer of the bank, let us say, in talking to some officer in the bank indicates that he is interested in making some investments. That would be transmitted to the National City Co., and that name would be called upon immediately.

[77] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6, pp. 1042–1043.

Mr. PECORA. So that when a depositor of the bank went to the bank seeking advice on matters of investments the name of that customer or depositor would be transmitted by the bank's representative to the company?

Mr. BAKER. The probabilities are that it would; yes, sir.

Mr. PECORA. And that is the way the bank would advise such an inquirer on matters of investments?

Mr. BAKER. It all depends on the nature of the inquirer.

Mr. PECORA. If it was an inquiry for the making of investments that was the way he would be advised frequently?

Mr. BAKER. I think he would say that "the investment part of this organization is the National City Co. and I would be glad to refer you to them," some particular name.

Mr. PECORA. And if that depositor or customer then followed up that suggestion by calling upon the National City Co. for advice as to his investments, it was not an unusual thing for the National City Co. to suggest investment in securities that the company was sponsoring, was it?

Mr. BAKER. That is right.[28]

Not only did the managers and employees of the banks recommend prospective customers to the salesmen of the investment companies but these bank employees directly sold securities to customers, the branch banks receiving a service allowance for such sales.[29]

Mr. PECORA. As president of the bank did you give any instructions or directions to the employees of the bank in any of its branches to sell stock of the bank for the account of the National City Co.?

Mr. RENTSCHLER. Branch of the bank managers? No.

Mr. PECORA. Are you quite sure of that, Mr. Rentschler?

Mr. RENTSCHLER. The managers or the bank officers themselves directly are not selling stock of any kind. It may be that there may be instances where a branch officer might find a customer who wanted to buy this or that and he would turn him over to a City Co. man to effect the sale.

* * * * * * *

Mr. PECORA. I have before me what is described as the annual report of the National City Co. and its subsidiary corporations for the year ended December 31, 1929, summarizing the operating results and various activities of the year, and on the last page thereof appears this statement:

"With the closing of our Jacksonville (Fla.) office 69 district and representative offices were in operation at the year end, all served either directly or indirectly by our private-wire system of 11,386 miles. Sales facilities are also available at 26 of the bank's Greater New York City branches, each connected with our home office by private line, telephone, or teletype service."

* * * * * * *

"This makes a total of 95 points offering National City Co. facilities to investors through its own staff, proof of the excellent service rendered for our account by bank employees at offices where City Co. men are not yet located."

* * * * * * *

Mr. PECORA. Did that bring home to you knowledge for the first time that the employees of the bank were supplementing the selling efforts of the sales force of the company in the sale of securities in which the company was engaged?

Mr. RENTSCHLER. Yes; they would take orders for them, unquestionably.

Mr. PECORA. I did not ask you if they would take orders. I asked you if you learned for the first time that that was being done.

Mr. RENTSCHLER. No.

Mr. PECORA. Well, you knew of it currently, didn't you?

Mr. RENTSCHLER. Certainly.

Mr. PECORA. Was that done with your consent and knowledge and approval as president of the bank?

Mr. RENTSCHLER. Yes. I knew that was the practice.

Mr. PECORA. You approved of it?

Mr. RENTSCHLER. Surely.[30]

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[28] Hugh B. Baker, Feb. 24, 1933, National City, pt. 6, p. 2019.
[29] Hugh B. Baker, supra, p. 2017.
[30] Gordon S. Rentschler, Feb. 22, 1933, National City, pt. 6, pp. 1885-1886.

The investment affiliates developed the most effective machinery for the distribution of securities, employing many salesmen throughout the Nation to quickly sell the securty issues which were either sponsored by the affiliates or in which they had a pecuniary interest. By far the greatest part of the business of the National City Co. was the selling of securities to the general public.[31] Over a 10-year period the National City Co. sold on an average a billion and a half dollars of securities a year to the general public.[32]

In 1927 the National City Co. departed from its previous policy of not selling common stocks to the public.[33] In 1929 one of the issues most exclusively dealt in by the National City Co. was Anaconda Copper Mining Co. common stock.[34] On December 12, 1928, the Anaconda Copper Mining Co. and the National City Co. agreed to accumulate up to 200,000 shares of the common stock of the Andes Copper Mining Co. for joint account on a 50–50 basis. Charles E. Mitchell, president of the National City Co., and John D. Ryan, chairman of the board of directors of the Anaconda Copper Mining Co., were designated to run the account, which was conducted in the trading department of the National City Co.[35] The common stock of Andes Copper Mining Co., a subsidiary of the Anaconda Copper Mining Co., was listed at the time on the New York Stock Exchange.[36]

The account ran from December 13, 1928, to January 18, 1929, a period of about 5 weeks; 151,045 shares were accumulated on the books of the National City Co., of which 127,945 shares were sold to the public and 23,100 shares were sold through brokers. The total profit realized by this account was $335,043.42.[36]

In July 1929 the stock of Andes Copper Mining Co. was exchangeable for stock of Anaconda Copper Mining Co.[37]

The National City Bank indirectly financed this joint account, since the National City Co.'s capital and surplus were derived in the first instance from the sale of stock of the National City Bank.[38]

On January 14, 1929, John D. Ryan, Daniel Guggenheim, Harry F. Guggenheim, and the National City Co. formed a joint account to accumulate 100,000 shares of Chile Copper Co. common stock. The account was managed by John D. Ryan.[39] That account was extended; and under the agreement 140,500 shares were purchased and 29,400 shares were sold, leaving the account 111,100 shares long, which were exchanged for 81,103 shares of Anaconda Copper Mining Co. stock; 51,103 of these shares were sold, leaving the account 30,000 shares long on February 14, 1929;[40] 10,000 shares were distributed to the National City Co., John D. Ryan, and the Guggenheims, respectively. The Guggenheims sold their 10,000 shares at a profit of $400,000. The National City Co. and John D. Ryan retained their stock, which could have been liquidated at $800,000 profit, for a total profit to the account of $1,200,000.[41]

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[31] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, p. 1765.
[32] Charles E. Mitchell, supra, p. 1766.
[33] Charles E. Mitchell, Feb. 22, 1933, National City, pt. 6, p. 1838.
[34] Charles E. Mitchell, supra, pp. 1839–1840.
[35] Charles E. Mitchell, supra, pp. 1842–1843.
[36] Charles E. Mitchell, supra, p. 1844.
[37] Charles E. Mitchell, supra, p. 1842.
[38] Charles E. Mitchell, supra, p. 1846.
[39] Charles E. Mitchell, supra, pp. 1847, 1851–1852.
[40] Charles E. Mitchell, supra, p. 1847.
[41] Charles E. Mitchell, supra, p. 1848.

Conversion of the Chile Copper Co. stock for Anaconda Copper Mining Co. stock was contemplated, and the joint account was admittedly organized to facilitate the contemplated conversion of Chile Copper Co. stock for Anaconda Copper Mining Co. stock by artificially maintaining the market values of these stocks immediately prior to the conversion.[42]

On December 12, 1928, a joint account to accumulate 100,000 shares of Greene-Cananea Copper Co. stock was formed by the National City Co., and John D. Ryan. The National City Co. had a one-half participation, and John D. Ryan, Cornelius F. Kelley, president of Anaconda Copper Mining Co., and W. D. Thornton the other half. The account was managed by John D. Ryan and Charles E. Mitchell.[43] Two hundred twenty-six thousand shares were purchased and 151,100 shares sold, leaving the account approximately 75,000 shares long. The National City Co. converted its Greene-Cananea Copper Co. stock into Anaconda Copper Mining Co. stock on the basis of 1½ shares of Anaconda Copper for each share of Greene-Cananea. The purpose of this joint account was also to facilitate the conversion of Greene-Cananea stock for Anaconda Copper stock by artificially maintaining the market values of the stock.[44]

During the year 1929 the National City Co. accumulated and sold to the investing public 1,315,830 shares of Anaconda Copper Mining Co. stock.[45] This stock was sold to the public by the National City Co. through the medium of a selling organization which encompassed the entire country and European countries. This affiliate, during 1929, had a personnel of 1,900, of which 350 were salesmen, with offices in 58 cities and 11,300 miles of private wire.[46] These shares, accumulated by the National City Co. at about $100 per share and sold at about $120 per share, were sold in the period from August 6, to October 1, 1929.[47]

At the time of the hearing, February 22, 1933, Anaconda Copper Mining Co. stock was selling at $7 per share.[48]

Other common and preferred stock was sold by the National City Co. throughout the country by means of this extensive selling organization. As an inducement to accelerate the sale of securities, or to dispose of securities owned by the National City Co., which were not in great demand, intercontrol sales contests were held, with premiums and prizes offered to the most successful selling organizations.[49]

In connection with the marketing of its securities to the public, the National City Co., continually fed the names of prospective new customers to the selling force throughout the country. In 1927 the main office sent out to the selling agents in the field the names of 47,447 prospective customers; in 1928, 122,000 new names; and in 1929, 54,117 such names.[50]

A spectacle was presented where an investment affiliate of one of the largest commercial banks in the country, which had sponsored

[42] Charles E. Mitchell, supra, pp. 1848–1849.
[43] Charles E. Mitchell, supra, pp. 1852–1853.
[44] Charles E. Mitchell, supra, pp. 1850–1851.
[45] Charles E. Mitchell, supra, p. 1854.
[46] Charles E. Mitchell, supra, pp. 1863, 1865.
[47] Charles E. Mitchell, supra, pp. 1855, 1864.
[48] Charles E. Mitchell, supra, p. 1862.
[49] Hugh B. Baker, Feb. 24, 1933, National City, pt. 6, p. 2012.
[50] Hugh B. Baker, supra, pp. 2015–2017.

or had accumulated or had an option on a substantial block of securities, was vigorously engaged, through a highly geared selling organization, in selling securities to the investing public without any adequate disclosure of the interest of the investment affiliate in these securities. The investing public, relying upon the close affiliation of the investment company to the commercial bank, had a right to expect disinterested counsel. Instead, the investment affiliate, availing itself of the goodwill attendant to similarity to the name of the bank, was disposing of securities in which it had a substantial pecuniary interest in selling.

(2) *Trading and pool operations in the capital stock of commercial banks by investment affiliates.*—Commercial banks used their investment affiliates not only to circumvent the law forbidding banks to purchase and sell their own capital stock, but to participate in speculative ventures in such capital stock. These investment affiliates not only took substantial positions, both long and short, in the capital stock of the banking institutions, but participated in syndicate and pool accounts in such capital stock.[51]

Commencing in 1928 the National City Co. started a vigorous, extensive campaign for the sale of the capital stock of the National City Bank, which encompassed not only the public but the bank's employees. For a 3½-year period ending December 31, 1930, it sold approximately 1,950,000 shares of the bank stock at an approximate cost of $650,000,000 to the public. During the year 1929 alone the National City Co. acquired and disposed of approximately 1,359,000 shares of the bank stock.[52] The National City Co. not only acted as the trading post in this stock but took very extensive positions in the bank stock during that period. At the end of 1930 the National City Co. had a long position of 99,227 shares of the capital stock of the bank. This extensive position was maintained after 3½ years of campaigning, in which 2,000,000 shares were sold to the public.

The National City Co. during this period traded in the bank stock to a greater extent than any single person or group. This active buying and selling throughout the entire country was being conducted by the National City Co., although the National Banking Act forbade a national bank to buy or sell shares of its own capital stock.[53]

Not only did the National City Co. employ its force of 350 salesmen to sell this stock, but it utilized the selling facilities of hundreds of dealers throughout the country, and the bond and investment departments of correspondent banks of the National City Bank in the interior of the country.[54] Premiums were paid to these salesmen on the sale of the bank stock to accelerate its sale.[55]

On February 1, 1929, a flash was sent to the managers of the selling organizations of the National City Co. throughout the country making a special price to prospective purchasers of National City

[51] For a detailed discussion of the legality of purchases of bank stock through the medium of investment affiliates, see opinion of Solicitor General Frederick W. Lehmann, Nov. 6, 1911, National City, pt. 6, pp. 2030–2042.

[52] Gordon S. Rentschler Feb. 22, 1933, National City, pt. 6, pp. 1880–1881.

[53] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6. p. 1890. Gordon S. Rentschler, supra, p. 1881.

[54] Hugh B. Baker, Feb. 21, 1933, National City, pt. 6, pp. 2006–2007.

[55] Hugh B. Baker, supra, pp. 2008–2009.

Bank stock of 5 points under the market. The usual premium was allowed on these sales. The flash stated:

*** * * A premium will be allowed, of course, as usual, and if you will give us your complete cooperation in this matter it will result in the addition of a substantial number of new business prospects for all of us.[56]**

Hugh B. Baker admitted that the purpose in obtaining these new bank stockholders was to create a fertile field of potential customers for other securities that the investment company owned and wanted to sell.

Mr. PECORA. When you said at the very end of this flash of February 1, 1929, "if you will give us your complete cooperation in this matter, it will result in the addition of a substantial number of new business prospects for all of us" you meant to convey to your salesmen that additional holders of the stock of the bank would be regarded as new prospects of your company to whom other securities sponsored by your company could be more readily sold; is that correct?

Mr. BAKER. Absolutely.

Mr. PECORA. And in order to create these new prospects for the other securities that your company was selling to the public you were, in this flash, instructing your sales department and its men in the field to sell the stock of the bank at 5 points under the market?

Mr. BAKER. That is right.[56]

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Mr. BAKER. It seemed to me that the more stockholders that the National City Bank had in the United States the more business opportunities there would be opened to the bank and the more people there would be interested in the business of the bank.

Mr. PECORA. Well, why was that the concern of the National City Co. as the securities selling organization?

Mr. BAKER. Because those same people with whom we were doing business throughout the United States, and others, and we were constantly increasing our business range, they would be prospective customers of the bank and of the company and of any other facility we had in banking.

Mr. PECORA. In other words, the stockholder of the bank would become a potential customer of the National City Co. for its securities.

Mr. BAKER. If he were an investor; yes.

Mr. PECORA. And that was the special desire of the National City Co. in enlarging the number of shareholders of the National City Bank, wasn't it?

Mr. BAKER. Oh, no; not particularly.

Mr. PECORA. It was one of them, wasn't it?

Mr. BAKER. It was one, certainly.

Mr. PECORA. And it was not an insignificant feature of its desire in that respect, was it?

Mr. BAKER. Not at all.

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Mr. PECORA. Was that one of the purposes that actuated or prompted your company to sell the stock of the bank throughout the country?

Mr. BAKER. One of the purposes, of course, was to increase the business in the National City----

Mr. PECORA (interposing). For whom?

Mr. BAKER. For the bank and the company.

Mr. PECORA. Was the company engaged in increasing the business of the bank?

Mr. BAKER. No; but we were interested in promoting the interests of the bank in any way we could, of course.

Mr. PECORA. Because you were an integral part of the bank, weren't you, in substance if not in form?

Mr. BAKER. Because we were all stockholders, and we were all interested in the general progress of the institution.

Mr. PECORA. Well, the National City Bank was a national banking institution under its charter, and the National City Co. was an investment company

[56] Hugh B. Baker, supra, p. 2014.

under the charter given to it by the State of New York. They were two separate legal entities, but in truth and in fact they were inseparably interwoven with each other, weren't they?

Mr. BAKER. Well, we certainly were a part of the same institution.

Mr. PECORA. They were so inseparably interwoven with each other that it was not possible for anyone not a stockholder of the bank to have any interest in the stock of the company?

Mr. BAKER. That is correct.

Mr. PECORA. And the bank was helping the company, and the company was helping the bank, all along the line; isn't that the conclusion?

Mr. BAKER. Actually helpful all the time.

Mr. PECORA. For that reason, among other reasons, your company was desirous of enlarging the number of stockholders of the bank?

Mr. BAKER. That is right.

Mr. PECORA. You know that a bank under the law cannot trade in its own stock, don't you?

Mr. BAKER. Yes; that is right.[57]

The National City Co. encouraged its salesmen to "switch" the public to National City Bank stock.

Mr. PECORA. * * * When your salesmen were attempting to sell securities sponsored by your company, were they advising prospects to sell out securities which they then owned and use the proceeds of the sale to buy securities sponsored by the company?

Mr. BAKER. That might be, depending upon the securities held by the customer.

Mr. PECORA. That was the common practice, was it not?

Mr. BAKER. Not necessarily a common practice; no, not at all; but it did occur frequently.

Mr. PECORA. It occurred very frequently, did it not?

Mr. BAKER. I don't know about "very", but frequently.

Mr. PECORA. Do you know how frequently?

Mr. BAKER. No, sir.

Mr. PECORA. The practice was not discouraged, was it, by you?

Mr. BAKER. Not where the exchange, in the judgment of our experts, was a desirable exchange to make.

Mr. PECORA. Who were the experts who exercised that judgment and gave the advice to the prospect—the field salesmen?

Mr. BAKER. We tried to maintain in New York control of that, so that the judgment as to whether a security was desirable for a customer to hold as against some other security would be passed upon by some department in New York City in charge of that study; but it is true that exchanges were made from time to time. Whether on the recommendation of the salesman or whether at the suggestion of the holder of the security himself, I do not know.

Mr. PECORA. Well, don't you know that in many, many cases these exchanges were made on the advice and recommendation of your salesmen? Don't you personally know that, Mr. Baker?

Mr. BAKER. I say that I know where exchanges of such character have been made; yes.

Mr. PECORA. And don't you have that knowledge because of the avalanche of letters that have come to you and to your company from customers all over the country who told you of that practice?

Mr. BAKER. I have had some letters of that kind sent directly to me; yes.[58]

The National City Co. not only took a substantial long position in National City Bank capital stock but also, during the months of April and May 1929, this affiliate sold the capital stock of that bank short. In order for the investment company to make deliveries of the stock that it had sold to customers it had to borrow from Charles E. Mitchell 15,000 shares during the month of April 1929 and an additional 15,000 shares during the month of May 1929.[59] The

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[57] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6, pp. 1938-1939.
[58] Hugh B. Baker, Feb. 24, 1933, National City, pt. 6, pp. 2020-2021.
[59] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6, pp. 1911-1913.

30,000 shares of borrowed stock were returned to Charles E. Mitchell on July 10, 1929, with $128,850 interest.[60]

Mr. PECORA. The question is, Where did the company get the 30,000 shares of bank stock which it returned to Mr. Mitchell on July 10, 1929?

Mr. BAKER. From purchases in the market and from exchange of Farmers Loan & Trust stock into City Bank stock.

Mr. PECORA. And does not that still prove that the company took a short position in the stock of the bank in April and May and June?

Mr. BAKER. If you are unwilling to include in that that we had this other stock coming to us.

Mr. PECORA. You mean that it was coming to you?

Mr. BAKER. Yes.

Mr. PECORA. Not that you had it in possession?

Mr. BAKER. That is probably right.

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Senator BROOKHART. That means, then, that you were using Mr. Mitchell's stock just as a matter of stock transactions as if it were your own, does it not?

Mr. BAKER. Yes; just the same as a loan to us.

Mr. PECORA. In other words, you were using it to cover a short position?

Mr. BAKER. Well——

Mr. PECORA. That is what actually was done, wasn't it?

Mr. BAKER. A short position as far as actual stock in the box to deliver; yes.

Mr. PECORA. Yes; the actual, physical operation consisted of the borrowing and the use of that stock to cover a short position, did it not?

Mr. BAKER. Well, as I have just said.

Senator FLETCHER. That borrowing is usually done for this purpose on the exchange, isn't it?

Mr. BAKER. Yes; but as I tried to explain, Senator, if we had no other stock coming in to offset that, I would readily admit that it would be a short sale.

Senator BROOKHART. You mean you had contracts at some time in the future that would bring in other stock?

Mr. BAKER. Yes.

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Mr. PECORA. You undertook to pay Mr. Mitchell 6 percent interest, which amounted to $128,000, for these borrowings of 30,000 shares, didn't you?

Mr. BAKER. Yes.

Mr. PECORA. And you did that without knowing whether or not you would need that stock with which to make deliveries of the stock you had sold?

Mr. BAKER. I say we did need it to make delivery.

Mr. PECORA. Of course you did.[61]

In addition to the active bank-stock selling campaign, the National City Co. on January 27, 1930, granted an option on 30,000 shares, ranging from a price of $212.50 per share to $240 per share, to Dominick & Dominick, members of the New York Stock Exchange.[62] The option was exercisable at any time and from time to time and was to continue in full force during the life of a trading account formed under this option, managed by Dominick & Dominick, with Hornblower & Weeks, Abbott, Hoppin & Co., C. D. Barney & Co., Cassatt & Co., Brown Bros. & Co., and Dominick & Dominick as participants.[63] There was no time limitation upon the exercise of this option. The only limitation was the right of the National City Co. to cancel upon 5 days' written notice.[64]

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[60] Hugh B. Baker, supra, p. 1013.
[61] Hugh B. Baker, supra, pp. 1017–1019.
[62] Hugh B. Baker, supra, pp. 1048–1049, 1056.
[63] Hugh B. Baker, pp. 1056, 1058.
[64] Hugh B. Baker, supra, p. 1056.

On January 27, 1930, the day the option was granted, the quotation for National City Bank stock was 223½ bid and 225½ asked.[65]

On January 29, 1930, two days after the option was granted, Dominick & Dominick drew down 5,000 shares at 212½, 5,000 shares at 215, 5,000 shares at 217½, and 100 shares at 220. The range of prices on the market for the stock on that day was 223 bid and 227 asked.[66] Dominick & Dominick drew down all the stock under this option, the last delivery being made on March 24, 1930, when the closing prices for the National City Bank stock was 246 bid and 248 asked. On that day there were delivered by the National City Co. to Dominick & Dominick under the option, 1,335 shares at 230, 5,000 shares at 235, and 500 shares at 240.[67] Dominick & Dominick drew down all the stock from the National City Co. at the prices fixed by the option, but at times when the market price for the shares was in excess of the option prices.[68]

The profit realized by the syndicate on this trading account under this option, for which no consideration was paid, was $354,088.10.[69]

On February 15, 1927, a stock-purchase plan, under which officers and employees of the National City Bank and affiliate were permitted to subscribe for shares of the capital stock of the bank, had been put into effect. Under the plan as modified in December 1929 to include the lower-grade employees, such as clerks, the employees were permitted to subscribe to the capital stock of the bank upon a 4-year installment basis, with interest charged on the unpaid balances. The installments were deducted from the monthly salaries of the employees.[70] Sixty thousand shares at $200 and $220 per share were allotted to these employees in December 1929, after the crash in October and November 1929. At the time of the hearings, February 22, 1933, the market for National City Bank stock was $40 per share, and the employees were being held to their subscription contracts.[71] Most of the employees, after paying the installments from December 1929, still owed more on the stock than it was worth in the market at the time of the hearing.[71] The total amount represented by the subscriptions of officers and employees was originally about $12,000,000. On February 18, 1933, there was still due on those accounts from officers and employees the sum of $5,303,276.96.[72]

On January 11, 1928, the capital stock of the National City Bank was stricken from the list of the New York Stock Exchange at the request of the National City Bank.[73] Hugh B. Baker testified that the National City Bank was induced to take this step because in September 1927, when there were 750,000 shares of the bank stock outstanding, a total volume of sales aggregating 50 shares on that day, with a range of 5 points difference between one sale, convinced the bank authorities that manipulation in the bank stock was possible.[74]

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[65] Hugh B. Baker, supra, p. 1950.
[66] Hugh B. Baker, supra, pp. 1950–1951.
[67] Hugh B. Baker, supra, p. 1955.
[68] Hugh B. Baker, supra, p. 1954.
[69] Hugh B. Baker, supra, pp. 1955, 1959–1960.
[70] Gordon S. Rentschler, Feb. 22, 1933, National City, pt. 6, pp. 1872–1873.
[71] Gordon S. Rentschler, supra, p. 1874.
[72] Gordon S. Rentschler, supra, p. 1877.
[73] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6, pp. 1921, 1924.
[74] Hugh B. Baker, supra, pp. 1919–1920.

Yet after the stock was stricken from the list of the New York Stock Exchange, the National City Co. alone, for the week commencing February 21, 1929, sold 92,709 shares of the bank stock.[75] The National City Bank stock reached a high of $575 to $580 for $20 par value shares.

Senator BROOKHART. It never could earn a return on that kind of price, could it?

Mr. RENTSCHLER. No; looking back at it now, it could not have.

Senator BROOKHART. Then, why didn't you advise the poor people that were buying it of that fact? Why didn't you stop the sale of it at such exorbitant price as that?

Mr. RENTSCHLER. It was not our stock they were buying, Senator Brookhart. They were buying stock from each other. They were making their own market.

Mr. PECORA. When you say it was not your stock they were buying, what do you mean, Mr. Rentschler?

Mr. RENTSCHLER. If you have the figures there of what the National City Co. had net long at the end of each day or the end of each week during those months under discussion, why, that would show what proportion of the stock actually was owned by the National City Co. The balance of it, Mr. Pecora, would be the stock that was bought and sold during the day of the trading when one customer came to buy and the other customer came to sell.

Mr. PECORA. Don't you know something about the long or short position of the National City Co. in the stock of the bank, inasmuch as you yourself are president of the bank?

Mr. RENTSCHLER. I don't know it exactly, and I would have to refresh my mind.

Mr. PECORA. Well, don't you know approximately?

Mr. RENTSCHLER. Yes. The general policy was to keep within 5,000 shares one way or the other, but there were times when it went above that. I would not know without consulting the records again just how much it did go above that.

Mr. PECORA. For instance, it does not surprise you to learn, does it, that at the end of 1930 the City Co. had a position of nearly a hundred thousand shares of the stock?

Mr. RENTSCHLER. Yes. As I explained to you, that was a very unusual situation that came as a result of the 1930 situation.[76]

The highest book value of the capital stock of the National City Bank was $70 per share in September 1929, or a total of $385,000,000, as compared to a market value of upward of $3,200,000,000.[77]

The investing public were not the only victims of the extensive campaign of stock selling by the National City Co. The affiliate itself suffered a loss of $10,393,000 upon its operations in National City Bank stock during the year 1929.[78]

The capital stock of the Chase National Bank was listed on the New York Stock Exchange until January 1928, when it was removed at the request of the bank.[79] The reason advanced by Albert H. Wiggin for this removal from the listing on the New York Stock Exchange was to avoid the harmful effects of marked fluctuations in prices between sales on the Exchange. Thereafter the bank stock was traded in on the "over-the-counter" market.[80]

Mr. PECORA. How did you think you could protect it in the over-the-counter market, which protection was not available in the exchange market?

Mr. WIGGIN. Well, I do not know that we did think so.

Mr. PECORA. You just said you hoped to do that.

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[75] Hugh B. Baker, supra, p. 1925.
[76] Gordon S. Rentschler, Feb. 22, 1933, National City, pt. 6, pp. 1882–1883.
[77] Gordon S. Rentschler, supra, p. 1887.
[78] Hugh B. Baker, Feb. 23, 1933, National City, pt. 6, p. 1918.
[79] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, p. 2373.
[80] Albert H. Wiggin, supra, p. 2374.

Mr. WIGGIN. Yes.

Mr. PECORA. How did you hope to do it?

Mr. WIGGIN. By buying when there were large fluctuations.

Mr. PECORA. What prevented the bank from doing that very thing while the stock was listed on the stock exchange?

Mr. WIGGIN. I do not think anything prevented its being done.

Mr. PECORA. Then why the striking from the list?

Mr. WIGGIN. Because we did not want the violent fluctuations that might occur.

Mr. PECORA. You said that those fluctuations could be affected by support given to the stock by the bank.

Mr. WIGGIN. Yes, sir.

Mr. PECORA. That was what you hoped to do in the over-the-counter market.

Mr. WIGGIN. Yes, sir.

Mr. PECORA. You could do the same thing in the exchange market.

Mr. WIGGIN. Yes; but we might——

Mr. PECORA. What was the reason, then, for the change?

Mr. WIGGIN. Because we did not want it listed on the New York Stock Exchange and have those fluctuations quoted in every paper all over the country.

Mr. PECORA. Are not the fluctuations and the ranges in the over-the-counter market published daily, too?

Mr. WIGGIN. Not very closely. They are published, but they are not right, and they are not close.

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Mr. PECORA. Did you notice much of a variance in the daily quotations in the over-the-counter market at that time as compared with those that prevailed on the exchange?

Mr. WIGGIN. No, sir.

Mr. PECORA. The range was about the same, then, in both the exchange market and the over-the-counter market, while the stock was traded in in both markets?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. That still would seem to remove the reason you have already given for striking the stock from the exchange list, would it not?

Mr. WIGGIN. No; I do not think so, Mr. Pecora. The big market on bank stocks is always over the counter. A number of them were listed on the stock exchange. The transactions were not many, and any fluctuations excited wide comment.

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Mr. WIGGIN. I am reminded that transactions on the stock exchange were so inactive that it would sometimes be weeks or months between one sale and the next sale, and the report would show the up or down from the last sale, and it might be a very serious difference because of the length of time.

Mr. PECORA. I thought you said a few moments ago that the daily quotations in the over-the-counter market were about the same as the quotations in the stock-exchange market.

Mr. WIGGIN. Yes; and that corroborated what I am trying to say. I have not made it clear to you. Suppose there was a sale of stock in July on the stock exchange, and suppose there was not another sale on the stock exchange until November. There might have been in 4 months' time a very serious change in the price, and yet the New York Stock Exchange quotation would show a sale in November and off or up so much from the last previous sale 4 months before.[81]

Chase Securities Corporation, through its wholly owned subsidiary, Metpotan Securities Corporation, which was organized in 1921 at the time of the merger of the Chase National Bank and the Metropolitan Bank, extensively traded in the capital stock of the Chase National Bank.[82]

On September 21, 1927, a joint account was formed, participated in by Metpotan Securities Corp., McClure, Jones & Co., Potter &

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[81] Albert H. Wiggin, supra, pp. 2375–2377.
[82] Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2413–2414.

Co., and Blair & Co., to buy and sell the capital stock of the Chase National Bank.[83] The account, originally, was to run for a period of 60 days commencing September 21, 1927, but was subsequently continued until March 20, 1928, and again extended until April 18, 1928. During this period, the syndicate purchased 22,217 shares of the capital stock of the Chase National Bank for $13,240,356.32, all of which shares were sold with a profit to the syndicate of $50,620.73.[84]

When interrogated as to the purpose of this trading account, Albert H. Wiggin testified:

Mr. PECORA. Mr. Wiggin, what was the purpose in the formation of this syndicate and the conduct of its operations in the stock of the bank?

Mr. WIGGIN. Hoping to keep a steady market in the stock.

Mr. PECORA. Was that the only purpose?

Mr. WIGGIN. I think so.

Mr. PECORA. Did the bank at that time contemplate any merger with any other bank?

Mr. WIGGIN. This is what year?

Mr. PECORA. 1928.

Mr. WIGGIN. I do not know, but I do not think there was anything of the kind in contemplation at that time.

The CHAIRMAN. Were those associates of yours particularly interested in keeping a market for the bank stock?

Mr. WIGGIN. No; I think they did it simply to make money.

Senator COUZENS. Do you consider that a good practice in the handling of stock of a national bank?

Mr. WIGGIN. I think so. I think it wise to have a market for stock.

Senator COUZENS. Well, then, why did you take it off the New York Stock Exchange listing?

Mr. WIGGIN. Well, for the reasons that I gave on yesterday, Senator Couzens. There are no other reasons.

Senator COUZENS. You must have changed your mind about it, because you think it is good practice to do that with national-bank stock, and still you took it off the market for the reasons you indicated on yesterday.

Mr. WIGGIN. Well, the stock exchange did not furnish the big market on bank stocks, you know. The big market was the over-the-counter market, as Mr. Pecora pointed out on yesterday.

Senator COUZENS. Would you think it good practice to engage in now, with the present status of banking generally?

Mr. WIGGIN. I think so; probably a much better practice now than then.

Senator COUZENS. Then you believe in speculation in bank stocks?

Mr. WIGGIN. I believe in the purchase and sale of bank stocks; yes, sir.

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Mr. PECORA. Do you believe in speculation in bank stocks? Do you believe it was the proper thing for any subsidiary of Chase Securities Corporation, which in terms was an investment affiliate of the Chase National Bank, to indulge in speculation in the stock of the bank, by the Securities Corporation?

Mr. WIGGIN. First, I should like to know what speculation is.

Mr. PECORA. Well, that seems to be a term that nobody in Wall Street is quite able to define, or at least is willing to define, so far as our experience here is concerned. But what does speculation in stock mean to you?

Mr. WIGGIN. This is simply asking my opinion as to what is speculation in stocks?

Mr. PECORA. Yes.

Mr. WIGGIN. An investment that is unsuccessful is usually called a "speculation."

Mr. PECORA. Is that what the term "speculation" means to you?

Mr. WIGGIN. I think that is about what it means to investors.

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[83] Committee exhibit no. 9, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2415.
[84] Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2416–2417

Mr. PECORA. Have you heard of persons operating in the stock market for speculative purposes right at the outset?

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Mr. WIGGIN. I think so; yes, sir.

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Mr. PECORA. When you hear that a person is going to invest in securities, what does that convey to you?

Mr. WIGGIN. That they have money to use, that they want to use it in a way that will give them an income return.

Mr. PECORA. And when you hear that a person is going to speculate in the stock market what does that convey to your mind as indicating what kind of operation it is?

Mr. WIGGIN. They they are planning to make purchases and sales hoping to make a profit.

Mr. PECORA. Hoping to make a profit by resale at a higher figure?

Mr. WIGGIN. Rather than income from the investment; yes.

Mr. PECORA. Well, now, when Metpotan Securities Corporation entered into this joint account in September of 1927, with Blair & Co., McClure, Jones & Co., and Potter & Co., did it contemplate going into a speculative transaction or an investment transaction?

Mr. WIGGIN. I do not consider that it was an investment, that it was intended as an investment, and I do not think they regarded it as a speculation. I think they regarded it as a temporary purchase, but not done for the purpose of speculation.

Mr. PECORA. As a temporary purchase, did you say?

Mr. WIGGIN. As a temporary investment.

Mr. PECORA. As a temporary investment, do you say?

Mr. WIGGIN. As a temporary investment, I would say.

Mr. PECORA. They did not make that investment for the purpose of getting income from it particularly, did they?

Mr. WIGGIN. No; I think they expected to turn it over.

Mr. PECORA. They expected to turn it over within a short period of time at a profit?

Mr. WIGGIN. They hoped to do so.

Mr. PECORA. And the period of time within which they expected to turn it over at a profit was originally fixed in the agreement among the participants as 60 days, a 60-day period.

Mr. WIGGIN. Whatever it was.

Mr. PECORA. Well, the exhibit that has been put in evidence shows that. I am now referring to committee exhibit no. 9 of this date.

Mr. WIGGIN. Yes.

Mr. PECORA. That was a speculative operation, wasn't it, which was contemplated in behalf of the syndicate at that time, as distinguished from an investment operation?

Mr. WIGGIN. Possibly. I think speculation is a very difficult term to describe. I think whether it is a speculation or not is dependent upon the wealth or the capital of the person doing it, whether they can afford to stay with it. There are a great many things that enter into the definition of speculation.

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Mr. PECORA. Returning to the question Senator Couzens asked you a few minutes ago, do you believe in speculation in banks stocks on behalf of an investment subsidiary of the bank?

Mr. WIGGIN. I believe that it is perfectly proper for a company to buy and sell bank stock.

Mr. PECORA. I do not think that answers the question, Mr. Wiggin. The question is not whether you believe it is proper for a company to buy and sell bank stock. Do you believe that it is proper to buy and sell the bank stock when the buying and selling operations are undertaken as a speculation, as distinguished from an investment?

Mr. WIGGIN. I cannot say yes to that question, because I cannot consider that it was a speculation just because they did not keep it any great time.

Mr. PECORA. You have seen, from the terms of the agreement among the syndicate members with regard to this account, that at the time it was formed the syndicate intended to trade in the stock of the bank for a period of only 60 days. Would not that stamp their operations as a speculation rather than as an investment?

Mr. WIGGIN. It would not stamp it as a permanent investment, I thoroughly agree, but I do not think it stamps it as a speculation, merely because a concern in the financial business buys some securities expecting to sell them out. That does not necessarily mean it is speculation.

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Senator COUZENS. When you entered into this agreement that has just been discussed, you had no knowledge that you were going to win or lose, did you?

Mr. WIGGIN. No, sir.

Senator COUZENS. Not having any assurance that they were going to make any money, or that they were going to lose any, it was purely speculative. In other words, it seems to me that is perfectly clear, by any interpretation of the agreement. I just wanted to have you say whether you thought that was not purely speculative, in view of the fact that you did not know whether you were going to make or lose anything in buying and selling this stock.

Mr. WIGGIN. I should not consider it purely a speculation; no, sir.

Mr. PECORA. Did you consider it an investment?

Mr. WIGGIN. It was not an investment in the sense that we expected to keep it forever.

Mr. PECORA. As a matter of fact, it was contemplated by this syndicate that in its operations it would not only buy Chase National Bank stock, but would sell at the same time, and within the same period of time, was it not?

Mr. WIGGIN. That is the reason I do not consider that it should be regarded as an investment.

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Mr. PECORA. You have already indicated that it was not an investment. If it was not an investment, what was it?

Mr. WIGGIN. It was a purchase made with the expectation of selling it out in the near future.

Mr. PECORA. How would you characterize the operations of such an account?

Mr. WIGGIN. I should characterize it as an account formed to stabilize the market in the stock, with the expectation of disposing of it in the near future.

Mr. PECORA. What interest did Blair & Co., Potter & Co., and McClure, Jones & Co. have in stabilizing the market for the bank stock?

Mr. WIGGIN. I do not think they had much interest in that part of it.

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Mr. PECORA. Why was it necessary for the Metpotan, if it had only that purpose that you have referred to, of stabilizing the market, to go into a syndicate with other participants who were not animated by that purpose?

Mr. WIGGIN. Because they expected to sell it out, and the Metpotan was not a selling organization.

Mr. PECORA. What do you mean when you say the Metpotan was not a selling organization?

Mr. WIGGIN. It had no organization for distribution of securities.

Mr. PECORA. Were not these open-market transactions, Mr. Wiggin?

Mr. WIGGIN. I think so.

Mr. PECORA. Were any special facilities needed by any of the syndicate members for distribution of the stock, in view of the fact that the operations or transactions were open-market transactions?

Mr. WIGGIN. Yes; I think so.

Mr. PECORA. Why was it necessary for them to have distributing facilities other than those provided by the open market?

Mr. WIGGIN. Perhaps it was not. Perhaps you are right.

Mr. PECORA. Now, will you answer the question? Why was it necessary for the Metpotan Corporation, if its sole purpose was to stabilize the market for the bank stock at that time, to enter into a syndicate arrangement with three other concerns that were not animated by the same purpose?

Mr. WIGGIN. I think it reduced the investment that the Metpotan would make. It reduced the amount of money that it would tie up, these other people participating.

Mr. PECORA. Was it necessary, in order merely to stabilize the market, to indulge in transactions that involved the purchase and sale of an aggregate of 22,217 shares?

Mr. WIGGIN. I do not know.

The CHAIRMAN. What effect did this operation have on the bank?

Mr. WIGGIN. I don't think it had any effect.

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Mr. PECORA. Can you find out from any of your associates whether the condition of the market immediately prior to the formation of this syndicate was such that it was deemed advisable or necessary to stabilize the market through the operations of this syndicate?

Mr. WIGGIN (after conferring with associates). Mr. Hargreaves advises me that there was not any violent fluctuation at that time, and he further advises me that the formation of this account was not so much at this time for stabilizing as to get the increased distribution, and an increased number of stockholders for the bank.

Mr. PECORA. How could that be accomplished if the members of the syndicate were going to buy these shares in the open market and sell them in the open market at the same time? How would that effect a wider distribution of the stock? In other words, if I understand your last answer, Mr. Wiggin, the members of this syndicate intended to buy in the open market a certain number of shares of the bank stock and sell those shares also in the open market. How could a wider distribution of the bank stock be effected by any such process?

Mr. WIGGIN. Well, I do not know. They may have bought it over their own counters. I do not know where they bought it. I presume most of it came from the open market. They may have sold some of it over their own counters. I do not know where they sold it.

Mr. PECORA. Were Blair & Co., Potter & Co., and McClure, Jones & Co. interested in obtaining wider distribution for the bank stock at that time?

Mr. WIGGIN. I think so; yes, sir.[85]

At the time the account was opened the quotation for Chase National Bank stock was 575 bid, 580 asked; and on April 18, 1928, the day the account was closed, the quotation was 684 bid and 690 asked, a rise of nearly 100 points.[86]

Immediately upon the close of this trading account on April 18, 1928, another account was formed, with Metpotan Securities Corporation, Blair & Co., McClure, Jones & Co., and Potter & Co. as participants, and with Metpotan and Blair & Co. carrying the stock for this account.[87] Fifty-nine thousand five hundred and fifty-two shares were purchased by this account, at a cost of $50,180,175.30. The account lasted until April 9, 1929, during which time the shares were resold by the syndicate, with a profit of $554,760.42. The average price to the syndicate was about $800 per share, the price of the stock having risen during the life of the syndicate from an interim low of $435 per share.[88]

Senator ADAMS. Mr. Wiggin, is it not a rather remarkable result in these two syndicate operations that one of them deals in 22,000 shares, an aggregate of over $13,000,000, and the net change in its result is about a half of 1 percent in profit; the other deals in a $50,000,000 transaction, with only 1 percent profit; while, at the same time, in this second transaction the stock showed a variation which ran from $483 to over $800? That is a rather careful riding of the horse, isn't it?

Mr. WIGGIN. Well, you understand, Senator, they did not buy a big amount and then wait till the end. They just traded in and out all the time.

Senator ADAMS. Would it not rather indicate that they bought and sold about the same day?

Mr. WIGGIN. Probably. Very likely.

Mr. PECORA. Was that engaging in the process of what has been termed a "churning of the market"?

Mr. WIGGIN. I do not think so. I do not think there were any—I know there were no imaginary sales, no fictitious sales. It was all straight purchasing and straight selling.

Mr. PECORA. Well, according to your answer to Senator Adams' question, the transactions that were consummated by these two accounts which had the

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[85] Albert H. Wiggin, supra, pp. 2417–2424.

[86] Albert H. Wiggin, supra, p. 2425.

[87] Committee exhibit no. 10, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2429.

[88] Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2431–2432, committee exhibit no. 10, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2429.

same syndicate members involved buying and selling at virtually the same time. That is so, is it not, Mr. Wiggin?

Mr. WIGGIN. Same days, undoubtedly.

Mr. PECORA. Is that not a scheme for "churning the market", and producing an activity that would stimulate the prices?

Mr. WIGGIN. I think the market was a God-given market.

Mr. PECORA. What is that?

Mr. WIGGIN. I think it was a God-given market.

Senator ADAMS. Are you sure as to the source?

Mr. WIGGIN. No, sir.

Mr. PECORA. God-given market, did you say?

Senator COUZENS. That is a new one.[89]

On April 10, 1929, another trading account in the stock of the Chase National Bank and Chase Securities Corporation, with Metpotan Securities Corporation, McClure, Jones & Co., Broomhall, Killough & Co., Inc., and Potter & Co. as participants, was formed.[90] Twelve thousand six hundred and thirty shares of $100 par value stock and 442,934 shares of $20 par value stock were bought for $103,216,184.88, the moneys to effect these purchases being advanced by Metpotan Securities Corporation.[91] The account was terminated on July 3, 1930, with 38,440 shares remaining in the account at an average cost to the participants of $167.85, the market price at that time being $140. The profit to the account was $321,250.14. In the interim Broomhall, Killough & Co., Inc., had become bankrupt, and Metpotan Securities Corporation took over the shares of Broomhall, Killough & Co., Inc., the loss on the shares being charged off against the entire account.[92]

On July 3, 1930, another trading account was formed between Metpotan Securities Corporation, McClure, Jones & Co., and Potter & Co., Metpotan Securities Corporation acting as managers. This account operated until August 5, 1931. Twenty-five thousand four hundred and fifty-four shares were purchased at a cost of $3,471,340.07, all of which shares were sold except 539, which were distributed pro rata to the participants for $68,489.64.[93]

On July 19, 1929, Chase Securities Corporation entered into a trading-account agreement with Dominick & Dominick, members of the New York Stock Exchange, to trade in the capital stock of the Chase National Bank. Subsequently Chase Securities Corporation reallotted three-quarters of its interest in the trading account to Metpotan Securities Corporation and one-quarter to Shermar Corporation, the private corporation owned by the family of Wiggin.[94] Options totaling 100,000 shares were granted by the Chase Securities Corporation to Dominick & Dominick for the purposes of this trading account. The trading account purchased and sold 172,806 shares under the options and in the open market, realizing a profit of $1,452,314.68.[95] Of this amount Chase Securities Corporation received $261,416.64.[96]

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[89] Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2432.

[90] See committee exhibit no. 27, Oct. 20, 1933, Chase Securities Corporation, pt. 5, p. 2512, and pp. 2533–2534 for trading-account agreement.

[91] Albert H. Wiggin Oct. 20, 1933, Chase Securities Corporation, pt. 5, pp. 2513–2514.

[92] Albert H. Wiggin, supra, pp. 2515–2516.

[93] Albert H. Wiggin supra, pp. 2523–2524.

[94] Albert H. Wiggin, supra, p. 2437. Committee exhibit no. 11, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2434.

[95] Committee exhibits nos. 20 and 21, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2462, 2463.

[96] Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2464. A detailed discussion of this account is contained in ch. I, sec. 8, of this report.

On January 7, 1930, another trading account was formed between the Chase Securities Corporation and Dominick & Dominick for the purposes of trading in the capital stock of the Chase National Bank and Chase Securities Corporation.[97] An option was granted to Dominick & Dominick on 50,000 shares of this stock.[98] In this trading account the Chase Securities Corporation reallocated its interest in the account to Metpotan Securities Corporation and Shermar Corporation. Since the Chase Securities Corporation did not possess the 50,000 shares to deliver under the option, Shermar Corporation undertook to deliver 30,000 shares and Metpotan Securities Corporation 20,000 shares.[99] Dominick & Dominick drew down 20,000 shares under this option, which were furnished by Metpotan Securities Corporation.[1] Metpotan Securities Corporation sustained a loss of $35,362.38, which was partially offset by a distribution to the Chase Securities Corporation of a profit of $25,789.85.[2]

On May 15, 1930, Chase Securities Corporation entered into another trading account in the stock of Chase National Bank with J. & W. Seligman & Co. and Dillon, Read & Co., with a maximum commitment not to exceed 75,000 shares of stock, which was subsequently increased to 90,000 shares.[3] The following day Chase Securities Corporation assigned its entire interest in this trading account to the Metpotan Securities Corporation.[4] The trading account terminated on August 13, 1930, with total purchases of 93,315 shares and total sales of 20,021 shares, leaving a balance of 73,294 shares in the syndicate account.[5] This remaining stock was taken down pro rata by the participants at an average price of approximately $170 per share, or $12,523,314.67.[5]

Senator COUZENS. The result of that operation, then, was less distribution than when you started, was it not?

Mr. WIGGIN. Yes. The syndicate bought more stock than they sold.

Senator COUZENS. So instead of getting greater distribution you got a contraction of distribution?

Mr. WIGGIN. Much of this stock that they bought they did not succeed in selling. Nevertheless, there may have been an increase in number of shareholders. That I cannot answer without looking it up.

Mr. PECORA. Well, the syndicate bought 93,000-odd shares and sold 20,000-odd shares?

Mr. WIGGIN. That is right, sir.

Mr. PECORA. So that, as Senator Couzens has observed, one of the two purposes for which the trading account was formed failed of accomplishment, namely, that of distributing the stock?

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Mr. WIGGIN. That is right; and yet there may have been an increase in the number of shareholders regardless of that.

Senator COUZENS. Well, there may have been an increase in the number of shareholders, but the fact was that there was a greater concentration of power or holding of the stock in one hand?

Mr. WIGGIN. That is right. Correct.[6]

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[97] Committee exhibit no. 22, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2465–2466.

[98] Committee exhibit no. 23, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2467.

[99] Committee exhibit no. 24, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2470. Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2468–2469.

[1] Albert H. Wiggin, supra, p. 2471.

[2] Albert H. Wiggin, supra, pp. 2472–2473.

[3] Committee exhibits nos. 69 and 77, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2823, 2840.

[4] Committee exhibits nos. 70 and 71, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2824, 2825. Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2823.

[5] Albert H. Wiggin, supra, p. 2841.

[6] Albert H. Wiggin, supra, pp. 2841–2842.

On August 12, 1930, the day before the termination of the prior account, a new trading account was formed in Chase National Bank stock with Metpotan Securities Corporation, J. & W. Seligman & Co., and Dillon, Read & Co. as participants.[7] Dillon, Read & Co. withdrew from this account on November 17, 1930. The account continued its operations until July 8, 1931, having purchased 9,288 shares and sold 9,040 shares, leaving a balance of 248 shares, which were distributed between the two remaining participants in the account.[8] The stock cost $1,236,437, and the amount realized from its sale was $1,205,456, with 248 shares left in the account.[9]

Senator COUZENS. In the meantime, I am curious to know why you created this second trading agreement after the two objectives of the first had failed; namely, you had failed to stabilize the market and you had failed to secure a wider distribution.

Mr. PECORA. And they had failed to make a profit.

Senator COUZENS. And you had failed to make a profit. And so, on the same day that you terminated the first trading agreement, you organized another trading agreement in spite of the almost complete failure of the first agreement. Just why did you do that?

Mr. WIGGIN. I think this is the answer, Senator: It was really a continuation of the same account. The termination and restarting was to aid in the detail of having the Metpotan take down the number of shares that they were going to use for the Harris Forbes purchase.

Senator COUZENS. So, in spite of the fact that on August 12 you failed of wider distribution, and you also failed to stabilize the market, yet you were continuing and did continue until Dillon, Read & Co. at last got tired, on November of the same year, and they withdrew; and then you continued until the following year; is that correct?

Mr. WIGGIN. Apparently.

Senator COUZENS. I do not think you demonstrate very well the accuracy of your statement with respect to the purpose for organizing these trade agreements.

Mr. WIGGIN. The success of it—I agree.

Senator COUZENS. I mean that the purpose that you ascribe for organizing the agreements does not seem to have been sustained by the results you obtained.

Mr. WIGGIN. Certainly you are right in this case.

Senator COUZENS. And yet in spite of that you continued the operations.

Mr. PECORA. For another 11 months.

Mr. WIGGIN. Yes; they did.[10]

In the period from 1928 through 1932, 2,313,020 shares were bought and 2,302,526.4 shares were sold, or a total of 4,615,546.4 shares, in the trading accounts dealing in stock of the Chase National Bank in which Chase Securities Corporation and Metpotan Securities Corporation participated. In addition, during the period from 1928 through 1930, 2,445,995 rights were purchased and 2,434,907 rights were sold, or a total of 4,880,902 rights, by such trading accounts. The total volume in dollars of these purchases was $430,772,795, and the total volume in dollars of the sales was $429,949,210, making a total, both on the buying and the selling side, of $860,722,005.[11]

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[7] Committee exhibit no. 78, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2844.

[8] Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2846.

[9] Albert H. Wiggin, supra, p. 2847.

[10] Albert H. Wiggin, supra, p. 2845.

[11] Albert H. Wiggin, supra, p. 2838. Committee exhibits nos. 75 and 76, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2862–2875 and 2830. Exhibit no. 75 contains a detailed, tabulated statement of the monthly purchases and sales in volume of shares and in volume of dollars by the joint accounts in which Chase Securities Corporation or Metpotan Securities Corporation participated, and shows the net short or long position of the accounts in Chase National Bank and Chase Securities Corporation stock from 1928 through 1930. Committee exhibit no. 80, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2875, shows the range of stock-market prices of Chase National Bank stock from Sept. 21, 1927 to Dec. 31, 1931.

On December 27, 1927, a plan to sell stock of the Chase National Bank and Chase Securities Corporation to their employees upon a partial-payment purchase plan had been devised by these institutions. The employees made an initial 20-percent payment, the Metpotan Securities Corporation advancing to these employees the balance of the purchase price, which had to be liquidated within 5 years.[12] The stock was sold to the employees at $425 per share (the equivalent of $85 per share for the split-up stock) at the time it was being offered to existing stockholders at $325 per share. The difference of $100 per share went to the surplus account of the Chase National Bank;[13] 11,600 shares of stock were sold to the employees under this plan for $4,930,000, Metpotan Securities Corporation advancing $2,135,-765.[14] After 5 years the unpaid balance on these advances was, at the time of the hearing, $232,600, with a collateral deficit of $142,287.18.

Senator COUZENS. Was there any protection to the employee as to the price he paid?

Mr. WIGGIN. No, sir.

Senator COUZENS. In other words, he took the chance of the stock going up or down, and he did it at the same time, apparently, when his chiefs were forming pools and creating markets and buying and selling. In other words, he was just sitting on the outside and was not familiar with what was going on in the inside.[15]

During the year 1929, Metpotan Securities Corporation realized a profit on a book basis of $1,828,254.82, and in 1931 sustained a loss of $2,386,011.24. For the period from 1928 through 1932, the net profit on the Chase stock units was $159,573.84.[16]

From 1921 to October 1933, Metpotan Securities Corporation had participated in 22 trading accounts in Chase National Bank stock, with a net profit of $600,000.[17] Albert H. Wiggin testified that the participation by Chase Securities Corporation in trading accounts in Chase National Bank stock was desirable and justifiable.[18] However, Winthrop W. Aldrich, president of the Chase National Bank, after Albert H. Wiggin had severed his connection with the bank, stated that the stockholders and the present management of the Chase National Bank were absolutely opposed to the participation by the bank affiliates in trading accounts in the stock of the bank.

Mr. ALDRICH. Mr. Chairman, in order that there shall be no misunderstanding on the part of the present stockholders of the bank as to what the attitude of the present management of the bank is with regard to the participation by the affiliates of the bank in trading accounts in bank stock, I would like to state that it is absolutely opposed to such transactions.

As a matter of fact, today the Metpotan Corporation does not deal in Chase stock in any way whatever, and as long as I have anything to do with the management the market in Chase stock shall not be affected by the operation of trading accounts by the affiliates of the bank.[19]

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12 Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, pp. 2922–2923.
13 Albert H. Wigging, supra, p. 2923.
14 Albert H. Wiggin, supra, p. 2925.
15 Albert H. Wiggin, supra, p. 2921.
16 Committee exhibit no. 79, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2849, tabulates the profit or loss of Metpotan Securities Corporation for each of the calendar years 1928 through 1932 on its trading in Chase National Bank stock.
17 Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2856.
18 Albert H. Wiggin, supra, p. 2833. Albert H. Wiggin, Oct. 19, 1933, Chase Securities Corporation, pt. 5, pp. 2418–2419.
19 Winthrop W. Aldrich, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2856–2857.

The quotations of Chase National Bank stock declined from a high of $1,325 during the year 1929 to a low of $17.75 in 1933 for the split-up stock, or a low of $88.75 for the old stock.[20]

(3) *Trading and pool operations in common stock by investment affiliates.*—The investment affiliates participated, not only in the underwriting of security issues and trading in the capital stock of their parent banks, but indulged in extensive trading and in syndicate and pool operations in various common stocks.

The National City Co., as has already been detailed, participated in the copper-stock trading accounts with John D. Ryan and conducted extensive selling campaigns, offering premiums and cash prizes to their salesmen for the sale of other common stocks.[21] By means of interorganization flashes, salesmen were urged to sell common and preferred stock owned by the National City Co. to the investing public, and premiums and prizes were offered for the largest sales.[22]

The Chase Securities Corporation, from 1928 to 1932, participated in numerous trading accounts, other than trading accounts operated in connection with security offerings.[23]

The speculative transactions of the affiliates were as disastrous to the affiliates as to the investing public.

The cash capital of Chase Securities Corporation from its inception on March 21, 1917, to June 30, 1933, aggregated $68,343,785; the stated value of all the capital stock issued by the Chase Securities Corporation in exchange for the capital stock of other institutions merged with the Chase Securities Corporation was $47,027,567.65, making a total of capital, both in cash and in capital stock, of $115,371,352.65.[24]

The net earnings, after payment of taxes, accruing to the Chase Securities Corporation to June 30, 1933, aggregated $41,081,956.19. The total capital and net earnings, therefore, of the Chase Securities Corporation from its inception to June 30, 1933, was $156,453,308.84. Of this sum, cash dividends were paid to stockholders of the Chase Securities Corporation in the aggregate sum of $21,907,500. There was set up for reserves to cover losses or against depreciation in the value of securities in the portfolio of Chase Securities Corporation from its inception to June 30, 1933, sums aggregating $120,138,075.87, of which sum $71,592,059 represented write-offs and reserves against assets still held by the Chase Securities Corporation at the time of the hearing.[25]

On June 30, 1933, there remained out of all the capital funds and earnings of the Chase Securities Corporation a capital and surplus

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[20] Committee exhibit no. 80, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2875.

[21] Hugh B. Baker, Feb. 24, 1933, National City, pt. 6, p. 2011.

[22] A copy of the flash, and the common and preferred stocks upon which premiums were paid, is set forth in the record at p. 2012 of pt. 6, the National City hearings.

[23] Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2836–2837. Committee exhibit no. 74, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2858–2859, contains a tabulated statement of each and every trading account, exclusive of trading accounts operated in connection with security offerings, participated in by the Chase Securities Corporation, the managers of and the participants in such trading accounts.

[24] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2406–2407. Committee exhibit no. 8, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2388–2389.

[25] Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2829. Committee exhibit no. 8, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2388–2389.

of $14,407,732.97, divided into a capital of $7,400,000 and a surplus of $7,007,732.97, which included an earned surplus of $407,732.97.[24]

The amount of write-downs, reserves against assets, and losses by the Chase Securities Corporation on its securities was considerably over five times the cash dividends paid by this affiliate.[24]

Senator COUZENS. Would you consider that a very good record?

Mr. WIGGIN. Oh, I think that is a very unfortunate record; but this is a world trouble, and we are probably better than the average. There were some security companies that were wiped out entirely, many of them.

Mr. PECORA. Do you think this record vindicates the judgment of the authorities of the bank when through the securities affiliate they engaged in issuing securities and underwriting them—trading in them?

Mr. WIGGIN. The figures do not verify that; no, sir.

Mr. PECORA. No. These results would rather condemn that, wouldn't they?

Mr. WIGGIN. Of course, until you realize and know what you are going to get from these assets you won't know how you are to come out or what the final result is. But I agree with you that there is nothing in these figures that is especially pleasant.[25]

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Mr. PECORA. As a matter of fact, the Chase Securities Corporation, during the years of its existence, participated either on its own behalf or in behalf of the Metpotan Securities Corporation, its wholly owned subsidiary, in trading accounts that dealt in common shares of many other corporations than the Chase National Bank, did it not?

Mr. WIGGIN. Yes, sir; more after 1928 or 1929 than earlier.

Mr. PECORA. Now we are getting down to a much more recent period than 1917 or 1916; 1917 was the year of the organization of the Chase Securities Corporation. What prompted the Chase Securities Corporation to engage in these trading accounts in the open-market dealing in securities other than the Chase National Bank from 1928 down?

Mr. WIGGIN. I think the times.

Mr. PECORA. What do you mean by that? That is a very general statement. You say you think "the times."

Mr. WIGGIN. I cannot answer that any better than that, sir.

Mr. PECORA. What do you mean by the "the times"? You do not mean the newspaper by that name, do you?

Mr. CONBOY. There are two of them by that name.

Senator COUZENS. I assume you mean the speculative atmosphere?

Mr. WIGGIN. I think perhaps that covers it. There was a great deal of atmosphere. There were a great many people who began to think you did a great injustice to everybody if you did not have equity stocks. It even got to be the custom to think that trust funds—it was a pity to limit them so that they could not invest in equity stocks; that we were doing a great injustice to them. In other words, it was the times.

Mr. PECORA. Did you yield to the temper of the times in that respect?

Mr. WIGGIN. I am afraid so.

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Mr. PECORA. * * * Do you now think that a national-bank affiliate should engage in stock-market speculation of the kind that you then had in mind?

Mr. WIGGIN. No, sir; if for no other reason than respect for public opinion.

Senator COUZENS. Oh, that is a new one. So public opinion does have some effect upon Wall Street?

Mr. WIGGIN. I think it has a pretty good effect.

Mr. PECORA. What is your own personal judgment?

Mr. WIGGIN. I certainly would not do anything today that, if it turned out unfortunately, was going to be criticized. And that is what would happen if we did make a mistake. Therefore I would not take the risk.

Senator COUZENS. Then these hearings are a good thing, aren't they?

Mr. WIGGIN. I hope so, Senator.

Mr. PECORA. Do you think they educate public opinion with respect to the existence of certain evils in banking and stock-market circles?

Mr. WIGGIN. I hope so.[27]

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[24] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2406–2407, Committee exhibit no. 8, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2388–2389.

[25] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, p. 2407.

[27] Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2833–2835.

(b) DIVORCEMENT OF COMMERCIAL BANKS FROM INVESTMENT AFFILIATES BY THE BANKING ACT OF 1933

The Banking Act of 1933, enacted on June 16, 1933, was promulgated to effect a complete severance of the commercial and investment banking functions and to eradicate many of the abuses disclosed at the hearings before the Senate subcommittee.

Section 20 of the Banking Act of 1933 provides:

SEC. 20. After one year from the date of the enactment of this Act, no member bank shall be affiliated in any manner described in section 2 (b) hereof with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities.[28]

Section 2 (b) of the Banking Act of 1933 provides:

(b) Except where otherwise specifically provided, the term "affiliate" shall include any corporation, business trust, association, or other similar organization—

(1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions; or

(2) Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank; or

(3) Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank.[29]

In order to effectuate this divorcement, section 18 of the Banking Act of 1933 provides:

After one year from the date of the enactment of the Banking Act of 1933, no certificate representing the stock of any such association shall represent the stock of any other corporation, except a member bank or a corporation existing on the date this paragraph takes effect engaged solely in holding the bank premises of such association, nor shall the ownership, sale, or transfer of any certificate representing the stock of any such association be conditioned in any manner whatsoever upon the ownership, sale, or transfer of a certificate representing the stock of any other corporation, except a member bank.[30]

The Banking Act of 1933 is an expression of the legislative policy of complete divorcement of commercial banking from investment banking. Further legislation may be required to completely effectuate this policy.

(c) ACTIVITIES AND PRACTICES OF OFFICERS AND DIRECTORS OF COMMERCIAL BANKS AND INVESTMENT AFFILIATES

Many of the evils that were disclosed at the hearings before the United States Senate subcommittee were inherent in the interrelationship of commercial banking and investment banking. A great many of these evils were, however, attributable to the utter disregard by officers and directors of commercial banks and investment affili-

[28] Banking Act of 1933, sec. 20.
[29] Banking Act of 1933, sec. 2 (b).
[30] Banking Act of 1933, sec. 18.

ates of the basic obligations and standards arising out of the fiduciary relationship extending not only to stockholders and depositors, but to persons seeking financial accommodation or advice. The hearings disclosed, on the part of many bankers, a woeful lack of regard for the public interest and a proper conception of fiduciary responsibility.[31] Personages upon whom the public relied for the guardianship of funds did not regard their position as impregnated with trust, but rather as a means for personal gain. These custodians of funds gambled and speculated for their own account in the stock of the banking institutions which they dominated; participated in speculative transactions in the capital stock of their banking institutions that directly conflicted with the interest of these institutions which they were paid to serve; participated in and were the beneficiaries of pool operations; bestowed special favors upon officers and directors of their banking institutions and investment affiliates to insure domination and control, for their own personal aggrandizement, of these officers and directors; received the benefits of "preferred lists", with resultant impairment of their usefulness and efficacy as executive officers; bestowed the benefits of "preferred lists" upon individuals who were in a position to aid and abet their purposes and plans; devoted their time and effort for substantial consideration to extra-banking activities and positions to the detriment of the institutions these officers were paid to serve; borrowed money from the banking institutions either without or with inadequate collateral; procured the banks' loans for other individuals to effectuate the purposes of these officers and directors; formed private companies to cover up operations conducted for their own pecuniary gain; availed themselves, as directors of private corporations, of inside information to aid them in transactions in the securities of these corporations; caused to be paid by the banking institutions to themselves excessive compensation; had voted to themselves participations in management funds and substantial pensions; and resorted to devious means to avoid the payment of their just Government taxes.

The record is a severe indictment of many bankers who have earned the condemnation of the reputable members of the banking fraternity and the Nation. The hearings before the Senate subcommittee have served the salutary purposes of weeding out bank officers who were oblivious to their vital duty, and reawakening the consciousness of reputable bankers to the sacredness of the trust imposed upon them by virtue of their guardianship of other people's money.

Far from having any detrimental, subversive effect upon the banking institutions of the country, the investigation performed the wholesome function of exposing the ills and evils of banking conditions and the perpetrators of these wrongs, with a view to the elimination of both the undesirable practices and personalities.

(1) *Extensive trading and pool operations in the capital stock of banks by officers and directors.*—Officers of commercial banking institutions, who were most substantially compensated to devote their time and energy to the performance of their essential duties, and whom the public expected would maintain a genuinely conserva-

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[31] Statement of Winthrop W. Aldrich, Nov. 29, 1933, Chase Securities Corporation, pt. 8, pp. 3975–3976.

tive banking and investment attitude at all times, encouraged and participated in speculative ventures for their own personal gain. These activities were inconsistent with a fitting banking viewpoint and conducive to a speculative and gambling state of mind inimical to the interests of the banking institutions, the depositors, the stockholders, and the investing public.

Not only did these officers and directors, possessed of a superior knowledge of the financial condition and trading activities of the bank, engage in trading and pool operations upon a large scale in the stock of the parent bank, but they had no hesitancy in availing themselves of the funds of the bank to abet them in these speculative ventures.

Typical of the speculative activities of bank officers were the operations in Chase National Bank stock of Albert H. Wiggin, chairman of the governing board of the Chase National Bank, and admittedly the dominant spirit of the bank. In these speculative ventures Albert H. Wiggin was assisted by other officers and directors of the banking institution.

Albert H. Wiggin caused to be organized the Shermar Corporation, the Murlyn Corporation, and the Clingston Co., Inc., to facilitate his securities transactions, to avoid any imputation of personal impropriety in the conduct of these transactions, and to benefit him in the matter of inheritance and income taxes. The sole stockholders of these three corporations were Albert H. Wiggin and the immediate members of his family.[82]

From the very inception of these corporations, its officers and directors were persons who were also officers and directors of the Chase National Bank and the Chase Securities Corporation. Lynde Selden, son-in-law of Albert H. Wiggin, was vice president of the Chase National Bank and vice president of the Shermar Corporation. Robert L. Clarkson, president of Chase Securities Corporation; William P. Holly, vice president and cashier of the Chase National Bank; Frank Callahan, vice president of Chase Securities Corporation; Otis Everett, second vice president of the Chase National Bank; Reeve Schley, vice president of the Chase National Bank; L. H. Johnston, vice president of the Chase National Bank; S. F. Telleen, second vice president of the Chase National Bank; George E. Warren, vice president of the Chase National Bank; Gates W. McGarrah, an officer of Chase National Bank and chairman of the board of directors of the Federal Reserve Bank of New York; and Eldon Bisbee, of Rushmore, Bisbee & Stern, counsel to the bank, were at one time directors of either the Shermar Corporation, Murlyn Corporation, or Clingston Co., Inc.[83]

During the periods of time when Shermar Corporation, Murlyn Corporation, and Clingston Co., Inc., were engaged in market operations in the capital stock of the Chase National Bank and Chase Securities Corporation, the directors of the private corporations, who were also officers or directors of the Chase National Bank or its affiliates, knew of these transactions but offered no objection.[84]

Not only were some officers and directors of the Chase National Bank and Chase Securities Corporation officers and directors of the private

[82] Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, p. 2878.
[83] Albert H. Wiggin, supra, pp. 2888–2890.
[84] Albert H. Wiggin, supra, p. 2891.

corporations of Albert H. Wiggin, but other officers and directors of the bank and affiliate owed substantial sums of money to these corporations. As of December 31, 1932, Gerhard M. Dahl, director of Chase National Bank, owed approximately $724,000; Murray W. Dodge, formerly a vice president and a director of Chase Securities Corporation, owed approximately $300,000; H. G. Freeman, former chairman of the executive committee, former president, and a director of Chase Securities Corporation, owed approximately $163,000; William P. Holly, vice president and cashier of Chase National Bank and a director of Chase Securities Corporation, owed approximately $131,000; J. C. Anderson, vice president of Chase Securities Corporation, owed approximately $72,000; Charles S. McCain, chairman of the board of directors of Chase National Bank, owed approximately $47,500; Leslie W. Snow, formerly assistant vice president of Chase Securities Corporation, owed approximately $9,900; and C. F. Batchelder, vice president of Chase Securities Corporation, owed approximately $1,000.[35] These indebtednesses were created either by personal loans made to these individuals by the private corporations of Albert H. Wiggin, or by the interest of these individuals in the participations of the private corporations of Albert H. Wiggin in trading or syndicate accounts.[36]

During the 5-year period from 1928 to 1932, both inclusive, Albert H. Wiggin was not only allotted participations in the trading accounts in Chase National Bank and Chase Securities Corporation stock, through the Shermar Corporation, but through the medium of his three private corporations Albert H. Wiggin engaged in extensive trading operations in the stock of those institutions.[37] For this 5-year period Shermar Corporation, Murlyn Corporation, and Clingston Co., Inc., realized an actual cash profit of $10,425,657.02 on transactions in the capital stock of the Chase National Bank. This amount included the profit to the Clingston Co., Inc., for the calendar year 1927, which was $666,621.40.[38] Although Albert H. Wiggin dominated the activities of Chase Securities Corporation and its subsidiary, the Metpotan Securities Corporation, for the same 5-year period, Metpotan Securities Corporation realized a profit of only $159,573.84 on its operations in the capital stock of Chase National Bank and Chase Securities Corporation.[39]

During the year 1931 Metpotan Securities Corporation sustained a loss on its trading in the capital stock of the bank and its securities ~~affiliate of~~ $2,386,011.24, whereas the Shermar Corporation for that calendar year realized a profit from its market operations in Chase Bank stock of $4,198,492.22. Murlyn Corporation realized a profit of $37,523.80.[40]

(2) *Short sales of bank stocks by officers and directors.*—Not only did the Shermar Corporation participate in the eight trading accounts and extensive trading operations in Chase National Bank

[35] Albert H. Wiggin, supra, pp. 2892–2898.
[36] Albert H. Wiggin, supra, pp. 2898–2899.
[37] Committee exhibit no. 74, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2858–2859, tabulates the participations in trading accounts of Chase National Bank stock allotted by Chase Securities Corporation to Shermar Corporation.
[38] Albert H. Wiggin, Oct. 27, 1933, Chase Securities Corporation, pt. 6, p. 2851.
[39] Albert H. Wiggin, supra, pp. 2851–2852. Committee exhibit no. 20, Oct. 19, 1933, Chase Securities Corporation, pt. 5, p. 2462.
[40] Albert H. Wiggin, Chase Securities Corporation, pt. 6, p. 2854.

stock (81 purchases and 141 sales), but during the period from September 23, 1929, to November 4, 1929, Albert H. Wiggin, through his private corporations, had sold 42,506 shares of Chase National Bank stock short for the aggregate sum of $10,596,968.[41] Mr. Wiggin testified that he was motivated to effect these short sales because he felt that the price of Chase National Bank stock, as well as other bank stocks, was ridiculously high and he wanted to reduce his family holdings in Chase National Bank stock.[42] Yet Albert H. Wiggin did not only sell the stock owned by the members of his family, but also sold the stock short.[43] Furthermore, these short sales were effected during the period when Albert H. Wiggin, as executive head of the Chase National Bank and its securities affiliate, permitted Chase Securities Corporation and Metpotan Securities Corporation to participate in trading syndicates in Chase National Bank stock allegedly formed to stabilize the market, maintain their price, and obtain a wider distribution among the investing public when he knew the bank stock was selling at a " ridiculously high " price.

The trading account managed by Dominick & Dominick, formed on July 19, 1929, and terminated on November 11, 1929, covering substantially the same period during which the Shermar Corporation was selling the bank stock short, bought 172,806 shares and sold the same number. All the trading accounts maintained a fairly even position.[44] Shermar's short position of 42,506 shares was covered by Murlyn Corporation purchasing on Deecember 11, 1929, 42,506 shares from the Metpotan Securities Corporation for a total cost of $6,588,430, Murlyn Corporation borrowing the money to effect such purchase from the Chase National Bank and from Shermar Corporation.[45]

Subsequently, on February 4, 1931, a merger was effected between the Murlyn Corporation and the Shermar Corporation, and in that manner Shermar Corporation acquired the 42,506 shares to close out its short account.[46] The difference between $10,596,968, the aggregate of the sales price of the 42,506 shares sold short, and $6,588,430, the price of the stock used to cover, or $4,008,538, was the profit on these short sales.[47]

Albert H. Wiggin's defense of this short selling, while executive head of the bank, was most unconvincing. He admittedly had hoped to realize a profit on this short trading.[48] He allegedly indulged in this short selling of the stock in order to provide a purchasing power for the bank stock. The shares of stock were purchased by the Murlyn Corporation, not in the open market, but from the Metpotan Securities Corporation, and Mr. Wiggin admitted that he had no knowledge or assurance that Metpotan Securities Corporation would use the cash for further purchases of Chase National Bank stock.

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[41] Albert H. Wiggin, Nov. 1, 1933, Chase Securities Corporation, pt. 6, p. 2854.
[42] Albert H. Wiggin, supra, pp. 2951, 2972.
[43] Albert H. Wiggin, supra, p. 2960.
[44] Albert H. Wiggin, supra, p. 2074.
[45] Albert H. Wiggin, supra, p. 2966.
[46] Albert H. Wiggin, supra, pp. 2961, 2964. A detailed description of postponement in the payment of income tax on this profit effected by Shermar Corporation by covering this short position by means of the Murlyn Corporation is contained in ch. V, Income Tax Avoidances.
[47] Albert H. Wiggin, supra, p. 2962.
[48] Albert H. Wiggin, supra, pp. 2971-2972.

Mr. PECORA. When the Shermar Corporation made those short sales it did not know what the Metpotan Co. was going to do, did it?

Mr. WIGGIN. No, sir.

Mr. PECORA. When the Metpotan Corporation made those short sales was it in the contemplation that the Shermar Corporation would cover its short position by purchasing the stock of the Metpotan Co.?

Mr. WIGGIN. It had no definite plan.

Mr. PECORA. As a matter of fact you said among other things that another purpose you had in making those short sales for the Shermar Corporation was to enable your family to sell some of their holdings.

Mr. WIGGIN. Yes, sir.

Mr. PECORA. That purpose was not accomplished either, was it?

Mr. WIGGIN. Yes, sir. They did sell, and when the stock was repurchased it was at a lower price.

Mr. PECORA. Well, now, the stock was repurchased by the family interests, wasn't it?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And meanwhile the family had enough stock to enable the Shermar Corporation to deliver under its short sales without buying in the market, didn't it?

Mr. WIGGIN. That is very true; yes, sir.

Mr. PECORA. So that did not help to provide a purchasing power for the stock, did it?

Mr. WIGGIN. Why, I think it did.

Mr. PECORA. How?

Mr. WIGGIN. Because they did buy back.

Mr. PECORA. They bought back, not in the market, but from the Metpotan Co.?

Mr. WIGGIN. Yes, sir. They bought from the Metpotan Co.

Mr. PECORA. How did that improve the purchasing power in the market for the stock?

Mr. WIGGIN. It put the Metpotan Co. in funds, with that cash in case they wanted to buy.

Mr. PECORA. But you said that the sales made by the Shermar Corporation were not made in combination with the Metpotan Co. In other words, you did not know that the covering was going to be done through purchases made from the Metpotan Co., did you?

Mr. WIGGIN. No, sir.[49]

* * * * * * *

Mr. PECORA. Now, was it the purpose of the Metpotan in going into those trading accounts to dispose of its shares of the bank stock, or was it its purpose to stabilize the market and obtain a wider distribution of the bank stock?

Mr. WIGGIN. Both.

Mr. PECORA. What was the purpose of the Shermar Corporation in engaging in those short sales in the summer and fall of 1929?

Mr. WIGGIN. To reduce the family holdings and to be in position to buy stock if it seemed advisable, or in the interest of the bank.

Mr. PECORA. In the interests of the bank? Will you be good enough to tell the committee how the bank's interests were served directly by the Shermar Corporation selling short 42,000 shares? Just explain that in detail to the committee.

Mr. WIGGIN. It gave them a purchasing power.

Mr. PECORA. When you say "they", whom do you mean?

Mr. WIGGIN. The Shermar Corporation.

Mr. PECORA. To do what?

Mr. WIGGIN. To purchase bank stock.

Mr. PECORA. From whom?

Mr. WIGGIN. Anybody.

Mr. PECORA. How did it profit the bank?

Mr. WIGGIN. It didn't profit the bank.

Mr. PECORA. How did it serve the bank's interests?

Mr. WIGGIN. Because there were frequently occasions when a violent fluctuation in the stock, with no purchaser, was injurious to the bank, and it was wise to have somebody that could purchase stock.

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[49] Albert H. Wiggin, supra, p. 2970.

Mr. PECORA. When the Shermar Corporation engaged in these short sales, was it making some contribution possibly to bringing about those wide fluctuations?

Mr. WIGGIN. No, sir.

Mr. PECORA. Does not short selling operate to depress the value of a security, as a rule?

Mr. WIGGIN. They would not have done it if it depressed the stock.

Mr. PECORA. Does not short selling as a rule have that effect, namely, to depress?

Mr. WIGGIN. As a rule I cannot say, but perhaps it does.

* * * * * * *

Mr. PECORA. You have said in the past that one of the main reasons you had the affiliate of the Chase Bank go into these trading accounts that dealt in the bank stock was to stabilize the market for the bank stock.

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And that is true, is it not?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. You have seen that one of these trading accounts, formed for the purpose, among other things, of stabilizing the market in the bank stock, was formed in July and operated until the 11th of November 1929, which period takes in the larger part of the period between August 8 and December 2, 1929, when our company, the Shermar Co., sold 42,506 short?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. Now, you said one of the reasons for your company selling short was because you hoped to make a profit thereby. Is that correct?

Mr. WIGGIN. I hoped it would make a profit.

Mr. PECORA. But you knew that it could not make a profit unless it could cover the short sales at a lower price; is that right?

Mr. WIGGIN. That is the only way the Shermar Corporation could make a profit.

Mr. PECORA. You also said, in the course of your testimony here, that you thought in the summer and fall of 1929 all bank stocks, including the Chase Bank stocks, were selling too high?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. Now, keeping in mind all those elements, why did you, as the chief executive officer of the Chase Bank, as well as of its security affiliate, permit or sanction the security affiliate of the bank going into these trading accounts to stabilize the market or maintain the price for the bank stock?

Mr. WIGGIN. Because they had the right to buy and also the right to sell and they wanted to reduce their holdings.

Mr. PECORA. You did not permit them to do that in order that they might have the right to buy and the right to sell. That was simply an attribute of a trading account, was it not? It was not the reason for the trading account?

Mr. WIGGIN. I think it was the reason for the trading account.

Mr. PECORA. You said the reasons for the trading account were to stabilize the market and enable the security affiliate to sell some of its holdings.

Mr. WIGGIN. Yes, sir.

Mr. PECORA. You said, also, that in your opinion, the market prices for the bank stock in that period of time were too high or, in other words, out of proportion to its real value.

Mr. WIGGIN. I said I thought the market on bank stocks was high; yes, sir.

Mr. PECORA. And you, through your private corporation, the Shermar Corporation, acting upon the belief that you had—that the market price for the bank stock was too high—and acting further upon the hope that you had that by selling the stock short your corporation would make profits, nevertheless permitted the security affiliate of the bank to go into trading accounts designed to stabilize the market at the time when you thought the market price was too high Why did you do that?

Mr. WIGGIN. I permitted them to go in to stabilize the market and buy and sell with the hope that they would reduce their holdings, the same purpose exactly.

Mr. PECORA. The Shermar Corporation had no holdings to reduce. They were engaged in a speculation, were they not?

Mr. WIGGIN. The family had large holdings, and the interests were the same.

Mr. PECORA. And the family never let go of those holdings, because it caused the Murlyn Corporation to buy back the total amount of its short stock from the Metpotan Co. on December 11, 1929?

Mr. WIGGIN. It did not buy it back until December.[50]

* * * * * * *

Mr. PECORA. Now, the Shermar Corporation was engaged only in selling from August 8, 1929, up to and including December 2, 1929?

Mr. WIGGIN. I think so. That is right.

Mr. PECORA. And selling short in large part?

Mr. WIGGIN. Yes.

Mr. PECORA. The Metpotan was not selling short as a participant in that trading account, was it?

Mr. WIGGIN. No, sir.

Mr. PECORA. And the trading account itself was not selling short, was it?

Mr. WIGGIN. No, sir.

Mr. PECORA. That trading account was organized, as you have already testified, among other reasons, for the purpose of stabilizing the market—right?

Mr. WIGGIN. And buying and selling.

Mr. PECORA. Well, the buying and selling was the process by which stabilization was effected, was it not?

Mr. WIGGIN. And I have also stated that it was for the desire to reduce their holdings, which they did.

Mr. PECORA. All right; but one of the purposes was stabilization of the market, and that market price at that time, in your opinion, was too high?

Mr. WIGGIN. Yes, sir.

* * * * * * *

Mr. PECORA. So that the price remained fairly stabilized between August the 8th and October 25, did it not?

Mr. CONBOY (counsel to Albert H. Wiggin). Oh, yes; apparently. In fact it increased during that period.[51]

Mr. Wiggin admitted that he felt some impropriety in personally selling the stock of the Chase National Bank short.

Senator GORE. You felt, Mr. Wiggin, that there would have been some impropriety in your personally selling the stock of your own bank short?

Mr. WIGGIN. Yes, sir.[52]

Yet he had no hesitancy or compunction in effecting these short sales through the medium of the Shermar Corporation, his family corporation.

Nor was Mr. Wiggin the only officer who sold the stock of the Chase National Bank during the summer and fall of 1929, while the trading accounts were operating to stabilize the market and to effect a wider distribution among the public.

The CHAIRMAN. Mr. Wiggin, while Mr. Pecora is looking that up, do you know of any other officer or officers of the Chase Bank who sold stock in the summer and fall of 1929 of the bank; bank stock?

Mr. WIGGIN. Oh, I think a good many of them did.[53]

(3) *Speculation and pool operations of bank officers and directors in securities others than bank stocks.*—Albert H. Wiggin's operations, while executive head of the Chase National Bank, were not confined to the capital stock of the bank. Through his family corporations he participated in trading and pool operations in various other securities. The most notable instance was the Sinclair Consolidated Oil Corporation common-stock pool, where Chase Securities Corporation, having a 25-percent participation, granted to Shermar Corporation, a 7½-percent subparticipation. This pool disposed of 1,130,000 shares at a profit of $12,420,492.95, without any of the participants, except Blair & Co., having paid a single dollar

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[50] Albert H. Wiggin, supra, pp. 2974–2977.
[51] Albert H. Wiggin, supra, pp. 2982-2988.
[52] Albert H. Wiggin, supra, p. 2958.
[53] Albert H. Wiggin, supra, p. 2973.

toward the financing of this operation. Shermar Corporation received as its 7½-percent profit in the pool, $891,600.37.[54]

Albert H. Wiggin, through Shermar Corporation, while a director of Underwood-Elliott-Fisher Co., had a 20-percent participation in a pool account organized June 14, 1929, to acquire 25,000 shares of the Underwood-Elliott-Fisher common stock.[55] This account was closed on July 8, 1929, and a proportionate profit of $55,539.84 was paid to the Shermar Corporation.[56]

Mr. PECORA. Does not this letter, Committee Exhibit No. 101, indicate that this account evidenced by the letter of June 14, 1929, marked "Committee Exhibit No. 100", was a trading or pool account?

Mr. WIGGIN. Absolutely.

Mr. PECORA. What is that?

Mr. WIGGIN. Absolutely.

Mr. PECORA. And it was a trading or pool account trading in the stock of a corporation in which you were then a director?

Mr. WIGGIN. Yes, sir.[57]

Mr. Wiggin, when interrogated as to the propriety of a director of a corporation selling the stock of that corporation short, testified:

"Mr. PECORA. * * * let me ask you if you recall any transactions with Gude, Winmill & Co. in the stock of the Underwood Elliott Fisher Co. that were short sales?

Mr. WIGGIN. I do not recall any. I might not have known anything about it and yet there might have been some.

Mr. PECORA. Would you have any scruples against engaging in short sales of the stock of the company in which you were a director or officer?

Mr. WIGGIN. Oh, yes. I would not do it.

Mr. PECORA. What is that?

Mr. WIGGIN. I would not do it.

Mr. PECORA. Did not the Shermar Corporation do just that in connection with the stock of the Chase National Bank that it sold between August and December 1929?

Mr. WIGGIN. Yes, sir. But the family always had a great deal more than that amount of stock, as you know.

Mr. PECORA. Well, it was a species of short selling, then, against the box?

Mr. WIGGIN. The corporation entered into a short sale.

Mr. PECORA. What?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And the corporation and the family did not actually divest themselves of any shares because they covered the short sales by the purchase through the Murlyn Corporation on December 11, of the 42,506 shares that they sold short?

Mr. WIGGIN. Ultimately; yes, sir.[58]

The fact is that the Murlyn Corporation had entered into a short account with one Oscar L. Gubelman, a stock-market operator, in the stock of the Underwood-Elliott-Fisher Co. Murlyn Corporation realized a proportionate profit of $3,130.98 from the short-selling activities of this account.[59]

Mr. PECORA. But do these entries convey to you now information that at about the time of the making of those entries you, while a director of the Underwood-Elliott-Fisher Co., engaged in an account that made short sales of the stock of that company?

Mr. WIGGIN. I do not recall it, but I have no doubt that this is so.[60]

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[54] Committee Exhibits Nos. 96 and 97, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3009, 3015. A detailed recital of the pool operation in Sinclair Consolidated Oil Corporation stock is contained in ch. I, sec. 8c, of this report.

[55] Committee Exhibit No. 100, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3019.

[56] Committee Exhibit No. 101, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3021.

[57] Albert H. Wiggin, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3021.

[58] Albert H. Wiggin, supra, pp. 3021–3022.

[59] Albert H. Wiggin, supra, pp. 3018, 3030.

[60] Albert H. Wiggin, supra, pp. 3030–3031.

Albert H. Wiggin was the recipient of the profits of numerous syndicates without assuming any responsibility in connection with those operations.

On April 6, 1927, Howard P. Ingles, a member of the firm of Theodore Schulze & Co., a banking firm, wrote to Albert H. Wiggin as follows:

DEAR MR. WIGGIN: You will recall that a couple of days before you left I spoke to you about a small operation that we were undertaking in connection with Universal Leaf Tobacco Co.

Having had you as a participant in every one of our syndicates since we have been in business, we wouldn't leave you entirely out of this one, so carried a very modest participation for you. I am glad to enclose herewith the check covering the profits on the same.

We are very much pleased with the way things are going with the Splitdorf Co., especially in connection with the deal we have just made with the Radio Corporation.

Yours very truly,[61]

——— ———.

On April 6, 1927, Albert H. Wiggin replied:

DEAR HOWIE: Thank you very much for including me in the tobacco syndicate without any responsibility. It is most generous of you. Regards to all. Renewed thanks.

Yours sincerely,[62]

——— ———.

The Shermar Corporation and the Murlyn Corporation also engaged in the business of lending various securities to stock-market operators, corporations, and stock-exchange firms to enable these parties frequently to cover short sales.

Mr. PECORA. When requests were made of you or your family corporation for the loaning of stock what did you think that you were loaning the stock for if it was not to enable the persons to whom you loaned it to cover short sales?

Mr. WIGGIN. Well, it may have been to enable them to make delivery of something that was delayed in being received.

Mr. PECORA. It is also done for the purpose of enabling sellers of securities, which they do not own, to make delivery?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. In other words, to enable them to make delivery of short sales?

Mr. WIGGIN. Frequently.[63]

In some instances, as the loans to Chase Securities Corporation, the securities were used to effect banking transactions or to make deliveries pursuant to options.[64]

Albert H. Wiggin, through his family corporations, was allotted by the Chase Securities Corporation subparticipations in numerous trading accounts in which the Chase Securities Corporation participated.[65] These subparticipations were approved by the executive officers of the Chase Securities Corporation. Among these executive officers in 1928 and 1929 were Halstead G. Freeman and

[61] Committee exhibit no. 104, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3035.
[62] Committee exhibit no. 103, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3034.
[63] Albert H. Wiggin, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3017.
[64] Albert H. Wiggin, supra, p. 3020. Committee Exhibit No. 98, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3036–3037, contains an itemized, tabulated statement of the stock loaned by Murlyn Corporation. Committee Exhibit No. 99, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3038–3039, contains an itemized, tabulated statement of the stock loaned by Shermar Corporation.
[65] Committee Exhibit No. 74, Oct. 27, 1933, Chase Securities Corporation, pt. 6, pp. 2858–2859, contains an itemized tabulation of the trading accounts in which Shermar Corporation was allotted subparticipations by Chase Securities Corporation.

Murray W. Dodge, who were indebted in substantial sums to the Shermar Corporation, and Frank Callahan, who was granted a subparticipation by the Shermar Corporation in the profitable Sinclair Consolidated Oil Corporation pool.

Albert H. Wiggin had developed a system whereby his family corporations granted subparticipations in its syndicate interests to the executive officers of the Chase Securities Corporation, whose function it was to approve the subparticipations given by the Chase Securities Corporation to the family corporations of Albert H. Wiggin.[66] It is manifest that these grants of subparticipations by Albert H. Wiggin to these executive officers, and the loans by the family corporations of Albert H. Wiggin to these officers to finance the subparticipations, created a relationship between Albert H. Wiggin and these executive officers which was inimical to the interest of the banking institution and the securities affiliate.

Mr. PECORA. What was the reason for any subparticipations being granted by the Shermar Corporation?

Mr. WIGGIN. Just to be helpful to the key men of the institution.

Mr. PECORA. Helpful to key men?

Mr. WIGGIN. Of the institution; yes, sir.

Mr. PECORA. In what respect were they key men?

Mr. WIGGIN. They were the active executive officers of the company.

* * * * * * *

Mr. PECORA. Well, the Shermar Corporation had nothing to do with the Chase Securities Corporation, did it?

Mr. WIGGIN. No; but I was very much interested in having the men in Chase Securities Corporation make money.

* * * * * * *

Senator TOWNSEND. What actual service did they render to you that they should receive such participation?

Mr. WIGGIN. None.

Mr. PECORA. You wanted them to make money outside of their salaries?

Mr. WIGGIN. Yes.

Mr. PECORA. And one of the ways by which it was hoped they might make money was to put them in stock operations?

Mr. WIGGIN. When I had something that——

Mr. PECORA (interposing). That looked like a sure thing?

Mr. WIGGIN. No; when I had something that I thought was a good risk, and they were willing to take some of it, I let them have it.

Mr. PECORA. In this case did they come to you and ask you to let them have a participation in the Shermar Corporation's interest, or did you take the initiative in offering it to them?

Mr. WIGGIN. I don't know.

Mr. PECORA. Did you do that frequently with officers of the Chase Securities Corporation?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. You invited them to participate in various syndicate operations and transactions of your family corporations?

Mr. WIGGIN. Yes, sir.

Senator COUZENS. Did they put up any actual money?

Mr. WIGGIN. Some of them paid cash and some would have the corporation advance the money.

Senator COUZENS. For their participation?

Mr. WIGGIN. Yes, sir. You understand that the Chase Securities Corporation was always paid for their share. There was never a carrying of anybody by Chase Securities Corporation.[67]

(4) *Bank loans to officers and directors.*—Officers and directors of commercial banks and their investment affiliates were not only ac-

[66] Albert H. Wiggin, Nov. 1, 1933, Chase Securities Corporation, pt. 6, p. 2937.
[67] Albert H. Wiggin, supra, pp. 2934–2935.

tively engaged in speculative securities transactions, but borrowed, either without collateral or with inadequate collateral, large sums of money from the banking institutions to finance these speculative ventures or to extricate them from the financial predicament in which they found themselves by virtue of such speculation.

On November 13, 1929, the board of directors of the National City Bank adopted the following resolution:

> *Resolved,* That the proper officers are hereby authorized to advance to Eric P. Swenson and James H. Perkins, as trustees and not individually, upon their unsecured note or collateral loan agreement, signed by them as such trustees without personal responsibility, such sum or sums as such trustees may call for, not exceeding a total of $2,000,000, and without interest, in order to enable such trustees to make loans or advances, either with or without security as in their complete discretion they may deem proper, to such officers of the bank and its affiliate corporations as they may deem proper for the purpose of making loans to such officers in the present emergency, and thereby sustaining the morale of the organization.[68]

Subsequently, the amount was increased to $2,400,000. Eric P. Swenson and James H. Perkins both were directors of the National City Bank. Loans without interest were made to approximately 100 officers, with and without collateral.[69] Up to December 15, 1930, when these loans were written off or taken over by the National City Co., which "bailed out" National City Bank, not over 5 percent of these loans had been repaid.[70]

At the time of the hearing, February 22, 1933, many of these borrowers were still officers of the bank and affiliated companies.[71]

> Mr. PECORA. Now, as a matter of fact, the morale of the officers in the emergency that confronted them in November of 1929 because of the stock-market crash was due in large part to their own commitments for shares of stock of the bank; isn't that so?
>
> Mr. RENTSCHLER. Quite right—oh, I beg pardon. I answered that question too quickly. It is due to their commitments for various things. It may have been bank stock or for their houses or for something else.
>
> Mr. PECORA. Don't you know it was principally commitments in the stock of the bank?
>
> Mr. RENTSCHLER. I think that was the principal item, perhaps; yes, sir.
>
> Mr. PECORA. You know that to be a fact, don't you?
>
> Mr. RENTSCHLER. I have not been over all these loans enough to say.
>
> Mr. PECORA. Isn't that a fact which has been called to your attention as the president of the bank through the examinations of the bank?
>
> Mr. RENTSCHLER. Yes. I think you are probably correct—that a majority of it represents stock; yes.[72]

Edward F. Barrett, vice president of the National City Bank, borrowed $296,000 from this fund, of which he repaid only $11,000. The balance was taken over by the National City Co. in December 1930 and written down to $65,000. No attempt was made to collect this written-down balance from Barrett's salary as an officer of the bank. Lee Olwell borrowed $345,272, no part of which indebtedness had been paid up to the time of the hearing. This loan was transferred to the National City Co., written off to $200,000, and no proceedings were ever taken to enforce that obligation.[73]

The officers of the bank were relieved of commitments to the bank to the extent of approximately $2,400,000, yet the employees of the

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[68] Gordon S. Rentschler, Feb. 22, 1933, National City, pt. 6, pp. 1868–1869.
[69] Gordon S. Rentschler, supra, p. 1869.
[70] Gordon S. Rentschler, supra, p. 1870.
[71] Gordon S. Rentschler, supra, p. 1871.
[72] Gordon S. Rentschler, supra, p. 1875.
[73] Gordon S. Rentschler, supra, p. 1876.

bank, who had subscribed to National City Bank stock under the bank-stock purchase plan, were not relieved of any part of that $12,000,000 obligation.[74]

The Chase National Bank, during 1928, made 7 loans to the Shermar Corporation, and in 1929, 8 loans, all on collateral, for a total of $11,820 000.[75] From February 14 to 24, 1929, the Shermar Corporation borrowed from the Chase National Bank an aggregate of $4,000,000, and from November 8 to December 11, 1929, an aggregate of $5,000,000, which borrowings were used by the Shermar Corporation to carry on its trading activities in the capital stock of the Chase National Bank and Chase Securities Corporation and other securities. On December 11, 1929, the Murlyn Corporation borrowed from the Chase National Bank the sum of $3,000,000. Between November 8 and December 11, 1929, loans aggregating $8,000,000 were made by the Chase National Bank to the Shermar Corporation and the Murlyn Corporation, the private family corporations of Albert H. Wiggin. The Murlyn Corporation used $6 588,430 of these loans to purchase from the Metpotan Securities Corporation, the affiliate of Chase National Bank, the 42,506 shares of Chase National Bank stock, subsequently transferred to the Shermar Corporation on February 14, 1930, and used by it to cover the short sales of Chase National Bank stock made by Shermar Corporation during 1929, on which short sales a profit of $4,008,538 was realized.[76]

Albert H. Wiggin did not deem the practice of officers of banks making loans from the banks to engage in market activities in the stock of the banks unsound or unethical.

Mr. PECORA. Do you think, Mr. Wiggin, it is a sound and ethical policy for a national bank to make loans to individuals among its officers or directors to enable those officers or directors, either individually or through the medium of private corporations, to engage in market activities in connection with the stock of the bank itself?

Mr. WIGGIN. I think so, as long as the loans are properly secured and have nothing to do with the stock of the bank; I mean, as long as the collateral has nothing to do with the stock of the bank. I think it is highly desirable that the officers of the bank should be interested in the stock of the bank.

Mr. PECORA. It is a practice that you would commend to banks?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. To loan its funds to officers to enable those officers to undertake individual transactions in the stock of the bank for their individual account?

Mr. WIGGIN. I think it is commendable for the officers of the bank to be interested in the institution for which they are working, and I think it is entirely commendable and proper for the bank, on proper collateral, to loan to its officers.

Mr. PECORA. For that purpose?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. That is, for the purpose of engaging in market activities in the stock of the bank?

Mr. WIGGIN. Yes, sir.

Senator GORE. You know that the Glass Act prohibited banks from lending to their officers?

Mr. WIGGIN. I understand so.

Senator GORE. Do you think that was a mistaken policy?

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[74] Gordon S. Rentschler, supra, p. 1877.

[75] The testimony contains an itemized statement of each and every loan made during these years. See Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, p. 2907.

[76] Albert H. Wiggin, supra, pp. 2908–2909.

Mr. WIGGIN. I think it is much better, if a person is going to borrow money, to borrow it from his own bank, where all the directors know all about it, than it is to do it outside.

Senator GORE. You do not think there might be any good fellowship between the officers so that they would lend more to officers than they ought to lend?

Mr. WIGGIN. They should not do that, anyway.[77]

Gerhard M. Dahl, chairman of the board of directors and executive head of the Brooklyn-Manhattan Transit Corporation, and a member of the executive committee and a director of the Chase National Bank, was an endorser or guarantor of a loan of $4,340,576 made by the Chase National Bank to the Waubesa Corporation, the family corporation of Gerhard M. Dahl. In addition, Dahl personally owed the bank $260,127.[78] The loan of $4,340,576 to Waubesa Corporation was secured by 76,083 shares of B.M.T. common, 9,636 shares of B.M.T. preferred, 12,450 shares of New York Railway stock, and $447,000 of New York Railway 6-percent bonds, and was made to enable Dahl, through his family corporation, to carry this most substantial block of B.M.T. stock and other collateral.[79]

On March 12, 1930, the Waubesa Corporation, Dahl's family corporation, paid off this loan, and a new loan in the sum of $4,244,114.91 was made to Dahl personally. Dahl, on October 13, 1933, owed the Chase National Bank $3,176,016.69, with collateral of only approximately $1,300,000.[79] The loan was reduced by the Chase National Bank from $4,798,000 to $3,176,016.69 by selling part of the collateral, which was originally estimated at $7,023,000.[80]

On January 14 and 15, 1930, while Harvey C. Couch was a director of the Chase National Bank, loans aggregating $625,000 were made by the bank to him and one C. H. Moses jointly, which was used by them as participants in a syndicate in Seaboard Airline Co. stock managed by Dillon, Read & Co.[81]

The joint Couch-Moses loan became undercollateralized, and on April 24, 1931, the Chase National Bank wrote to Harvey C. Couch as follows:

DEAR HARVEY: Almost every time at our discount committee meetings in the morning when the loans with a deficiency of margin are brought up, yours has quite a prominent part in the list. When Charlie was here it used to be referred back to him, but since he has been on his holiday it has been referred to me to ask you if you would not have the same put in shape.

This is naturally embarrassing to me, but the fellows here all feel that the loan should be in order, and I am sure you will appreciate the position of the bank in the matter.[82]

The original loan of $600,000 (subsequently $625,000) had been reduced to $153,000 and was covered by collateral estimated at $220,000 at the time of the hearings.[83]

On September 24, 1929, Harvey C. Couch, head of Southwestern Investors, Inc., which had made small loans from the Chase National Bank while Couch was a director of the bank, wrote to Albert H. Wiggin, as follows:

DEAR MR. WIGGIN: Last night we mailed you allotment certificate for 25,000 shares of Southwestern Investors, Inc.

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77 Albert H. Wiggin, supra, pp. 2012–2013.
78 Albert H. Wiggin, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3031–3032.
79 Albert H. Wiggin, supra, p. 3032.
80 Albert H. Wiggin, supra, pp. 3033–3034.
81 Charles S. McCain, Dec. 7, 1933, Chase Securities Corporation, pt. 8, pp. 4159–4160.
82 Committee Exhibit No. 287, Dec. 7, 1933, Chase Securities Corporation, pt. 8, p. 4161.
83 Charles S. McCain, Dec. 7, 1933, Chase Securities Corporation, pt. 8, p. 4162.

We are glad to include you on this although we are not making a general offering at this time. This comes to you at the suggestion of our mutual friend, Mr. C. S. McCain. We have already made a nice profit but you are getting in on the original basis. The time is rather short to October 1 and if you find it more convenient to make your remittance so as to arrive not later than October 10, this will be satisfactory but it will be necessary to include interest on the delayed payment.[84]

Albert H. Wiggin replied:

DEAR MR. COUCH: I have your courteous note of the 24th instant. Thank you sincerely for your thought of me in connection with Southwestern Investors, Inc. I will make the remittance so that it will reach you not later than October 10, as you suggest. I assume that the "original basis" includes a share of the option warrants.

With renewed thanks for your courtesy, yours sincerely.[85]

Charles S. McCain, chairman of the board of directors of the Chase National Bank, when interrogated upon this transaction, testified:

Mr. PECORA. It was an outburst of generosity on Mr. Couch's part, was it not, in favor of Mr. Wiggin?

Mr. MCCAIN. Yes; I think so.

Mr. PECORA. That was done at your suggestion? You are the mutual friend mentioned in Mr. Couch's letter to Mr. Wiggin?

Mr. MCCAIN. We will say at my suggestion; yes.

Mr. PECORA. What advantages do you think might have accrued to the Southwestern Investors, Inc., from having this generous exhibition made toward Mr. Wiggin at that time?

Mr. MCCAIN. Mr. Wiggin at that time, as you know, was interested in a number of things, and he might have been very helpful to them in advising them with reference to investments.

Mr. PECORA. In other words, it was establishing a friendly contact with the man who was at the head of a great big bank, was it not?

Mr. MCCAIN. That plus the fact that the man was interested in a number of other enterprises.[86]

McCain had an individual loan account with the Chase National Bank with a peak indebtedness of $235,000. At the time of the hearing, December 7, 1933, he still owed $226,500 on this loan, which was not collateralized.[87] McCain, in addition, had borrowed $50,000 from the Shermar Corporation, $43,000 of which was still due at the time of the hearing.[88]

It has been estimated that approximately 33 percent of the bank failures were substantially contributed to by loans to officers and employees of banks.[89]

(5) *Loans to corporations, syndicates, and enterprises in which directors, officers, or trustees of the Chase National Bank were interested.*—In the year 1927 the aggregate amount of loans made to corporations, enterprises, and syndicates in which officers, directors, or trustees of the Chase National Bank were interested was $64,522,205; in 1929 the aggregate amount was $62,668,500; and in 1932 the aggregate amount was $66,643,402.[90]

Many loans were made by the Chase National Bank during the period from January 4, 1928, through August 1933 to syndicates in

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[84] Committee Exhibit No. 235, Dec. 7, 1933, Chase Securities Corporation, pt. 8, p. 4155.

[85] Committee Exhibit No. 236, Dec. 7, 1933, Chase Securities Corporation, pt. 8, p. 4156.

[86] Charles S. McCain, Dec. 7, 1933, Chase Securities Corporation, pt. 8, pp. 4157–4158.

[87] Charles S. McCain, supra, pp. 4166, 4100.

[88] Charles S. McCain, supra, pp. 4166–4167.

[89] Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, p. 2913.

[90] Albert H. Wiggin, supra, p. 2914. The testimony contains an itemized list of these corporations, the amounts of the loans, whether collateralized or not, and the interested officer, director, or trustee of the Chase National Bank. (See Albert H. Wiggin, supra, pp. 2914–2920.)

which officers and directors of the Chase National Bank were interested or participated.[91]

Typical of these loans was the loan of $2,795,000 made on January 29, 1930, to a syndicate in Louisiana & Arkansas Railway Co. managed by Dillon, Read & Co., Harvey C. Couch, a director of Chase National Bank, and Charles S. McCain, chairman of the board of directors of the Chase National Bank, and the loan of $3,300,000 made on January 15, 1930, to a syndicate in Seaboard Airline Railway stock managed by Dillon, Read & Co., Harvey C. Couch, Coverdale & Colpitts, Charles S. McCain, and S. Z. Mitchell.[92] Coverdale & Colpitts, participants in the Louisiana & Arkansas Railway Co. syndicate, was the firm which issued the engineers' report as to the condition and earning facilities of the railroad.

Senator COUZENS. Do you mean to say Coverdale & Colpitts speculate after issuing engineers' reports as to the condition of railroads?

Mr. WIGGIN. I do not know, sir.

Senator COUZENS. It looks as though they were participating in this syndicate.

Mr. WIGGIN. They were one of the participants in the loan of $2,795,000.

Senator COUZENS And yet the public are asked to rely upon Coverdale & Colpitts' reports as to the earning facilities and the condition of railroads. It seems to me that is a most unusual situation.[93]

Winthrop W. Aldrich severely condemned the practice of commercial banks making loans to executive officers for speculative transactions.[94] Aldrich urged that executive officers of banks be prohibited from participating, directly or indirectly, in syndicates which are offering securities to the public or in trading accounts or pool operations in securities which are dealt in publicly. He stated that as such executive officers may be called upon to make syndicate loans, and may be responsible for the formulation of the policies of their banks in connection with loans on stock and bond collateral, these officers should be prohibited from having any interest in or subscribing to any such syndicate or in joining in any such trading accounts or pool operations. Aldrich stated "Banking experience has conclusively demonstrated the undesirability of participation by bank officers in transactions of this kind."

Aldrich admitted the responsibility of the commercial banks in encouraging the orgies of gambling upon stock and commodity exchanges by means of these loans.

Mr. PECORA. May I call your attention to another portion of your statement, one to be found on next to the last page of it, where you say as follows: "Bankers have enough to atone for without being held responsible for orgies of gambling upon stock or commodity exchanges or for the rapacity of individuals who seek to gain inordinate financial profits by reckless speculation."

As I recall a good deal of the evidence that has been presented to this committee with regard to the operation of trading and pool accounts in the stock market, those operations were largely financed by bank loans.

Mr. ALDRICH. You are perfectly right. If a banker makes a loan for that purpose he is responsible.

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[91] Committee Exhibit No. 81, Nov. 9, 1933, Chase Securities Corporation, pt. 6, pp. 3130–3154, contains a tabulated list of all syndicates, loans, and the participants, made by Chase National Bank from Jan. 4, 1928, to Aug. 23, 1933. Ch. I, sec. 5 (e) of this report contains statistics and discussions of loans made by 33 selected banks throughout the country to syndicates trading in stocks.

[92] Committee Exhibit No. 81, supra, pp. 3145–3146. Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, p. 2927.

[93] Albert H. Wiggin, supra, p. 2928.

[94] Statement of Winthrop W. Aldrich, Nov. 20, 1933, Chase Securities Corporation, pt. 8, p. 3986.

Mr. PECORA. So that to the extent to which those accounts have been financed by banks, and to the extent that those orgies of gambling have been indulged in and have passed on their economic evils to the country at large, bankers are called to a share of responsibility for the making of those loans, are they not?

Mr. ALDRICH. I agree with that entirely. Insofar as bankers have made loans for those purposes they certainly are.[95]

(6) *Regulation of loans to officers by the Banking Act of 1933.*—The Banking Act of 1933 provides that no executive officer of any member bank shall borrow from or otherwise become indebted to any member bank of which he is an executive officer, and no member bank shall make any loan or extend credit in any other manner to any of its own executive officers. The act further provides that if any executive officer of any member bank borrows from or becomes indebted to any bank other than a member bank of which he is an executive officer, he must make a written report to the chairman of the board of directors of the member bank of which he is an executive officer, stating the date and amount of such loan or indebtedness, the security therefor, and the purpose for which the proceeds are to be used.[96]

(7) *Extra banking activities of officers and directors of commercial banks.*—Executive officers of commercial banks, charged with the weighty responsibilities attendant to those offices, regularly assumed other responsible positions with compensation and devoted their efforts to other activities for personal profit, to the obvious deprivation of their institutions of their time and energy to the banking tasks for which they were being substantially compensated.

(i) *Bank officers as directors of private corporations.*—Albert H. Wiggin, while executive head of the Chase National Bank and the Chase Securities Corporation, held 59 directorships in various public utility, industrial, insurance, banking, and holding corporations.[97] For many of these directorships Albert H. Wiggin received substantial compensation, in addition to the salary and bonuses he received as chairman of the governing board of the Chase National Bank. Albert H. Wiggin received at one time $40,000 a year from Armour & Co., $20,000 a year from the Brooklyn-Manhattan Transit Corporation, $5,000 a year from the Finance Co. of Great Britain and America, $3,000 a year from the American Express Co., $3,000 a year from Western Union Telegraph Co., $2,000 a year from the International Paper Co., $2,000 a year from Underwood-Elliott-Fisher Co., $1,500 a year from Stone & Webster, $300 a month from the American Locomotive Co., and $300 a month from the American Sugar Refinery.[98]

Charles S. McCain, chairman of the board of directors of the Chase National Bank, was a director or officer of 20 corporations. Other executive officers of the Chase bank were directors of private corporations.[99]

Albert H. Wiggin and the other executive officers of the bank held these numerous directorships, although employees holding sub-

[95] Statement of Winthrop W. Aldrich, supra, p. 3907.

[96] Banking Act of 1933, sec. 12 (g).

[97] Committee Exhibit No. 4, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2353–2354, contains an itemized tabulation of the corporations of which Albert H. Wiggin was a member of the board of directors and executive committees, the business of the corporations as of Dec. 31, 1931, Dec. 31, 1932, and Apr. 30, 1933. An explanation of the abbreviations in the tabulation is contained on pp. 2316–2317.

[98] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2319–2320.

[99] Charles S. McCain, Dec. 7, 1933, Chase Securities Corporation, pt. 8, pp. 4150–4152.

ordinate positions in the bank, exclusive of the officers of the bank, were required to sign a pledge not to engage in any other business without the written consent of the bank.[1]

Albert H. Wiggin denied that his extra banking activities either impaired his utility to the bank or militated against the time and service he was rendering to the bank by these numerous directorships.

Mr. PECORA. Do you think it was a benefit to the bank, for instance, during the years that you were its executive head and receiving by way of salary and additional compensation, sums exceeding in 1 year over $300,000, for you to be connected with other corporations which paid you salaries as high as $40,000?

Mr. WIGGIN. I am sure of it.

Mr. PECORA. I presume, of course, that you rendered service to the Armour Co. for the $40,000 annual salary that you received during the time that you received it?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And did those services improve your value to the bank as its executive head?

Mr. WIGGIN. I think so .

Mr. PECORA. In what way?

Mr. WIGGIN. The business between the two was greatly increased.

Mr. PECORA. Is that true also of the affiliation you had with the Brooklyn Manhattan Transit Co. during the time that you received a salary from that company of $20,000 a year?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. When you were serving the Chase National Bank and received from it the salary and additional compensation shown here to have been received by you, you were, of course, attempting to devote yourself to the best interests of the bank, were you not?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And when, during any of those times, you were also functioning as an officer, say, of the Armour Co., from which company you received a salary at the rate of $40,000 a year, you were attempting to render those services for the best interests of the Armour Co.?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. Presumably those services were of an extensive character in view of the amount of salary you received from them?

Mr. WIGGIN. I think so.

Mr. PECORA. Did they not in any way militate against the time and service that you were rendering to the Chase National Bank during that time?

Mr. WIGGIN. I do not think so.[2]

Charles S. McCain, however, admitted that too many executive officers of the bank should not be permitted to hold directorships in corporations.

Mr. PECORA. And is that also true of other executive officers of the bank so far as you know?

Mr. McCAIN. Of the Chase Bank?

Mr. PECORA. Yes.

Mr. McCAIN. Some of them are; yes.

Mr. PECORA. And do you think that is good practice?

Mr. McCAIN. I think there should not be too many of them.

Mr. PECORA. How?

Mr. McCAIN. I do not think there should be too many. They will take too much of the time. Nor do I think one should be a director in corporations which are apt to use the bank in any way. I do not think you can serve two masters, as far as that is concerned.[3]

Commercial bankers as members of the boards of directors of industrial and other corporations was a highly undesirable situation, for not only were the banks deprived of their undivided effort and

[1] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2324–2325.
[2] Albert H. Wiggin, supra, p. 2325.
[3] Charles S. McCain, Dec. 7, 1933, Chase Securities Corporation, pt. 8, p. 4152.

attention, but these officers assumed the inconsistent position of representing conflicting interests when passing upon loans to or investing banking transactions with corporations and syndicates in which they were interested.

The General Theatres Equipment, Inc., on April 23, 1930, issued $30,000,000 of debentures which it sold to a group of bankers, Chase Securities Corporation, Pynchon & Co., West & Co., and W. S. Hammons & Co., at 90. The entire issue was sold to the public in one week at 99½, a spread of 9½ points.[4] The members of the original purchase group effected this merchandising operation without advancing a dollar of their own money, and realized a gross profit of $1,950,000, and a net profit of $1,806,075.10. In addition, the selling group realized a gross profit of $900,000.[5]

Murray W. Dodge, one of the directors of the General Theatres Equipment, Inc., the issuer, was an officer of the Chase Securities Corporation, one of the purchasers.[6] When interrogated on the inconsistency of this position, Dodge claimed he disassociated his relationships.

Mr. DODGE. I want to clear this up, Mr. Pecora. You asked me if I was a director of the company. I was. But my negotiations were with Mr. Clarke and the officers of the company. I was not negotiating as a director.

Mr. PECORA. How could you disassociate your relationship from the General Theatres Equipment as one of its directors in any of those negotiations?

Mr. DODGE. I could.

Mr. PECORA. Then why didn't you?

Mr. DODGE. I did.

Mr. PECORA. You just told us to the contrary.

Mr. DODGE. No, sir; I said I did disassociate myself.

Mr. PECORA. How could you do that?

Mr. DODGE. I did not find it difficult.

Mr. PECORA. How could you respond to your trust responsibilities as a director of General Theatres Equipment in the negotiations which led to the sale of these bonds by General Theatres at 90 to a banking group or syndicate that included your other company, the Chase Securities Corporation?

Mr. DODGE. I did not vote on the contract., My negotiations were made in good faith together with the bankers, with the officers of the company.

Mr. PECORA. Oh, the bankers have no reason to complain of getting the bonds at 90, which they were able to sell within 5 days to the public at 99½.

Mr. DODGE. They would have complained very bitterly if they had not been able to sell them.

Mr. PECORA. Then no such complaint was ever forthcoming, because they sold them within 5 days.

Mr. DODGE. Correct.[7]

Banking officials who were officers and directors of private corporations availed themselves of inside information of corporate condition and activities for their transactions in the corporation securities.

Albert H. Wiggin, while a director and chairman of the finance committee of the Brooklyn-Manhattan Transit Corporation, was, through the Shermar Corporation, the owner on June 1, 1932, of 26,400 shares of common and a substantial block of preferred stock of the Transit Corporation. On June 3, 1932, Shermar Corporation sold 8,700 shares of B.M.T. common stock; on June 6, 1932, 17,100

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[4] Murray W. Dodge, Nov. 22, 1933, Chase Securities Corporation, pt. 7, pp. 3589–3593.
[5] Committee Exhibit No. 160, Nov. 22, 1933, Chase Securities Corporation, pt. 7, pp. 3643–3644.
[6] Murray W. Dodge, Nov. 22, 1933, Chase Securities Corporation, pt. 7, pp. 3591–3595.
[7] Murray W. Dodge, supra, p. 3592.

shares of common stock, which practically disposed of all of the shares owned by the Shermar Corporation. Gerhard M. Dahl, chairman of the board of directors and executive head of the B.M.T., sold at the same time large blocks of the B.M.T. common stock which he owned. The Chase National Bank, on June 4, 1932, sold 50,000 shares of B.M.T. common stock pledged by Gerhard M. Dahl as collateral for the loan by the bank, and on June 6, 1932, an additional 5,000 shares of Dahl's B.M.T. common stock. Shermar Corporation sold its holdings of B.M.T. common stock at an average of about $24. Chase Securities Corporation sold Gerhard M. Dahl's common stock at about the same average.[8]

On June 4, 1932, the high for B.M.T. common stock was 25, the low 23½. On June 9 the high was 14¾ and the low 12. On June 7, the day after Shermar Corporation and Chase National Bank had sold the B.M.T. stock, there was a decline in the high quotation of the stock of about 6 points from the preceding day.[9]

Albert H. Wiggin, knowing of the financial condition of the company by virtue of his chairmanship of the finance committee, and knowing that notes of the B.M.T. held by the Chase National Bank were maturing and that the Transit Corporation would be in financial difficulty, had concluded on June 3 that the dividend would be passed, and commenced selling the B.M.T. stock on that day.[10]

Albert H. Wiggin effected these sales in reliance upon the peculiar and superior knowledge that he, as chairman of the Finance Committee of the B.M.T., had that dividends on B.T.M. stock would be passed.[11]

Mr. PECORA. Do you recall in the early summer of 1932 engaging in heavy selling transactions in the common stock as well as the preferred stock of the Brooklyn-Manhattan Transit Corporation?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. Do you recall the circumstances under which you made those transactions?

Mr. WIGGIN. I think so.

Mr. PECORA. What were they, generally?

Mr. WIGGIN. The company had owned the stock some time, and I realized that the company would probably have to stop paying dividends on the common stock, so we sold it.

Mr. PECORA. You sold it before any public announcement that the dividends would be passed?

Mr. WIGGIN. Before we knew positively.

Mr. PECORA. Before who knew positively?

Mr. WIGGIN. Before I knew.

Mr. PECORA. Before you as chairman of the finance committee knew positively that the dividend would be passed?

Mr. WIGGIN. Yes, sir. Before anybody knew it.

Mr. PECORA. About how many shares did you sell of the common stock of the Brooklyn-Manhattan Transit Corporation at that time?

Mr. WIGGIN. I think they sold practically all they had. I will find out the number.[12]

The B.M.T. dividend was passed on June 20, 1932, and a marked depreciation in the market value of the common stock followed.[13]

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[8] Albert H. Wiggin, Nov. 2, 1933, Chase Securities Corporation, pt. 6, pp. 3025–3026.
[9] Albert H. Wiggin, supra, pp. 3025, 3029.
[10] Albert H. Wiggin, supra, p. 3025. Committee Exhibit No. 102, Nov. 2 1933, Chase Securities Corporation, pt. 6, p. 3027.
[11] Albert H. Wiggin, Nov. 2, 1933, Chase Securities Corporation, pt. 6, p. 3022.
[12] Albert H. Wiggin, supra, p. 3022.
[13] Albert H. Wiggin, supra, p. 3023.

Winthrop W. Aldrich suggested that legislation be passed governing the outside activities and interests of executive officers of commercial banks. He stated:

D. The act should be so amended as to require an executive officer of a member bank to report to his board of directors every case where any such officer becomes a director, officer, or member of the firm of or financial adviser to any outside interest, whether an individual, corporation, or partnership; and if any fee or salary is paid for such service, other than ordinary director's fee, the amount thereof.

It is desirable that a bank officer, particularly in large cities, should have his primary interest, and usually his exclusive interest, in the bank for which he works. Many exceptions to this rule may, of course, arise—especially in small communities. The important thing is that his board of directors should know and approve of any outside interest on the part of a bank officer. There are many occasions when an executive officer without question should be permitted to have an interest in and take a salary from an outside activity, but the law should require that his board of directors should be apprised of the details of every such instance, except in the case of ordinary directors' fees, and should approve thereof.[14]

(ii) *Provisions of the Banking Act of 1933 relating to officers and boards of directors of banks.*

The banking Act of 1933, section 32, provides:

SEC. 32. From and after January 1, 1934, no officer or director of any member bank shall be an officer, director, or manager of any corporation, partnership, or unincorporated association engaged primarily in the business of purchasing, selling, or negotiating securities, and no member bank shall perform the functions of a correspondent bank on behalf of any such individual, partnership, corporation, or unincorporated association, and no such individual, partnership, corporation, or unincorporated association shall perform the functions of a correspondent for any member bank or hold on deposit any funds on behalf of any member bank, unless in any such case there is a permit therefor issued by the Federal Reserve Board; and the Board is authorized to issue such permit, if in its judgment it is not incompatible with the public interest, and to revoke any such permit whenever it finds, after reasonable notice and opportunity to be heard, that the public interest requires such revocation.[15]

The Banking Act of 1933 further provides that the board of directors or board of trustees, or other similar governing body of every national association which is a member of the Federal Reserve System, shall consist of not less than 5 nor more than 25 members, and every such director, trustee, or member of such governing board shall be a bona fide holder in his own right of the shares of such bank having a par value in the aggregate sum of not less than $2,500, except in certain specified instances where the capital of the bank does not exceed $50,000.[16]

(8) *Excessive compensation to commercial-banking officers.*—In addition to the large salaries paid to officers of commercial banks and their investment affiliates, these officers had themselves voted interests in the net earnings of both the bank and investment affiliates, without assumption of any losses. This arrangement was an incentive to these officers to have the institutions engage in speculative transac-

[14] Statement of Winthrop W. Aldrich, Nov. 29, 1933, Chase Securities Corporation, pt. 8, p. 3987.

[15] Banking Act of 1933, sec. 32. An analysis of the history of section 8 of the Clayton Act and section 32 of the Banking Act of 1933, and section 8 (a) of the Clayton Act and section 33 of the Banking Act of 1933, is contained in the record, Committee Exhibits Nos. 210 and 211, Nov. 29, 1933, Chase Securities Corporation, pt. 8, pp. 4007–4014, and also in statement of Winthrop W. Aldrich, supra, pp. 3981–3986.

[16] Banking Act of 1933, section 31.

tions and float securities issues which were hostile to the interests of these institutions and the investing public.

(i) *Management funds of National City Bank and National City Co.*—The National City Co. had created a management fund whereby the executive officers received as a group 20 percent of the yearly net earnings after deducting 8 percent for capital, surplus, and undivided profits. This fund was theoretically divided into two parts. At the outset of the year the executive committee (after 1926, when the executive committee was abolished, the board of directors acted) determined the percentages to be received by each officer for the coming year out of one-half of the management fund.[17] In January and July of each year the eligible officers by secret ballot voted the pro rata distribution of the remaining one-half of the fund among the other officers, each officer excluding himself from consideration.

The distribution of the management fund of the National City Bank, which consisted, like the affiliate fund, of 20 percent of the net earnings of the bank after deducting 8 percent for capital and surplus, was determined twice a year by a vote taken of all the officers, three ballots being cast. The first ballot, an unsigned ballot, determined the portion of the management fund to be allocated to Charles E. Mitchell, chairman of the board of directors; the second, a signed ballot, determined the percentage of the balance of the fund to be distributed to each other eligible officer, each officer so voting eliminating himself from consideration; and the third, a signed ballot, indicated what other persons, other than the eligible officers, should be considered in the distribution of the fund. The executive committee, with Charles E. Mitchell absent, determined what proportion he was to receive and fixed the percentages of the other officers, and all disputes were referred to Charles E. Mitchell for recommendation.

The salary of Charles E. Mitchell and each of the other executive officers of the National City Co. was $25,000 a year. For the year 1927, Charles E. Mitchell received as his portion of the management fund of the National City Co., $529,230, and of the management fund of the National City Bank, $527,000, for a total of $1,056,230. For the year 1928, Charles E. Mitchell received from the bank management fund $566,634.14, and from the affiliate management fund $750,000, for a total of $1,316,634.14. For the year 1929, Charles E. Mitchell received from the bank management fund, $608,000, and in July 1929 from the affiliate management fund approximately $500,000, for a total of approximately $1,108,000. For the years 1927, 1928, and 1929, Charles E. Mitchell received from the management funds of the National City Bank and National City Co., $3,481,732 exclusive of his salary and of $15,997.38 as his participation for 1929 in the management fund of the City Bank Farmers Trust Co., the trust affiliate of the National City Bank.[18]

Subsequent to July 1929 the National City Co., because of the stock-market crash, sustained severe losses during the balance of the year. There was, of course, no accumulation in the management fund, and the officers received no management-fund moneys for the latter half of the year. Charles E. Mitchell and the other officers, however, were not required to refund any part of the moneys re-

[17] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, pp. 1770–1771.
[18] Charles E. Mitchell, supra, pp. 1785, 1787.

ceived by them out of the management fund in July 1929. Charles E. Mitchell, who had received approximately $500,000 in July 1929, insisted that the officers could declare a dividend out of the management fund at any time when an accumulation existed and that such a payment was absolute and not subject to any refund, no matter how great the losses were during the balance of the year. The officers, Mitchell insisted, were under no duty to return any portion of the fund, or even to treat any such payment as an advance against future management-fund payments. He testified, however, that he prevailed upon the officers to treat the July 1929 payment as an advance rather than an absolute payment. Since July 1929 there have not been any accumulations in the management fund against which these advances could be offset; and since the investment affiliates of commercial banks have been dissolved under the Banking Act of 1933, there will be no further accumulations. These officers will, therefore, never be called upon to refund any part of the July 1929 advances made to them.

Charles E. Mitchell could not perceive any unfairness or impropriety in an arrangement which permitted officers, at any time when there was an accumulation, to collectively vote to themselves moneys which they were under no obligation to refund, regardless of what the losses of the institution would subsequently be.[19]

Hugh B. Baker, president of the National City Co., received as his participation in the National City Co. management fund $185,260 for the year 1927; $266,670.41 for the year 1928; and $225,000 for the first 6 months of 1929, in addition to his salary of $25,000 a year.[20]

Victor Schoepperle, vice president of the National City Co., received in 1928 as his participation in the management fund a total of $70,000, in addition to his salary of $20,000 a year.[21]

It is patent that this arrangement whereby the executive officers substantially shared in the net earnings may have induced these officers to float securities issues which were not of a sound character and nature, but which were readily saleable to the public at a profit. Any arrangement whereby officers shared in the earnings without bearing any part of the losses, necessarily warped the judgment of these persons, who had all to gain and nothing to lose by the flotation of securities which they could sell to the investing public. This effect was clear, and Charles E. Mitchell would not deny the possibility of such effect. It can be queried whether the officers of the National City Co. would have undertaken the flotation of the $90,000,000 Peruvian bond issues and the $16,500,000 Minas Geraes bond issue, which are all in default, were it incumbent upon them to bear the same proportionate part of the losses as they received from the profits of these flotations.

Senator COUZENS. And, as you look at it in retrospect, do you think that was a good system to set up for a financial institution?

Mr. MITCHELL. Yes; I think so, and I would really feel quite strongly about that. I have seen it apply in the bank where it was established after I became president of the bank, and it establishes an esprit de corps and an interest in one officer in another officer's work that is to me most noticeable.

Senator COUZENS. Does it not also inspire a lack of care in the handling and sale of securities to the public, because each individual officer has a split?

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[19] Charles E. Mitchell, supra, p. 1786.
[20] Hugh B. Baker, Feb. 24, 1933, National City, pt. 6, p. 1965.
[21] Victor Schoepperle, Feb. 27, 1933, National City, pt. 6, p. 2117.

Mr. MITCHELL. I can readily see, from your point of view, that that would seem so, and I must grant that it must have some influence, Senator Couzens. At the same time I do not recall seeing it operate in that way.

Senator COUZENS. You would not see it. Only the customers would see it after they had gotten the securities. May I ask you at that point, if you have not the figures convenient you may furnish them perhaps later, how many securities that you have sold are now in default?

Mr. MITCHELL. That is a rather difficult figure. I carry in my mind these general figures, Senator Couzens. During a 10-year period our total sales, which included governments and states and Canadians and other things that perhaps are not in those first figures I gave you, were about $20,000,000,000, and I think that there has been difficulty of one sort and another—a good deal of it, of course, developing during this latter period of depression—with something under $1,000,000,000.

Senator COUZENS. Did that include all your South Americans, and all?

Mr. MITCHELL. Oh, yes.

Senator COUZENS. And so, after counting in all of your sound State, municipal, and Government bonds, which aggregated $20,000,000,000, you say less than $1,000,000,000 are in default or trouble?

Mr. MITCHELL. That is my recollection. If I am wrong in regard to that, I would like to have the opportunity of correcting it.[22]

(ii) *Salaries and bonuses to banking officers.*—Albert H. Wiggin, as chairman of the governing board of the Chase National Bank, received for the year 1928, $175,000 salary and $100,000 bonus; 1929, $175,000 salary and $100,000 bonus; 1930, $218,750 salary and $75,000 bonus; 1931, $250,000 salary; 1932, $220,300 salary; and for the first 6 months of 1933, $52,970 salary.[23] In addition to these salaries and bonuses from the Chase National Bank, Albert H. Wiggin received a substantial compensation as director or officer of private corporation..[24] Other executive officers of the Chase National Bank received, besides their substantial salaries, large bonuses.[25] These additional compensations were paid in profitable times, without any charge-off in the periods when losses were sustained by the bank.

Senator ADAMS. Upon what theory were those bonuses paid?

Mr. WIGGIN. Additional compensation in profitable times, on the theory that the salaries of the officers, which were distributed all through the entire staff, you know——

Senator ADAMS. They credited you with being responsible for some of their added profits in the good years.

Mr. WIGGIN. I think so, sir.

Senator ADAMS. In the bad years did they charge you in any way with responsibility for losses?

Mr. WIGGIN. No, sir.

Senator ADAMS. It has only worked one way?

Mr. WIGGIN. Only one way.[26]

The method of distribution of this additional compensation was to create a fund ($325,000 was voted in 1929), with the chairman of the board of directors, the chairman of the executive committee, and certain vice presidents determining the amount to be allotted to each officer.

Mr. PECORA. Who made that determination with regard to the portion of this fund that was set aside for additional compensation for senior officers?

Mr. WIGGIN. You mean the proportion to me?

Mr. PECORA. Yes, sir.

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[22] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, p. 1772.
[23] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2323.
[24] Albert H. Wiggin, supra, p. 2325.
[25] Committee Exhibit No. 7, Oct. 17, 1933, Chase Securities Corporation, pt. 5, pp. 2356–2358, contains a tabulation of officers' salaries and bonuses received for the years 1928 through June 30, 1933.
[26] Albert H. Wiggin, Oct. 17, 1933, Chase Securities Corporation, pt. 5, p. 2321.

Mr. WIGGIN. My associates always suggested the amount, and I always took it up with the board or the committee to explain what they wanted to do.
Mr. PECORA. Who do you mean by your associates?
Mr. WIGGIN. The president, vice presidents.
Mr. PECORA. Well, did you also, as chairman of the governing board, help to fix the amounts of their additional compensation?
Mr. WIGGIN. Yes, sir.
Mr. PECORA. You helped to fix theirs and they helped to fix yours; is that right?
Mr. WIGGIN. We all sat in together.[27]

(iii) *Wiggin pension.*—Albert H. Wiggin, on December 21, 1932, by letter, requested the executive committee that he be not reelected as the chairman of the governing board.[28] On that day the executive committee of the Chase National Bank adopted a resolution which, after reciting the services rendered to the bank by Mr. Wiggin, voted him a life salary of $100,000 a year.[29] This resolution provided:

Resolved, That in order to discharge in some measure the obligations of this bank to Mr. Wiggin and in anticipation that he will be always prepared, when consulted by them, to assist the principal officers and the board of directors of the bank with advice upon important matters affecting its welfare and management, after the expiration of his present term of office, he be paid during his life a salary or compensation which, during the year 1933, shall be at the rate of $100,000 per year and, thereafter, shall be $100,000 per year.[30]

When interrogated as to the services that he rendered under this resolution to earn $100,000 a year, Albert H. Wiggin testified that they consisted largely in retaining large depositors with the bank. The $100,000 figure was suggested by Albert H. Wiggin during the conferences with Aldrich, Debevoise, Ecker, and Milbank prior to the meeting adopting the resolution.[31]

The legality of this pension was seriously questioned. James M. Beck, in a letter dated October 23, 1933, to Senator Carter Glass, stated:

Turning to another subject, I have been following with some interest the investigation of your banking committee, and I am wondering whether its members know that the highest court of New York decided that no corporation had a right to vote an annuity to any officer after he resigns, even though the gift was camouflaged by the statement that the beneficiary would be subject to call for future duties and service.

The case I have in mind is *Beers* v. *The New York Life Insurance Co.* (or possibly the New York Equitable). Beers was its president, and upon his retirement was voted a pension of $50,000 a year on the ground that he would continue to act in an advisory capacity. The court held that the act was not only beyond the power of the corporation, but that it was opposite to public policy.

How the directors of the Chase Bank, in view of this decision—of which they must have been advised—voted the extraordinary annuity to Mr. Wiggin whose services to the bank could hardly be regarded as beneficial, passes my comprehension.[32]

The inadvisability of this pension was admitted:

Mr. ALDRICH (interposing). If I may be permitted, I can only say that we were advised by counsel that it was a proper resolution to pass. And I can further say that it was the sincere belief of the board of directors at the time that action was taken, that it was for the best interests of the bank, and it was done in order that the bank might have the right to call on Mr. Wiggin

[27] Albert H. Wiggin, supra, p. 2338.
[28] Albert H. Wiggin, supra, p. 2303.
[29] Albert H. Wiggin, supra, pp. 2302, 2304.
[30] Albert H. Wiggin, supra, p. 2302.
[31] Albert H. Wiggin, supra, p. 2311.
[32] Dec. 5, 1933, Chase Securities Corporation, pt. 8, p. 4010.

at any time for his advice and services if they were needed in connection with the operation of the bank in the future.

Senator GLASS. Well, in view of recent disclosures I imagine it has somewhat aggravated the case.

Mr. ALDRICH. There is no doubt at all that the board at the present time considers it was a mistake to have voted that resolution. But you must remember that a great many things have been brought out here that the board did not know about at the time when it passed that resolution.[83]

This payment of $100,000 a year was voted to Albert H. Wiggin, although the Chase National Bank and Chase Securities Corporation, for the period from January 1, 1929, to July 31, 1933, had written down and reserved against losses $212,233,694.22, and the Chase Securities Corporation, for the period from June 1, 1917, to June 30, 1933, had written down and reserved against losses $120,138,075.87.[84]

After having made our inquiry and revealed the facts concerning this pension, Albert H. Wiggin renounced this $100,000 yearly compensation.[85]

(9) *Banking officers on "preferred" lists.*—Officers of commercial banks, in addition to the salaries, bonuses, and participations in management funds, had a lucrative source of income as recipients of the favors of "preferred" lists in private offerings. Charles E. Mitchell, of the National City Bank, and Albert H. Wiggin, of the Chase National Bank, as well as other officers of various banks, were on the "preferred" lists of J. P. Morgan & Co. and Kuhn, Loeb & Co.[86]

(d) *Employment of National and State bank examiners by commercial banks.*—Commercial banks evidently made it a practice to employ National and State bank examiners after the termination of their Government employment. The Chase National Bank employed Charles Smith, who became a senior officer; Mr. Rovensky, who became a vice president in the foreign department; Mr. Biggerman, who became a second vice president; and Mr. Hughes, who became an assistant cashier.[87] The Guardian Detroit Union Group, Inc., gave executive positions to former national-bank examiners, including B. K. Patterson, who had been at one time chief national-bank examiner of the seventh Federal district, which included Detroit; R. L. Hopkins, a national-bank examiner, who examined the Guardian Detroit Bank and the National Bank of Commerce at the time of the merger of these institutions; C. A. Bryan, and W. J. Penningroth.[88]

There may exist the temptation, where a bank examiner feels that he can make a substantial connection with a bank, to fulfill his official duties in a manner to curry favor with the executive officers of the institution. The possibility of obtaining substantial employment by banks may be responsible for the type of reports on the Chase National Bank made by the national-bank examiners in November 1929, wherein Albert H. Wiggin was referred to as "the

[83] Winthrop W. Aldrich, supra, p. 4019.

[84] Committee Exhibits Nos. 6 and 8, Oct. 17 and 18, 1933, Chase Securities Corporation, pt. 5, pp. 2355 and 2388–2389, respectively.

[85] Pt. 5, p. 2719.

[86] Committee Exhibit No. 51, June 9, 1933, J. P. Morgan & Co., pt. 2, pp. 885–904, and Committee Exhibit No. 18, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1262–1268. For a discussion of "preferred" lists and their significance, see ch. II, sec. 3, subsec. (2), of this report.

[87] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, pp. 2409–2410.

[88] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4229–4230.

most popular banker in Wall Street", and in the report of April 1930, wherein it was stated:

So long as A. H. Wiggin continues to dominate the policies of this institution, I feel that its responsibility will be as adequately carried on in the future as in the past.[39]

(e) *Inadequate reports and statements of commercial banks.*—Commercial banks have consistently issued financial statements to stockholders which obfuscated the true condition of the banks' affairs.

The report of the Chase National Bank and Chase Securities Corporation for the year 1930, referring to the Chase Securities Corporation, stated:

The net profits of the corporation from December 31, 1929, to December 31, 1930, including net profits of the Equitable Corporation and the Interstate Corporation, for the year were $6,989,627.60.

* * * * * * *

The corporation owns and carries over 97 percent of the capital stock of the American Express Co. and all of the stock of the Harris Forbes Co.'s, and the reserves of the corporation are sufficient to mark down the other assets of the corporation to market prices as of the close of business December 31, 1930. The surplus and undivided profits as of December 31, 1930, aggregated $13,594,328.25.[40]

The fact is that $17,536,905 from the surplus account and $2,065,733 from the profit account, or a total of $19,602,638, was transferred from the capital funds of the company to reserves and write-downs occasioned by depreciation in the value of securities in the portfolio of the company at the end of the year. The annual report to the stockholders for the year 1930 did not embody any statement about this transfer from surplus and profit to reserves and write-downs.

Mr. PECORA. Was there any statement about that embodied anywhere in the annual report to the shareholders for the year 1930?

Mr. WIGGIN. I think all that was embodied was the statement of what the surplus and profits were on page 19 that you just read.

Mr. PECORA. Yes. Now, there is nothing there which serves to inform a shareholder that, although the net profits for the year were $6,984,244.87, sums aggregating nineteen million six hundred-and-odd-thousand dollars were taken out of capital funds, such as surplus and undivided profits, and set up as a reserve to absorb losses or depreciation in the value of securities in the portfolio?

Mr. WIGGIN. Except by comparing this surplus and profit, as stated here, with the previous surplus and profit.

Senator COUZENS. In other words, you mean a stockholder would have to go back and get the previous year's report and compare it before he could discover that?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. The simpler way would have been to have given the stockholder the information, just as you have given it here, would it not?

Mr. WIGGIN. Perhaps so.

Mr. PECORA. Was there any reason why the shareholders were not enlightened in that way?

Mr. WIGGIN. Not that I know of.

Mr. PECORA. Such information would have given the shareholder a more complete and more comprehensive picture of the company's condition, would it not?

Mr. WIGGIN. Perhaps so.

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Mr. PECORA. Well, you say all the figures are there. That is not literally the fact, is it?

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[39] Albert H. Wiggin, Oct. 18, 1933, Chase Securities Corporation, pt. 5, p. 2410.
[40] Albert H. Wiggin, supra, p. 2390.

Mr. WIGGIN. The shrinkage is not there; but if they compare with previous years it is.

Mr. PECORA. The shrinkage is nowhere stated in this annual report for 1930, is it?

Mr. WIGGIN. I do not think it is.

Mr. PECORA. And the amount of reserves set up to provide for that shrinkage is nowhere stated in the annual report for the year 1930, is it?

Mr. WIGGIN. I do not think so.[41]

In the report to stockholders of Chase National Bank and Chase Securities Corporation for the year 1931 the statement did not contain the information that the Chase Securities Corporation took out of the capital surplus account $37,078,919.34, and from undivided profits account $14,908,393.67, or a total of $51,987,313.01, as a reserve against losses and depreciation of securities in its portfolio as of the close of 1931.[42]

Mr. PECORA. How could a shareholder, from the reading of that report, learn that during the year, or at the end of the year, reserves from capital funds amounting to nearly $52,000,000 had been set up as reserves for losses and depreciation of securities in the portfolio?

Mr. WIGGIN. By comparison.

Mr. PECORA. What is that?

Mr. WIGGIN. By comparison.

Mr. PECORA. How would you have made the comparison?

Mr. WIGGIN. Taken the last year's figures and compared them.

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Mr. PECORA. Which would not have enabled any shareholder, by a comparison or analysis of the two reports for the years 1930 and 1931, respectively, to have ascertained exactly what sum was set up as reserves against losses and depreciation at the end of the year 1931, would it?

Mr. WIGGIN. No; not easily. They would have to get the two figures together.[43]

Similarly, in the report to stockholders for the year 1932, there was no disclosure that the $4,713,676.64 reserves for losses or depreciation in securities was made up by allocating $2,921,080.66 from surplus and $1,792,595.98 from undivided profits.[44]

In the 1932 annual report of the Chase Securities Corporation, under the caption "Resources", was the item "Securities and investments, $91,340,996.56", which represented the aggregate inventory value of the securities in the company's portfolio. The report did not disclose the securities that comprised this item. The basis for determining the inventory statement of these securities was the market value of those securities which had a market value, and a "fair valuation" of those securities which had no market value. The "fair valuation" of the securities was fixed by the officers of the affiliate.[45] Included in this "Securities and investments" item were 176,996 shares of the capital stock of the American Express Co., which had no market value but were ascribed an inventory value of $40,031,677.85. These shares represented about 42 percent of all the securities and investments that aggregated $91,340,996.56.[46]

On December 31, 1932, the date as of which the report was made to the stockholders, and for some time prior thereto, these 176,996

[41] Albert H. Wiggin, supra, pp. 2301–2302.
[42] Albert H. Wiggin, supra, p. 2303.
[43] Albert H. Wiggin, supra, pp. 2304–2305.
[44] Albert H. Wiggin, supra, p. 2305.
[45] Albert H. Wiggin, supra, pp. 2400–2401.
[46] Albert H. Wiggin, supra, pp. 2402–2403.

shares had been pledged with the Chase National Bank as collateral for a loan of $17,586,810.67 to the securities affiliate, and were subject to a lien in that amount. The existence of this lien on the American Express Co. stock was not disclosed in the report to stockholders. Albert H. Wiggin testified that he did not deem the nondisclosure of this lien important.[47] Upon further interrogation, Wiggin testified:

Mr. PECORA. What difference does it make to the bank, then, when a customer seeks to borrow money and is asked to present a verified financial statement of his condition?

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Mr. WIGGIN. Why, I think a lender of money is entitled to know when the concern's assets are pledged.

Mr. PECORA. Is not a shareholder entitled to a knowledge equivalent to that when a report is given to him purporting to represent his company's operations and state of condition?

Mr. WIGGIN. Yes; but it does not affect the stockholder one way or another.

Mr. PECORA. Each stockholder himself can judge of that better than anyone else, can he not?

Mr. WIGGIN. I can see no impropriety in listing an inventory as an asset without explaining that so many of them are hypothecated. It does not affect the stockholders at all.

Mr. PECORA. You mean that in this case it would not affect the stockholder or the shareholder of the Chase Securities Corporation to know what liens were impressed upon assets of the company in favor of the Chase National Bank because, perchance, such a shareholder was an equal shareholder in the bank. Is that what you mean?

Mr. WIGGIN. No; I do not mean that. That has nothing to do with that equal ownership. It is simply that the capital stock of any corporation has no value until the liabilities are paid. Whether the liabilities are secured or unsecured does not affect the value of the stock.

Mr. PECORA. But when a bank makes a loan to a customer on a financial statement, does not the bank require the customer to include in his financial statement of assets whether or not those assets are subject to any lien?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. Why does the bank want to know that? Of what value is it to the bank in such cases?

Mr. WIGGIN. Each bank wants to be in just as good a condition as any other lender.

Mr. PECORA. Do you not think similar information would be of some value to the shareholders of the Securities Corporation?

Mr. WIGGIN. I do not see that it would be of any value, but I would have no objection to giving it to them.

Mr. PECORA. Was it ever given to the shareholders in any annual report?

Mr. WIGGIN. Of the Securities Corporation?

Mr. PECORA. Yes.

Mr. WIGGIN. I do not think so. I think it was always done the same way.[48]

Clarence Dillon, of Dillon, Read & Co., advocated that banks be required to publish their securities portfolio in reports to stockholders to make banks more circumspect in their investments and to give the public the maximum information as to the condition of the banks.[49]

Withrop W. Aldrich felt that, although in ordinary times full publicity of the securities portfolio of banking institutions was desirable, at the present time, since banks were holding large blocks of securities, the publication of the portfolios might be used by market traders and operators to their advantage.[50]

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[47] Albert H. Wiggin, supra, p. 2404.
[48] Albert H. Wiggin, supra, pp. 2404–2405.
[49] Clarence Dillon, Oct. 4, 1933, Dillon, Read & Co., pt. 4, pp. 1631–1632.
[50] Winthrop W. Aldrich, Dec. 6, 1933, Chase Securities Corporation, pt. 8, p. 4129.

The abuses relative to financial statements and reports of banking institutions existed in a most aggravated form in the group-banking systems in Detroit, Mich., and Cleveland, Ohio, where well-devised and elaborate schemes were concocted to enable the banks to issue reports and statements which superficially showed a sound financial condition for these institutions.[51]

(f) *Ethics of banking officers.*—A series of practices and transactions which banking officials either engaged in or countenanced cast a sombre reflection upon the ethical standards of the banking fraternity.

(1) *Loan by National City Co. to John Ramsey, general manager of the Port of New York Authority.*—In connection with the purchase by the National City Co. on March 9, 1931, of an issue of $66,000,000 of 4½-percent serial bonds issued by the Port of New York Authority, a syndicate expense account in the sum of $15,000 was set up.[52] These bonds were sold and the account closed April 22, 1931.[53] On June 2, 1931, within 6 weeks after the syndicate was closed, pursuant to a telephonic direction by Horace C. Sylvester, senior vice president of the National City Co., Samuel W. Baldwin, the treasurer, drew a cash ticket for $10,020 to his order as treasurer, procured the cash thereon, and turned the money over to Sylvester. Sylvester did not disclose to Baldwin the purpose of this cash withdrawal, which was charged to the syndicate expense account, although never before had any cash withdrawals been made to pay any of the joint syndicate account expenses.[54]

Harry S. Law, Secretary of the National City Co., who set up and supervised the system of accounting of the National City Co., could not explain the purpose of this withdrawal.[55]

Sylvester testified that he gave the money to Edward F. Barrett, vice president of the National City Bank, on the understanding that a loan was to be made by the National City Co. to John Ramsey, general manager of the Port of New York Authority.[56] The loan was not set up on the books of the National City Co. but charged to the expenses of the bond issues in connection with the Port of New York Authority. Sylvester admitted that it was not customary to carry loans in the reserve funds set up for expenses and could not enumerate another instance where that had been done by the company, although he had handled $4,500,000,000 worth of municipal, Government, and State bonds in 10 years.[57]

Edward F. Barrett, vice president of the National City Co., could not explain why the loan to Ramsey was made by cash and not by check.[58] Barrett testified that he had received a note to his individual order, without any endorsements, from Ramsey but that he had not disclosed the receipt of this note to anybody connected with the National City Co. He could not give any reason for suppressing this fact.[59]

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[51] For a detailed discussion of the abuses relating to financial statements by the group-banking institutions of Detroit, Mich., and Cleveland, Ohio, see chapter on same.

[52] Samuel W. Baldwin, Feb. 28, 1933. National City, pt. 6, p. 2145.

[53] Horace C. Sylvester, Jr., Mar. 1, 1933, National City, pt. 6, p. 2184.

[54] Samuel W. Baldwin, Feb. 28, 1933, National City, pt. 6, p. 2143.

[55] Harry S. Law, Feb. 28, 1933, National City, pt. 6, p. 2147.

[56] Horace C. Sylvester, Jr., Mar. 1, 1933, National City, pt. 6, p. 2185.

[57] Horace C. Sylvester, Jr., supra, p. 2186.

[58] Edward F. Barrett, Mar. 1, 1933, National City, pt. 6, pp. 2198–2199.

[59] Edward F. Barrett, supra, p. 2199.

Although this was a loan for about 3 weeks, neither payment on account of interest or principal nor demand for payment was ever made. Barrett did not produce the note at the hearings, testifying that he had searched for the note without avail.[60]

(2) *Chase National Bank and the Cuban loans.*—An officer of the Chase National Bank testified at the subcommittee hearings that private loans had been effected by the Chase National Bank to General Machado, President of Cuba.[61]

Credit was first extended by the Chase National Bank to General Machado on December 10, 1927, in the form of a traveler's letter of credit in the sum of $3,170.[62] This credit was paid on January 7, 1928. Subsequently, on December 11, 1928, a 3 months' loan of $100,000 was made to General Machado. This loan was paid at maturity, and thereafter, in April 1929 a formal line of credit with a maximum of $100,000 was established by the Chase National Bank in favor of General Machado. The maximum drawing by General Machado under this line of credit during 1929 was $85,000.[63] In January 1930 General Machado's line of credit was increased to a maximum of $200,000 and the amounts drawn under this credit fluctuated from nothing to the full amount.[63] On October 10, 1930, the total amount of loans outstanding to General Machado under this line of credit was $130,000 which was gradually reduced to $15,000 in July 1933. Ultimately, this balance was paid by General Machado.[63]

In addition to the loans made to General Machado personally, the Chase National Bank extended credit to two companies owned by him, in the form of discounts of trade paper or in credit commercial arrangements. Loans by the Chase National Bank to General Machado's shoe company in the form of discount of trade paper reached a high point of $65,625 between July 1929 and November 1931. This was subsequently paid in full.[63] Loans by the Chase National Bank to General Machado's paint company in the form of commercial sight letters of credit reached a maximum amount of $35,639.75 subsequent to May 1928. This loan was gradually reduced and finally paid in full.[63]

The Chase National Bank from January 19, 1928, to September 4, 1928, made loans totaling $265,488.50 to Dr. Carlos Migual De Cespedes, a member of the Cuban Cabinet during the term of office of General Machado.[64] The first loan made by the bank to Dr. De Cespedes was for $40,000 on January 19, 1928. After this loan was repaid on April 19, 1928, another loan of $37,788.50 was made to De Cespedes on June 5, 1928. Upon repayment of this loan, another loan in the sum of $200,000 was made by the bank to De Cespedes on September 4, 1928, which loan was secured by a million dollars par value of American Realty Co. bonds. This final loan was paid on December 20, 1930.[64]

(3) *The payment by the Sinclair Consolidated Oil Corporation pool participants to William S. Fitzpatrick.*—In the Sinclair Consolidated Oil Corporation pool, out of the total net profit of $12,200,109.41 realized by the participants, which included the Chase

[60] Edward F. Barrett, supra, p. 2201.
[61] Adam K. Geiger, Oct. 24, 1933, Chase Securities Corporation, pt. 5, p. 2645–2648.
[62] Adam K. Geiger, supra, p. 2645.
[63] Adam K. Geiger, supra, p. 2646.
[64] Adam K. Geiger, supra, p. 2647.

Footnotes and references [65] to [69], inclusive, are omitted in the print.

Securities Corporation and the Shermar Corporation, 2½ percent, or a total of $300,052.73, was paid on April 16, 1929, to one William S. Fitzpatrick, who was the president of the Prairie Oil & Gas Co., a competing company in production of the Sinclair Consolidated Oil Corporation.[70]

Albert H. Wiggin, Arthur W. Cutten, Ruloff Cutten, and Harry F. Sinclair, participants in this pool could advance no reason for this payment to Fitzpatrick, who had assumed no liability in connection with the purchasing syndicate, except that Blair & Co., another pool participant, suggested this payment to him.[71]

Senator COUZENS. What did Mr. Fitzpatrick do for this money? He was not a participant in the syndicate, and so what did he do for it?

Mr. SINCLAIR. I don't know. He didn't do anything for me.

Mr. PECORA. So that the first time you heard that Fitzpatrick was being declared in on the profits to the extent of the percent thereof was then, when you have stated?

Mr. SINCLAIR. Yes.

Mr. PECORA. And you offered no objection to it?

Mr. SINCLAIR. I did not.

* * * * * * *

Mr. PECORA. Did Fitzpatrick play any part in the syndicate operations at all?

Mr. SINCLAIR. Not that I know of.

Mr. PECORA. Then why should he have gotten 2½ percent of the profits?

Mr. SINCLAIR. Mr. Pecora, you will have to ask him. I don't know. You will have to get your information some place else.

* * * * * * *

Senator COUZENS. And Mr. Fitzpatrick did not take any risk, because he did not take the risk you are now referring to?

Mr. SINCLAIR. I don't think he did.

Mr. PECORA. Was this a gift to Mr. Fitzpatrick?

Mr. SINCLAIR. You may call it what you wish.

Mr. PECORA. What would you call it?

Mr. SINCLAIR. Well, it wasn't Christmas.

Mr. PECORA. What was that?

Mr. SINCLAIR. It was not Christmas. I don't know what you would call it—a gift, or what.[72]

It developed that negotiations for the consolidation of the Prairie Oil & Gas Co., of which William S. Fitzpatrick was president, and the Sinclair Consolidated Oil Corporation had commenced in the early part of 1928 and was successfully concluded in March 1932.[73]

This payment of over $300,000 was given to Fitzpatrick without any risk on his part, with the consent of Sinclair and the other pool participants, while Blair & Co. was conducting the consolidation of the Prairie Oil & Gas Co. and the Sinclair Consolidated Oil Corporation.[74] Sinclair testified that Fitzpatrick had informed him that Blair & Co. had assigned him this profit because the Rockefellers, who had a substantial interest in the Prairie Oil & Gas Co., wanted

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[70] Committee Exhibit No. 114, Nov. 9, 1933, Chase Securities Corporation, pt. 6, p. 3093. Harry F. Sinclair, Nov. 14, 1933, Chase Securities Corporation, pt. 7, pp. 3283–3284.

[71] Arthur W. Cutten, Nov. 9, 1933, Chase Securities Corporation, pt. 6, pp. 3095–3096. Ruloff E. Cutten, Nov. 14, 1933, Chase Securities Corporation, pt. 7, p. 3258. Harry F. Sinclair, Nov. 14, 1933, Chase Securities Corporation, pt. 7, pp. 3284–3286.

[72] Harry F. Sinclair, supra, pp. 3285–3286.

[73] Harry F. Sinclair, supra, p. 3287.

[74] Harry F. Sinclair, supra, p. 3288.

Fitzpatrick to make some money for his faithful services. This money was not paid by the Rockefellers but by Sinclair and the other pool participants.

Mr. PECORA. When Fitzpatrick told you 2 weeks ago the story of how he came to get this 2½ percent, he, among other things, told you as part of the story that the Rockefellers were anxious or desirous of making some money for him. Did it not occur to you that that purpose was not effected by giving him 2½ percent of the profits of this transaction?

* * * * * * *

Mr. SINCLAIR. It did not.
Mr. PECORA. It did not?
Mr. SINCLAIR. Certainly not. Did he not receive $300,000?
Mr. PECORA. Not from the Rockefellers.
Mr. SINCLAIR. From Blair & Co.
Mr. PECORA. Did he get it from Blair & Co.?
Mr. SINCLAIR. I think he got it from the syndicate through Blair & Co.
Mr. PECORA. Of which you were a member?
Mr. SINCLAIR. Yes.
Mr. PECORA. And of which Blair & Co. were members?
Mr. SINCLAIR. Yes.
Mr. PECORA. And Blair & Co. had no greater interest in the syndicate than you had originally?
Mr. SINCLAIR. No.
Mr. PECORA. And no greater interest than Cutten had originally?
Mr. SINCLAIR. Correct.
Mr. PECORA. So that Blair & Co. were making him some money at the expense of all the other syndicate participants?
Mr. SINCLAIR. There is no doubt about that.
Mr. PECORA. No doubt about it at all?
Mr. SINCLAIR. No, sir.
Mr. PECORA. So that you were one of the Santa Clauses? This was a Santa Clause syndicate, so far as giving Fitzpatrick $300,000 was concerned?
Mr. SINCLAIR. It sounds a bit like it, doesn't it?
Mr. PECORA. Very much so.
The CHAIRMAN. How did the subject come up? Did you ask him about the 2½ percent?
Mr. SINCLAIR. Yes, sir.
Mr. PECORA. Did you know they were hanging Santa Claus whiskers on you at that time?
Mr. SINCLAIR. Yes, sir.
Mr. PECORA. You were willing to wear them?
Mr. SINCLAIR. I did.[75]

William S. Fitzpatrick testified that the Rockefeller interests, through one Bertram Cutler, their financial adviser, had informed him that they had arranged "to do something" for him. When the Rockefellers, through Blair & Co., had disposed of the Prairie Oil & Gas Co. stock which was being held in trust for the Rockefeller Foundation for Medical Research and other trusts, Fitzpatrick received a first payment of $130,000 and a second payment about a year later of approximately $19,000.[76] These payments were wholly apart from the payment that Fitzpatrick received from the participants in the Sinclair Consolidated Oil Corporation pool. Fitzpatrick testified that the Rockefellers had arranged for this payment of 2½ percent of the profits of the purchasing syndicate, although the Rockefellers

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[75] Harry F. Sinclair, supra, p. 3291.
[76] William S. Fitzpatrick, Nov. 15, 1933, Chase Securities Corporation, pt. 7, pp. 3309–3310.

had no interest in this syndicate. He testified that he had apprised Cutler of the receipt of this $300,052.73 payment by the Sinclair Consolidated Oil Corporation pool.[77]

Elisha Walker, president of Blair & Co. at the time the negotiations for the formation of the Sinclair Consolidated Oil Corporation pool were conducted and consummated, was also a member of the executive committee of the Sinclair Consolidated Oil Corporation.

Elisha Walker testified that the payment to Fitzpatrick by the pool participants was motivated by a desire on the part of Blair & Co., while it was negotiating for the purchase of the shares of the Prairie Oil & Gas Co. and Prairie Oil & Pipe Line Co. from the Rockefeller trust funds, to maintain the goodwill of Fitzpatrick, the executive head of the Prairie Co. The payment to Fitzpatrick by the pool participants was made prior to the consummation of the purchase of the Prairie Co. stock from the Rockefeller interests. Walker testified that in lieu of giving Fitzpatrick a large percentage interest in the profits realized from the purchase of the Prairie common stock from the Rockefellers, it was determined to allot Fitzpatrick an interest in the profits of the sale of this Prairie common stock and an interest in the profits realized by the Sinclair Consolidated Oil Corporation pool.[78] He testified that this allocation to Fitzpatrick had been discussed with and approved by the other participants in the Sinclair Consolidated Oil Corporation pool.[79]

Mr. PECORA. And you suggested to the other participants in that Sinclair purchasing group, what?

Mr. WALKER. Yes; as I remember it, that they should give 2½ percent in both of these accounts.

Mr. PECORA. Well, now, let me see about that. Mr. Wiggin, of the Shermar Corporation, testified here that he never learned why or how that 2½ percent was paid to Mr. Fitzpatrick. And let me say further that Mr. Sinclair testified here yesterday afternoon that he did not learn until about 2 weeks ago why Mr. Fitzpatrick received that 2½ percent. Do you quarrel with their testimony?

Mr. WALKER. I cannot help what anybody else testifies.

Mr. PECORA. And let me remind you further that Mr. Arthur W. Cutten testified before this subcommittee that he never knew why that 2½ percent was paid to Mr. Fitzpatrick. Do you quarrel with Mr. Cutten's testimony?

Mr. WALKER. Some people have poor memories.[80]

* * * * * * *

Mr. PECORA. Now, the purpose of giving 2½ percent to Mr. Fitzpatrick was to satisfy some idea or notion of Blair & Co., wasn't it?

Mr. WALKER. We were working with Mr. Fitzpatrick in connection with the purchase of those Prairie stocks, and that must have been the reason and is the only reason I can offer.

Mr. PECORA. Well, if Blair & Co. found it expedient, advisable, or necessary to take care of Mr. Fitzpatrick in that fashion, why, in Heaven's name, did not Blair & Co. give Fitzpatrick that $300,000 out of their own share of the profits and not require all of the other participants to contribute to it?

Mr. WALKER. Because they were equally interested in this purchase. There was no reason why Blair & Co. should have assumed it. We were not the only purchaser of this stock. They had their relative interests the same as we had ours. That was done in everybody's interest.

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[77] William S. Fitzpatrick, supra, pp. 3316–3317.
[78] Elisha Walker, Nov. 15, 1933, Chase Securities Corporation, pt. 7, pp. 3333–3337.
[79] Elisha Walker, supra, p. 3335.
[80] Elisha Walker, supra, p. 3337.

Mr. PECORA. I can understand the reason you give, although I may not approve of it. I can understand the reason you give for wanting to take care of Mr. Fitzpatrick in a transaction in which you were going to become a stockholder in his company, in the company of which he was the president. In other words, you wanted to stand in with the management. But I cannot understand why you should have thought of Mr. Fitzpatrick in the other way, in a deal that he was in no way connected with, in a company of which Mr. Fitzpatrick was neither president nor manager. Can you enlighten me on that?

Mr. WALKER. We would not, except that the other deal was pending at the time. That was all. The two deals were practically simultaneous.

Mr. PECORA. But they had nothing in common.

Mr. WALKER. Nothing in common; absolutely not.[81]

Bertram Cutler testified that the only conversations he had with Blair & Co., relating to Fitzpatrick, were to the effect that the Rockefeller interests did not object to Blair & Co. selling to Fitzpatrick some of the Prairie Co. common stock, sold by the Rockefeller trust funds, upon the same terms that the stock had been acquired by Blair & Co. There was no discussion about allowing Fitzpatrick a percentage of the profits on the sale of the Prairie Co. stock.[82]

As regards the payment of $300,000 to Fitzpatrick, which Fitzpatrick said he had disclosed to the Rockefeller interests, Cutler testified that the Rockefellers would not have approved such an unethical payment:

Mr. PECORA. Mr. Cutler, you learned eventually, did you not, that Mr. Fitzpatrick had received something like $300,000?

Mr. CUTLER. Yes, sir.

Mr. PECORA. Out of the profits that accrued to this purchasing syndicate in the Sinclair Oil stock deal?

Mr. CUTLER. Yes, sir.

Mr. PECORA. When did you first learn of it?

Mr. CUTLER. Yesterday.

Mr. PECORA. Never heard of it before that?

Mr. CUTLER. Never heard of it before. Yesterday or the day before.

Senator COUZENS. Was it a surprise?

Mr. CUTLER. Very much of a surprise; yes, sir.

Mr. PECORA. Had you learned of it at the time it happened would you, as the financial adviser of interests that owned around 14 percent of the stock of the company of which Fitzpatrick was president, have approved of it?

Mr. CUTLER. I do not think I could approve of it; no, sir.

Senator COUZENS. Do you know any reason for having kept it secret for all these years?

Mr. CUTLER. I know nothing about it.

Senator COUZENS. Can you conceive of any reason for keeping it secret all this time?

Mr. CUTLER. No. I cannot think of any reason for publishing it, if that will answer the question.

Senator COUZENS. Well, that is a reverse answer. But apparently there was an effort, was there not, to keep the payment secret?

Mr. CUTLER. Well, now you are asking me something which I had nothing to do with whatsoever. I did not even know there was a syndicate. I did not even know there was a payment.

The CHAIRMAN. What would be your objection to his receiving it? You said you would not have approved it, you think. What would be your objection to his receiving this donation?

Mr. CUTLER. I don't know as I would have any objection if somebody wanted to give him $300,000.

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[81] Elisha Walker, supra, p. 3339.
[82] Bertram Cutler, Nov. 15, 1933, Chase Securities Corporation, pt. 7, pp. 3350, 3352.

Senator COUZENS. Would it not depend on who the giver was?

Mr. CUTLER. If it was my money that was given it might; yes. If it was not——

Senator COUZENS. If you were interested in a corporation and a competitor came along and gave your management $300,000, would you not be interested?

Mr. CUTLER. I had not, from reading the testimony, understood that the corporation gave him $300,000. I thought some banking group gave it.

Mr. PECORA. Well, a banking group, or a purchasing group, rather, that included the Chase Securities Corporation, one of the officers of which, namely, Mr. Clarkson, was at that time a director of the Sinclair Co.; that included Blair & Co., the president of which at that time was also a director of the Sinclair Oil Corporation; and that included Mr. Harry F. Sinclair, who at that time was chairman of the board of directors of the Sinclair Oil Corporation—with that knowledge would you have approved of it?

Mr. CUTLER. I do not see why I should be asked if I approve of it. I do not know whether I follow your question. I do not see that I am interested in it.

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Mr. PECORA. Now, having in mind that the Prairie Oil Co. at that time was a competitor, to a certain extent, in the producing field of the Sinclair Consolidated Oil Co., would you have approved of the president of your company, meaning the Prairie Co., receiving——

Mr. CUTLER (interposing). Now you are putting it in a different way. No.

Mr. PECORA (continuing). Receiving from interests that included executive officers and directors of the Sinclair Corporation or making of a payment by the latter to Mr. Fitzpatrick of $300,000, or any sum?

Mr. CUTLER. The answer is, certainly "No", if you put it that way.

Mr. PECORA. For what reason? Now, I will ask Senator Fletcher's question of you. For what reason would you have disapproved of it?

Mr. CUTLER. Why, I would not think the president of my company had a right to take the payment from some other company.[83]

In February 1929 Fitzpatrick exchanged the shares of the Prairie Oil & Gas Co. that he had purchased from Blair & Co., for shares of common stock of the Sinclair Consolidated Oil Corporation, a competing company, without disclosing this fact to the Rockefeller interests. The exchange was effected on the basis of five shares of Sinclair stock for three shares of Prairie Oil stock, pending the negotiations for consolidation of these two companies. This offer was limited to Fitzpatrick and other officers of the Prairie Oil & Gas Co. in an amount of 20,000 shares.[84] The consolidation of the Prairie Oil & Gas Co. with the Sinclair Co. was effected upon a share-for-share basis, without any disclosure to the stockholders of the Prairie Oil & Gas Co. that the officers of that company had effected their exchange on the basis of five shares of Sinclair stock for three shares of Prairie Oil stock.[84]

(iv) *The payment to Juan Leguia, son of President Leguia, of Peru.*—In connection with the flotation of $50,000,000 of Peruvian bonds on December 21, 1927, by the National City Co. and J. & W. Seligman & Co., pending negotiations with the Peruvian Government for this loan, a payment of $450,000 was made to Juan Leguia, son of Agosto Leguia, the President of Peru. This payment has been characterized by bankers involved in this flotation as "blackmail" and formed the basis of a suit for "illegal enrichment."[85]

Victor Schoepperle, vice president of the National City Co., had testified before the Senate Finance Committee that he did not know

[83] Bertram Cutler, supra, pp. 3355–3356.
[84] William S. Fitzpatrick, Nov. 15, 1933, Chase Securities Corporation, pt. 7, p. 3361.
[85] See Senate Finance Committee, Sale of Foreign Bonds, hearings, pt. 3, pp. 1280, 1772.

of this payment at the time it was made, but that he had become apprized of the payment about 10 days before the $50,000,000 Peruvian issue was floated.

Mr. PECORA. Mr. Schoepperle testified that at the time of the payment of that sum of money, whether it was a bribe, a gift, a gratuity, whatever it was, he did not know of it?

Mr. BAKER. I think that is correct; yes.

Mr. PECORA. But he also testified that he found out about it about 10 days before this $50,000,000 loan was floated?

Mr. BAKER. Yes.

Mr. PECORA. Do you recall his reporting to the executives of your company about the payment of that sum of money to the son of the then President of Peru?

Mr. BAKER. I do not recall just when he mentioned it in an officers' meeting; no. I do not remember the date that he mentioned it. I do remember there was a discussion about it, led by Mr. Schoepperle.

Mr. PECORA. If any such sum of money was paid to that particular individual for no apparent reason, that would not be a circumstance which would make the loan sound, would it? It would not contribute to the soundness of the loan or the risk, would it?

Mr. BAKER. Why, no; of course not.[98]

The abuses and practices of commercial banks and their officers and directors were not confined to the banking institutions situated in the great financial centers. They existed even in more flagrant form in the Detroit and Cleveland banking institutions, the only other commercial banks investigated by the Senate subcommittee. A cross-section of the officials and directors of these banking institutions discloses that these boards of directors consisted of reputed and influential industrialists and financiers. There was generally predominant a moral and ethical pathology among these personalities dominating the financial world which can only be excised by a reawakened consciousness of the solemnity of the trust imposed upon them.

5. PRIVATE BANKING

(a) PRIVATE BANKERS AND BANKS OR INDIVIDUAL BANKERS

A bank is a corporation or unincorporated association whose business it is to receive money on deposit, cash checks or drafts, discount commercial paper, make loans, and issue promissory notes payable to bearer called "bank notes." The basic distinguishing feature between banks or individual bankers and private bankers is that the banks or individual bankers are persons who, having complied with the governmental prescriptions and requirements, have received governmental authority to engage in the business of banking, while private bankers are persons or firms engaged in the banking business without any special privileges or authority from the State. The incorporated bank or the unincorporated association bank or individual banker receives from the Government, Federal or State, certain rights, privileges, powers, and immunities in consideration for which the bank or individual banker must comply with the laws of the Government regulating the conduct of the business. The incorporated bank, unincorporated association bank, and the individual banker are creatures of the Government and possess those powers

[98] Hugh B. Baker, Feb. 27, 1933, National City, pt. 6, p. 2073.

and exercise those functions conferred upon them only upon the conditions imposed by the legislature.

The private bankers do not have these rights, privileges, powers, and immunities conferred upon them and, as a consequence, do not have to conform to any special governmental regulation. Private bankers thereby attain a greater freedom of action than banks or individual bankers.[87]

(1) *Organization and financial condition of private bankers*—(i) *J. P. Morgan & Co. and Drexel & Co.*—The firm of J. P. Morgan & Co., located at 23 Wall Street, in the Borough of Manhattan, City of New York, organized on December 31, 1894, and the successor firm of Drexel, Morgan & Co. and Drexel & Co., is a general partnership composed of 20 partners.[88] The existing firm of J. P. Morgan & Co. was organized on March 31, 1916. As of January 2, 1932, there were 20 general partners in J. P. Morgan & Co.[89] The senior partner of the firm is J. P. Morgan.[90]

Drexel & Co., located in Philadelphia, is a distinct partnership from J. P. Morgan & Co., although the 20 general partners of J. P. Morgan & Co., of New York, are all general partners of Drexel & Co., which has 4 additional partners.[91] Under the law each of the 20 partners of J. P. Morgan & Co. is jointly and severally liable for all the debts and obligations of J. P. Morgan & Co. and Drexel & Co., while the four additional partners of Drexel & Co. are jointly and severally liable only for the debts and obligations of Drexel & Co.

In addition to J. P. Morgan & Co. and Drexel & Co., there are the firms of Morgan, Grenfell & Co., of London, which is an English company organized under the unlimited liability company law, and Morgan & Cie, in Paris, which is a copartnership.[90] The English firm and the French firm have partners in addition to the 20 partners of the firm of J. P. Morgan & Co. Drexel & Co., in Philadelphia, Morgan, Grenfell & Co., in London, and Morgan & Cie, in Paris, are not branch houses of one copartnership, but are separate partnerships, although treated as one by J. P. Morgan & Co. Each firm has a separate capital structure and is conducted as a separate, distinct entity, as far as the business of each partnership is concerned.[92]

J. P. Morgan & Co. conducted a general banking and investment business, including the acceptance of deposits, the issuance of securities, the purchase and sale of exchange, the issuance of letters of credit, and the execution of orders on stock exchanges.

The copartners of the firm hold daily meetings, but no minutes or written record of the proceedings or deliberations of the partners

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[87] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 3.

[88] J. P. Morgan, supra, p. 7. The articles of copartnership of J. P. Morgan & Co., dated Mar. 31, 1916, and the various changes in the constituency of the partnership is contained in Committee Exhibit No. 36, June 1, 1933, J. P. Morgan & Co., pt. 2, pp. 521–526.

[89] J. P. Morgan, E. T. Stotesbury, Charles Steele, Thomas W. Lamont, Horatio G. Lloyd, Thomas Cochran, Julius S. Morgan, George Whitney, Russell C. Leffingwell, Francis D. Bartow, Arthur M. Anderson, William Ewing, Harold Stanley, H. S. Morgan, Thomas S. Lamont, H. P. Davison, Thomas Newhall, Edward Hopkinson, Jr., S. Parker Gilbert, and Charles D. Dickey. See J. P. Morgan, supra, p. 8.

[90] J. P. Morgan, supra, p. 7.

[91] Arthur E. Newbold, H. Gates Lloyd, Jr., Edward H. York, Jr., and Perry E. Hall. See J. P. Morgan, supra, p. 19.

[92] J. P. Morgan, supra, pp. 18–19.

at those meetings are kept by the firm. Only the names of the partners present at the conferences are recorded. This has been the practice of the firm since the daily meetings were commenced 23 years ago.[93]

The net worth, corresponding to capital and representing the balance standing to the credit of the partners' accounts beyond the total amount of liabilities, of the firms of J. P. Morgan & Co. and Drexel & Co., as of December 31, 1927, was $71,638,314.32; as of December 31, 1928, was $91,555,934.99; as of December 31, 1929, was $118,604,183.75; as of January 2, 1931, was $91,843,140.28; as of January 2, 1932, was $52,959,772.70; and as of December 31, 1932, was $53,194,076.80.[94] As of March 31, 1933, the net worth of J. P. Morgan & Co. and Drexel & Co. was $44,862,920.84.[95]

(ii) *Kuhn, Loeb & Co.*—Kuhn, Loeb & Co., private bankers, in existence about 65 years, with their principal and only office in New York City, was a copartnership composed of 11 partners.[96] The general nature of the business of Kuhn, Loeb & Co. was the buying and selling of securities, acceptance of deposits from clients, and execution of orders for clients on the stock exchanges. This firm specialized particularly in railroad financing.[97]

From March 31, 1927, to December 31, 1930, Kuhn, Loeb & Co., through its English resident partner, Godron Leith, were the owners of all the shares of stock, except a few qualifying shares, of European Merchants Banking Co., Ltd., an English stock corporation which was a private banking concern. This company was liquidated December 31, 1930.[98]

Meetings of the partners of the firm were held at irregular intervals, and no written record or memorandum was ever kept of those conferences.[99]

As of December 31, 1927, the capital of Kuhn, Loeb & Co. was $20,000,000; as of December 31, 1928, $20,000,000; as of December 31, 1929, $25,000,000; as of December 31, 1930, $25,000,000; and as of December 31, 1931, $21,250,000.[1]

(iii) *Dillon, Read & Co.*—Dillon, Read & Co., organized originally as a partnership on January 14, 1921, as the successor firm to William A. Read & Co., was organized on October 11, 1922, as a joint-stock

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[93] J. P. Morgan, supra, pp. 12–14.

[94] A consolidated statement of the condition of J. P. Morgan & Co. and Drexel & Co. from Dec. 31, 1927, through Dec. 31, 1932, is contained in the record, pt. 1, J. P. Morgan & Co., p. 22.

[95] A consolidated balance sheet of J. P. Morgan & Co. and Drexel & Co., exclusive of the interests of Morgan, Grenfell & Co., of London, and Morgan & Cie., of Paris, as of Mar. 31, 1933, is contained in the record, pt. 2, J. P. Morgan & Co., p. 948.

[96] The names of the partners, as of the date of the hearing, June 27, 1933, were Felix M. Warburg, Otto H. Kahn, George W. Bovenizer, Lewis L. Strauss, Sir William Wiseman, John M. Schiff, Gilbert W. Kahn, Frederick M. Warburg, Benjamin J. Buttenwieser, Hugh Knowlton, and Elisha Walker. See Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 958.

The articles of copartnership of Kuhn, Loeb & Co., dated Dec. 31, 1932, are contained in Committee Exhibit No. 3, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1080–1085.

[97] Otto H. Kahn, June 27, 1933; Kuhn, Loeb & Co., pt. 3, pp. 958–959.

[98] Benjamin J. Buttenwieser, June 27, 1933; Kuhn, Loeb & Co., pt. 3, p. 981.

[99] Otto H. Kahn, June 27, 1933; Kuhn, Loeb & Co., pt. 3, p. 983.

[1] Balance sheets of Kuhn, Loeb & Co. for each of the years 1927 through 1931 are contained in Committee Exhibit No. 4, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1085–1086. Balance sheets of European Merchants Banking Co., Ltd., London, for each of the years 1927 through 1931 are contained in Committee Exhibit No. 5, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1086–1089.

association under the laws of the State of New York. Clarence Dillon owned a majority of the stock of this association.[2]

In addition, there was the inactive Dillon, Read & Co., Inc., a Delaware corporation, organized in 1932, of which Clarence Dillon owned all the common stock, and the Dillon Read Corporation, a Connecticut corporation, which conducted the European business. The inquiry which was conducted by the subcommittee covered only the activities of Dillon, Read & Co., the New York joint-stock association.

Under the laws of the State of New York a joint-stock association has the attributes of a corporation in that it has a perpetual existence which does not cease upon the change or decease of a stockholder, and has the attributes of a copartnership in that all the stockholders are unlimitedly liable for the debts and obligations of the joint-stock association.[3]

Dillon, Read & Co. are not technically "private bankers." Unlike J. P. Morgan & Co. and Kuhn, Loeb & Co., Dillon, Read & Co., particularly since 1927, confined their activities to the investment banking business and did not perform any of the functions of a commercial bank. Dillon, Read & Co. did not accept any deposits or engage in the business of short-term credits, but engaged exclusively in long-term financing. Generically, there are commercial banks which deal in short-term credits and investment banks which deal in long-term credits. Private bankers, like J. P. Morgan & Co. and Kuhn, Loeb & Co., combined these two functions.[4]

The capital account of Dillon, Read & Co., the New York joint-stock association, and Dillon, Read & Co., Inc., the Delaware corporation, as of December 31, 1927, was $10,301,462.29; as of December 31, 1928, was $14,056,816.93; as of December 31, 1929, was $14,735,-055.64; as of December 31, 1930, was $12,134,223.04; and as of December 31, 1930, was $9,332,009.77.[5]

(*b*) PRIVATE BANKING AND COMMERCIAL BANKING

Private bankers, not being incorporated, do not depend upon the State for their grant of powers, and consequently have, in general, as broad powers as any individual, except where expressly restricted by law. In the State of New York, a private banker comes within the purview of the banking law and is subject to State supervision and requirements, including examinations, quarterly reports, reserve requirements applying to banks, etc., if such private banker—

(1) Makes use of the word "bank", "banker", "banking", or any derivative or compound of any such word, in or on any sign, passbook, check, pamphlet, circular, stationery, or advertising matter, or who solicits deposits by means of signs or other advertising;

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[2] The stockholders of this joint stock association, as of the date of the hearing, Oct. 3, 1933, were Clarence Dillon, Abbot Trading Corporation, the Beekman Co., Ltd., E. J. Bermingham, Isabelle Bollard, R. H. Bollard, W. M. S. Charnley, W. M. L. Fiske, W. M. A. Phillips, and Roland L. Taylor. The officers and directors of Dillon, Read & Co. as of that date were Clarence Dillon, president; W. M. L. Fiske, Roland L. Taylor, Wm. A. Phillips, James V. Forrestal, Ralph H. Bollard, Dean Mathey, Wm. S. Charnley, Robert O. Hayward, Henry G. Riter, 3d, and Harry H. Egly, vice presidents; and Robert E. Christie, Jr., secretary and treasurer.

[3] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1541.

[4] Clarence Dillon, supra, pp. 1540–1541.

[5] Consolidated balance sheets of Dillon, Read & Co., the New York joint-stock association; Dillon, Read & Co., Inc., the Delaware corporation; the Dillon, Read Corporation, and the Surrey Corporation for each of the years 1927 through 1931, with explanatory notes, are contained in the record, pt. 4, Dillon, Read & Co., pp. 2158–2164.

(2) Pays interest on any deposit balance of less than $7,500, provided the aggregate amount of such deposit balances on which interest is paid exceeds 2 percent of the total deposits of such private banker;

(3) Receives money on deposit in such sums that the average of all separate deposits from all depositors during any 12 months' period is less than $1,000; or

(4) Receives money for transmission in amounts of less than $500, except that a private banker may sell letters of credit, bankers' checks, or other similar documents, in amounts less than $500 if he has on deposit with the superintendent of banks bonds of the United States, or other political subdivision, in the sum of $100,000.[6]

Where the private banker does not perform any of the acts specified in section 150 of the banking law, he is not subject to the provisions of the banking law and there is no limitation or proscriptions on his commercial banking activities.

J. P. Morgan & Co. and Kuhn, Loeb & Co., as private bankers, were not subject to examination by the State banking authorities, except for the purpose of ascertaining whether the business conducted by J. P. Morgan & Co. and Kuhn, Loeb & Co., was within the purview of section 150 of the banking law of the State of New York, in which event they would be subject to the provisions of that banking law.[7] By virtue of the fact that J. P. Morgan & Co. and Kuhn, Loeb & Co. did not hold themselves out to the public as banking institutions, and complied with the provisions of section 150 of the banking law, they were purely "private banks", entitled to all the rights, privileges, powers, and immunities and subject to the restrictions and disabilities of such institutions. As private bankers, J. P. Morgan & Co. and Kuhn, Loeb & Co. were subject to unlimited personal liability, while incorporated National or State banks and the stockholders had a limited liability. Private bankers were not subject to State or Federal examination or supervision, except to determine whether the banker was within the scope of section 150 of the New York banking law; nor were they required to publish financial statements, while National and State banks were subject to supervision and examination and were required to publish reports of their condition. The private banker was not required to maintain any particular reserve, while the National and State banks were required to maintain prescribed reserves. The private banker could accept deposits, provided the average of all deposits from depositors within 12 months was not less than $1,000; could not pay interest on deposits of less than $7,500, unless the total of such deposits on which interest was paid did not exceed 2 percent of the total depositors; could not solicit deposits by signs or advertising or use of the word "bank" or "banker" on signs, stationery, or advertising matter; could not receive for transmission an amount less than $500, unless $100,000 in Government securities was deposited as security therefor. A National or State bank was not subject to any restrictions on

[6] New York State Banking Law, sec. 150, p. 99.

[7] Russell C. Leffingwell, May 23, 1933, J. P. Morgan & Co., pt. 1, pp. 25–26. J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, pp. 26–27. Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 984.

receiving and paying interest on deposits, soliciting business, or receiving money for transmission.

There were no restrictions on the character, amount of, or security for loans made by a private banker or upon his ownership of stock of other corporations or real estate. A National or State bank could not lend more than 10 percent of its capital to one borrower, was restricted as to its loans on real estate, etc., could not own stock in another corporation except for protection on bad debts, and could not own real estate, except its own office building, and to protect bad debts. A private banker could not be a member of the Federal Reserve System, had no authority to issue currency, could not act as a depositary for public funds, and possessed no trust powers, except to act as transfer agent, registrar, or fiscal agent. A national bank was required to be a member of the Federal Reserve System; a State bank might become a member and have the privilege of rediscount and clearing. A national bank had the authority to obtain and issue circulation notes, but a State bank did not. A national bank, when authorized by the Federal Reserve Board, and State banks had general trust and fiduciary powers. National banks and State banks might be designated as depositaries of Federal Government and State government funds, respectively.[8]

J. P. Morgan & Co. were primarily engaged in the general banking business, their investment-banking activities constituting the lesser part of their business.

J. P. Morgan & Co., as of December 31, 1927, had deposits in the sum of $562,406,896.60; as of December 31, 1928, $481,188,646.91; as of December 31, 1929, $492,292,666.39; as of January 2, 1931, $503,-898,014.82; as of January 2, 1932, $319,405,848.57; and as of December 31, 1932, $340,047,701.88.[9]

Kuhn, Loeb & Co., as of December 31, 1927, had $69,449,016.08 in deposits; as of December 31, 1928, $58,821,113.02; as of December 31, 1929, $88,549,766.13; as of December 31, 1930, $57,032,847.08; as of December 31, 1931, $29,118,918.20; and as of December 31, 1932, $15,210,248.09.[10]

Dillon, Read & Co., as of December 31, 1927, had deposits of corporations engaged in interstate commerce in the sum of $5,250,-907.98; as of December 31, 1928, $1,283,812.27; as of December 31,

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[8] A tabulated comparison of the powers, privileges, and immunities, restrictions and disabilities of national banks, New York State banks, and private bankers, is contained in the records, pt. 1, J. P. Morgan & Co., pp. 99–101.

[9] Pt. 1, J. P. Morgan & Co., p. 22. The record contains a list of corporations engaged in interstate commerce having an average daily balance of $1,000,000 or over, during any year of the period from Jan. 1, 1927 to Dec. 31, 1932, inclusive, pt. 1, pp. 49–50. Also, a list of corporations engaged in interstate commerce having an average yearly balance of $100,000 or over during any year of the period from Jan. 1, 1927, to Dec. 31, 1931, inclusive, pt. 1, pp. 50–51. Committee Exhibit No. 8, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 128–129, contains the names of the banks and trust companies in which J. P. Morgan & Co., maintained deposits since Jan. 1, 1927, together with balances of such accounts as of Mar. 24, 1933.

[10] Committee Exhibit No. 4, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1035–1036. Committee Exhibit No. 23, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1289. Committee Exhibit No. 6, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 987, contains the total amount of deposits of corporations engaged in interstate commerce with Kuhn, Loeb & Co. at the end of each of the calendar years 1927–31, inclusive, and the number of such corporations. Committee Exhibit No. 7, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 987–988, contains the names of all corporations engaged in interstate commerce having banking deposits with Kuhn, Loeb & Co. in excess of $50,000 during the period 1927–31, inclusive. Committee Exhibit No. 8, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 989–990, contains the names of banks and trust companies in which Kuhn, Loeb & Co. maintained deposits during the years 1927 to 1931, inclusive, and balances as of Mar. 31, 1933.

1929, \$3,117,706.16; as of December 31, 1930, \$123,850.69; and as of December 31, 1931, none.[11] They had discontinued receiving deposits.

J. P. Morgan & Co. paid the same rate of interest on these deposits as clearing-house member banks.[12]

J. P. Morgan urged that supervision or examination of private bankers by governmental banking authorities was unnecessary, undesirable, and objectionable, because the relationship between the private banker and client was more confidential than the relationship of an incorporated bank and depositor. When interrogated upon his opposition to any limitations upon the power of private bankers to make loans, he testified:

Mr. PECORA. Mr. Morgan, have you any opinion as to the wisdom or reasonableness of applying such a principle by legislation to the conduct of private banks, the business of private banks or bankers?

Mr. MORGAN. My opinion is that it would not be necessary—probably. It is merely an opinion.

Mr. PECORA. Why wouldn't it be necessary? Why do you think it would not be necessary?

Mr. MORGAN. Because of the fact that there is a great deal of property back of the private banker, involved in his business, although not actually on his books, all of his entire fortune and living is at the disposal of the firm if it goes wrong.

Mr. PECORA. Where is there any public record of that property worth?

Mr. MORGAN. There is no public record of it.[13]

Thomas W. Lamont, however, admitted that some of the functions of a private bank are similar to those of a commercial bank and personally could see no objection to examinations of private banks by governmental authorities.

Mr. PECORA. * * * Well, now, are not those same relationships entered into by a private banking firm that accepts for deposit moneys of individuals and corporations and loans those moneys for various purposes?

Mr. LAMONT. Well, you see, Mr. Pecora, as I think both Mr. Morgan and Mr. Whitney tried to make plain in their testimony, the relationship is really a very different one. The relationship is a much more limited one because by law we are not permitted to solicit deposits from the public generally. Therefore to the general public we do not occupy that same relationship of which you speak. We are not permitted under the law to have the custody of trusts and all that sort of thing. As a matter of fact, we do not conduct a commercial bank in the active sense of that term. And for that reason I do not think the relationship is on all fours.

Mr. PECORA. I recognize those differences. But essentially the private banking firm of J. P. Morgan & Co. functions in the same general fashion as does a commercial bank to the extent that it receives and accepts deposits from private individuals and corporations and loans those deposits or investments.

Mr. LAMONT. Yes.

Mr. PECORA (continuing). In one fashion or another.

Mr. LAMONT. Yes.

Mr. PECORA. To that extent at least the functions of your banking firm are similar to those of a commercial bank; isn't that true?

Mr. LAMONT. To that extent.

* * * * * * *

Mr. PECORA. Do you think that a law subjecting the bank or the private bank of J. P. Morgan & Co. to the same kind of examination as the State superintendent of banks is required by law to make of State banks in the State of New York would violate a sound principle or public policy?

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[11] Committee Exhibit No. 37, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2168, contains the names of all corporations engaged in interstate commerce having banking deposits with Dillon, Read & Co., the total amount of deposits of said corporations at the end of each of the calendar years 1927 to 1931, inclusive. Committee Exhibit No. 37, supra, pp. 2153–2154, contains the names of all banks and trust companies in which said firm maintained deposits during the period 1927 to 1931, inclusive, and the amount of said deposits as of Mar. 31, 1933.

[12] J. P. Morgan, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 94–96.

[13] J. P. Morgan, supra, p. 95.

Mr. LAMONT. No; I do not think it would violate anything of vast importance, Mr. Pecora. As Mr. Morgan testified, I do not think it would be essential, but I do not think it would violate anything that we should object to.

Mr. PECORA. You would not object to that?

Mr. LAMONT. I do not think that we should object to examination by any properly constituted authority that it was felt wise should conduct an examination.[14]

Otto H. Kahn testified:

Mr. PECORA. Do you recognize any disadvantages that would attach to your firm in the conduct of its business if it were subjected to examination by the State superintendent of banks of New York in the same fashion that commercial banks, State banks in New York are subjected to examination by the State superintendent of banks?

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Mr. KAHN. Well, my answer is that as far as examination is concerned, I personally—and I haven't conferred with my partners about it—but I personally see no reason why we should not be examined.[15]

(1) *Regulation of commercial banking by private bankers under the Banking Act of 1933.*—The Banking Act of 1933 makes it unlawful for any person, corporation, association, or other similar organization, other than a financial institution or private bank, subject to examination or regulation under State or Federal law, to engage in the business of receiving deposits subject to check or repayment upon purchase of a passbook, certificate of deposit, or other evidence of debt, or upon request of a depositor, unless such applying person, corporation, or association shall submit to periodical examination by the Comptroller of the Currency or by the Federal Reserve bank of the district, and shall make and publish periodical reports of its condition, exhibiting in detail its resources and liabilities; such examinations and reports to be made and published at the same time and in the same manner and with like effect and penalties as are now provided by law in respect to national banking associations transacting business in the same locality.[16]

(C) PRIVATE BANKING AND INVESTMENT BANKING

Private bankers heretofore have been permitted to directly engage in the investment banking business without resorting, as the commercial banks had to do, to the medium of investment affiliates.[17]

Winthrop W. Aldrich attributed the abuses arising out of the investment affiliates of commercial banks to the dual function of private bankers of commercial banking and investment banking. Aldrich stated:

A principal difficulty in the past has been that commercial banks doing an investment banking business have been paralleled in operation by private bankers doing a deposit and investment business. As there was no clear definition of function or differentiation in interest between the two types of banking, it was not unnatural that officers of commercial banks should have at times failed to appreciate the distinction between their own position and that of members of private banking firms. The system itself which permitted overlapping of function and interlocking of interests between these two types of banking has been responsible for much that the public now condemns.[18]

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[14] Thomas W. Lamont, June 9, 1933, J. P. Morgan & Co., pt. 2, pp. 860–861.
[15] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, p. 984.
[16] Banking Act of 1933, sec. 21, subsec. (a) (2).
[17] For a detailed discussion of the investment-banking business conducted by private bankers see ch. II of this report.
[18] Statement of Winthrop W. Aldrich, Nov. 20, 1933, Chase Securities Corporation, pt. 8, p. 3978.

The evils inherent in the conduct by an incorporated bank, through an investment affiliate, of an investment banking business are equally ingrained in the conduct by a private banker accepting deposits of an investment banking business. The reasons impelling the divorcement of investment banking from incorporated commercial banks are equally cogent for the divorcement of investment banking from private bankers doing a commercial banking business.

(1) *Regulation of investment banking by private bankers under the Banking Act of 1933.*—The Banking Act of 1933 makes it unlawful for any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor.[19]

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[19] Banking Act of 1933, sec. 21, subsec. (a) (1).

CHAPTER IV. GROUP BANKING IN MICHIGAN AND COMMERCIAL BANKING IN OHIO

1. Group Banking

A most significant phase of your Committee's investigation was the inquiry into the group banking system as exemplified by the Guardian Detroit Union Group, Inc., and the Detroit Bankers Co., of Detroit.

Prior to the Michigan banking moratorium, declared on February 14, 1933, and our inquiry, respectable banking authority existed in favor of group banking, particularly as conducted in Detroit. Within less than 5 years after their organization, however, the group banking institutions of Detroit had completely collapsed. Their demise cannot be substantially attributed to the stock market collapse of October 1929, and the subsequent depression, since both groups were organized either just prior to or immediately following the October crash. Nor can the failure of these companies be attributed solely to the constituency, competency, or honesty of the persons controlling these institutions. An analysis of the evils and abuses uncovered at the hearings rather impels the conclusion that this system of banking, predicated upon centralized control of unit banks, possesses inherent latent deficiencies and dangerous potentialities which inevitably become patent when the system commences to function.

Despite the avowed determined intention of the dominant person of these institutions to avoid the known pitfalls of a banking system based on centralized control of unit banks, the basic principles and structure of the system were not consonant with or sympathetic to such intention. The very structure of the group banking system, ownership of unit banks in a superior body, encouraged and was conducive to the exercise of the most vital component power and right of ownership—control. The set-up afforded the opportunity for the indulgence in the practices disclosed, and the temptation to commit these acts, particularly in times of stress, seems irresistible.

The vital significance of the inquiry of group banking in Detroit must not be underestimated nor be confined to the particular institutions examined. Rather, the disclosures compel an examination and appraisement de novo of the wisdom and efficacy of any system of banking, regardless of its technical legal structure, composed of a central parent body with unit institutions—a dominant unit with subservient units. Other systems of unit banking may be distinguishable legally and structurally from group banking, yet be functionally and substantially similar and possess the same dangerous potentialities as group banking.

(*a*) DEFINITION

Group banking, technically, is a system of banking where a number of independent financial institutions, retaining their own identity, capital, personnel, and autonomy in operations, including loan and investment policies, are combined, usually through majority stock ownership, under a central administration, through a holding company operated by banking interests.

(b) DISTINCTIONS BETWEEN GROUP BANKING AND CHAIN BANKING

Chain banking is a system of banking where an individual, group of individuals, or closely held corporation, holds the stock in and directs the operations of two or more complete banking units, not functionally complementary, each bank operating on its own capital and with its own personnel. In both chain banking and group banking there are the common factors of centralized administrative control and retention of the identity, capital, personnel, and autonomy in operations of the individual units. The principal difference between chain banking and group banking is that in chain banking there is a close stock distribution, and control may be concentrated in one or more individuals; while in group banking there is a public distribution of stock and control centered in a holding company the stock of which is widely held.

(c) DISTINCTIONS BETWEEN GROUP BANKING AND BRANCH BANKING

Branch banking, as the name implies, is a system of banking wherein an institution operates and controls branches in one or more cities or States. All such institutions are mere agencies of the parent institution, without separate capital, and are subject to direct control by the parent institution. Group banking is distinguishable from branch banking in that in group banking the units retain their independent identity.

2. Group Banking in Michigan

(a) GUARDIAN DETROIT UNION GROUP, INC.

(1) *Organization and history.*—The Guardian Detroit Union Group, Inc., resulted on December 16, 1929, from the merger of Guardian Detroit Group, Inc. (subsequently known as Guardian Detroit Union Group, Inc.) and Union Commerce Corporation (formerly Union Commerce Investment Co.), the two pioneer holding companies in the Michigan banking field.[1] The Guardian Detroit Group, Inc., was organized as a holding company on May 9, 1929, under Act 84, Public Acts of 1921, as amended, for the following purposes:

> The purpose or purposes of this corporation are as follows: To acquire, own, hold, dispose of, and deal in stocks, bonds, and other evidences of indebtedness, and securities, including those issued by any corporation, domestic or foreign, and to possess and exercise in respect thereof all the rights, powers, and privileges of individual owners thereof, including the right to vote the same and to execute proxies therefor.[2]

The Guardian Detroit Group, Inc., as a holding company, acquired and held in its portfolio largely the stock of banks and trust companies located exclusively in the State of Michigan, its principal

[1] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4205.
[2] Committee Exhibit No. 1, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4205, 4268.

place of business being in Detroit.[3] Originally, the total authorized capital stock was 150,000 shares of common stock, $50 par value, or $7,500,000.[4] Robert O. Lord was the president, director, and leading spirit of Guardian Detroit Group, Inc., from the time of its inception.

There had been organized on June 15, 1927, under the banking laws of the State of Michigan, the Guardian Detroit Bank, with two affiliates—the Guardian Trust Co., a trust company, and the Guardian Detroit Co., a securities affiliate. Each subscriber to stock in Guardian Detroit Bank at the same time subscribed for an equal number of shares of Guardian Detroit Co., the investment affiliate, and for one-fifth of the number of shares of Guardian Trust Co., a fiduciary institution, organized under the banking laws of the State about 2 years previously.

Robert O. Lord testified that the Guardian Detroit Bank was organized to meet the banking exigency that had been created in Detroit by virtue of the growth of the automobile industry and the resultant tremendous and rapid rise in the population of Detroit's metropolitan area. In 1900, Detroit had a population of 285,704. In 1930 this had increased to 1,568,602. Similar substantial increases were also shown by other communities in the State of Michigan.[5]

The plan provided that the stock of the bank, the trust company, or the securities company could not be acquired or transferred except in connection with the acquisition or transfer of a proportionate amount of stock of each of the other two companies, so that each stockholder would at all times own the same percentage of the stock of any one of the same companies as he owned of the stock of each of the other two companies. The major portion of the authorized stock of the Guardian Detroit Group, Inc., was issued to acquire the unified stock of the Guardian Detroit Bank, the basis of exchange being 2 shares of Guardian Detroit Group, Inc., stock for 1 share of the unified stock of the Guardian Detroit Bank.[6]

Between May 9, 1929 and September 17, 1929, the Guardian Detroit Group, Inc., acquired seven[7] additional banking units in and out of Detroit, but all in the State of Michigan, by exchanging its capital stock, which was increased to meet the current requirements, for stock of the unit banks.[8]

The general method of procedure by which these acquisitions were effected was for the Group and the bank under consideration to each appoint a committee of three to examine the assets of the institution and fix a basis of exchange on the book value of the shares, with the earning power being taken into consideration. The offer became operative if and when 75 percent of the stockholders of the institution to be acquired consented and deposited their shares under a signed agreement.[9]

On November 12, 1929, by amendment to the articles of association, the authorized capital of Guardian Detroit Group, Inc., was

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[3] Robert O. Lord, supra, p. 4204.
[4] Committee Exhibit No. 1, p. 4268.
[5] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4209.
[6] Robert O. Lord, supra, p. 4210.
[7] Highland Park State Bank, Highland Park, Mich; Highland Park Trust Co., Highland Park, Mich.; Bank of Dearborn, Dearborn, Mich.; National Union Bank & Trust Co., Jackson, Mich.; Federal Commercial & Savings Bank, Port Huron, Mich.; First National Bank & Trust Co., Port Huron, Mich.; Bank of Detroit, Detroit, Mich. (R. O. Lord, supra, p. 4212).
[8] Robert O. Lord, supra, pp. 4211, 4246.
[9] Robert O. Lord, supra, p. 4246.

increased to $50,000,000, consisting of 2,500,000 shares, $20 par value each; 1,544,844 shares were issued and outstanding, and the name of the company was changed to Guardian Detroit Union Group, Inc., in contemplation of the prospective merger with Union Commerce Corporation.[10]

Union Commerce Investment Co., later known as Union Commerce Corporation, created to unify the management of the Union Trust Co. and the National Bank of Commerce, was organized under the laws of the State of Delaware on May 17, 1928, as a holding company[11] The objects and purpose of incorporation as contained in the certificate of incorporation were most broad and included the power of acquiring and holding securities of banking institutions and their affiliates.[12] Delaware was selected as the State of incorporation since the Michigan law did not permit of incorporation for the purposes desired.[13]

The Union Commerce Investment Co. was the pioneer in group banking in the State of Michigan.[14]

The Union Trust Co. of Detroit was organized in 1891 under the Trust Company Act of Michigan (Act No. 108 of the Public Acts of 1889), with the following purposes:

> The purpose and object of the corporation is to carry on a trust, deposit, and security business, and any other business authorized by the provisions of act 108 of the public acts of 1889 and acts amendatory thereof.[14a]

Although the Union Trust Co. was prohibited from doing a general banking business, it received deposits on certificates of deposits and subsequently received deposits in open accounts, payable on demand, which were subject to payment on oral demand or demand by letter.[15] Subsequent to 1910, the funds were classified either as class A funds, which were the pure trust funds, and class B funds, which were in the nature of deposit funds, or balances of "trusts", where owner retained the right to determine manner of investment, and deposit of general funds for which certificates of deposit were issued.

The class A funds were kept on deposit in outside banks. The class A funds and class B funds were grouped in the financial statements of the company under the head of "Trust deposits." As against the class A funds, the trust company maintained a 100 percent reserve, while the other funds were deposited in mortgages on real estate, collateral loans, and bonds.[16]

The Union Trust Co. had an initial capital structure of $500,000, represented by 5,000 shares of $100 par value. In 1912 the capital was increased to $1,000,000 by the issuance of 5,000 additional shares, $100 par value; and on August 29, 1923, it was increased to $2,000,000 by the issuance of additional capital stock.[17]

On January 12, 1927, a stock dividend of 5,000 shares of $100 par value was declared.[18]

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[10] Robert O. Lord, supra, p. 4211.
[11] Frank W. Blair, Jan. 16, 1934, pt. 10, p. 4775.
[12] Robert O. Lord, supra, p. 4205. Frank W. Blair, Jan. 16, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4775.
[13] Frank W. Blair, supra, p. 4776.
[14] Frank W. Blair, supra, p. 4777.
[14a] Ibid., p. 4760.
[15] Frank W. Blair, supra, pp. 4760–4761.
[16] Frank W. Blair, supra, pp. 4762–4765.
[17] Frank W. Blair, supra, p. 4767.
[18] Frank W. Blair, supra, p. 4768.

In 1923 the Union Co., of Detroit, was organized at the instance of the Union Trust Co. to take over the business and profits of the Union Trust Co., obtained in the form of commissions for loans effected as agents for insurance companies.[19] The initial capitalization was $100,000, represented by 10,000 shares, $10 par, which was subsequently increased to 20,000 shares, $10 par.[20]

On December 9, 1924, the stock of the Union Co. was distributed to the stockholders of the Union Trust Co. share for share.[21]

On January 29, 1929, the capital of the Union Trust Co. was increased to $5,000,000 by the issuance of 25,000 additional shares of stock, $100 par value, which was offered to stockholders at $300 per share; $2,500,000 being added to capital and $5,000,000 to surplus.[22]

The Union Trust Co. owned as a wholly owned subsidiary the Union Title & Guaranty Co., which was incorporated under the laws of Michigan in 1917 with an original authorized capital of $500,000, subsequently increased to $1,000,000 out of earnings, with which the company took over the title insurance business of the Union Trust Co. The capital to form this title company was obtained from the Trust Co.[23] In 1927 the Union Trust Co. caused to be organized the Union Building Co. to enable the Trust Co. to acquire real estate and erect the building for its home.

On October 24, 1927, in order to compete with national banks in Michigan, which under section 11K of the National Bank Act were permitted to do a trust business with the permission of the Federal Reserve Board, although the State laws of Michigan prohibited a trust company from doing a general banking business and a State bank from doing a trust business,[24] an affiliation was effected between the Union Trust Co. and the National Bank of Commerce under a "unified trust plan."[25]

On May 17, 1928, the Union Commerce Investment Corporation was incorporated as a holding company and acquired the stock of the Union Trust Co., Union Co., and National Bank of Commerce, which had acquired in 1928 the Griswold First State Bank on an exchange of stock basis.[26] The Union Commerce Investment Corporation then acquired a controlling or strong minority interest in 19 additional companies, including commercial banks, trust companies, security companies, and joint stock land banks.[27]

The original capital structure of the Union Commerce Investment Corporation was $5,000,000, consisting of 50,000 shares, $100 par

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[19] Frank W. Blair, supra, p. 4770.
[20] Frank W. Blair, supra, p. 4772.
[21] Frank W. Blair, supra, pp. 4771–4772.
[22] Frank W. Blair, supra, pp. 4769, 4774.
[23] Frank W. Blair, supra, p. 4773.
[24] Frank W. Blair, supra, pp. 4779–4780.
[25] Frank W. Blair, supra, pp. 4774, 4781.
[26] Frank W. Blair, supra, pp. 4774–4776.
[27] National Bank of Commerce, Detroit, Mich.; Union Trust Co., Detroit, Mich.; Union Co., Detroit, Mich; Michigan Industrial Bank, Detroit, Mich.; Union State Bank of Dearborn, Mich.; Bank of Commerce of Dearborn, Mich.; Jefferson Savings Bank, Grosse Pointe, Mich.; Union Joint Stock Land Bank, Detroit, Mich.; Ohio-Pennsylvania Joint Stock Land Bank, Cleveland, Ohio; City National Bank & Trust Co., Battle Creek, Mich.; Keene, Higbie & Co., Detroit, Mich.; Union Industrial Bank & Union Industrial Trust Co., Flint, Mich.; State Savings Bank, Vestaburg, Mich.; State Savings Bank, Stanton, Mich.; State Bank of Six Lakes; State Savings Bank, Remus; State Savings Bank, Clinton; Lansing State Bank; Thompson Savings Bank, Hudson. (Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4212.)

value. Subsequently, the capitalization was increased from time to time to take care of the acquisition of institutions, and on June 18, 1929, the name was changed to Union Commerce Corporation.

On December 16, 1929, the merger of the Guardian Detroit Group, Inc., and the Union Commerce Corporation became effective by the Guardian Detroit Group, Inc., acquiring the stock of the Union Commerce Corporation through an exchange of shares on a share-for-share basis after the declaration of a 20-percent stock dividend to stockholders by the Guardian Detroit Group, Inc.[28] The title of the Guardian Detroit Group, Inc., was thereupon changed to Guardian Detroit Union Group, Inc., and through this merger the Guardian Detroit Union Group, Inc., acquired the ownership of the stock of the financial institutions and other corporations owned by the Guardian Detroit Group, Inc., and Union Commerce Corporation.[29]

Subsequent to the merger, a systematic policy of expansion had been followed by the Guardian Detroit Group, Inc., throughout the State of Michigan. It acquired by exchange of stock substantially all of the stock, except directors' qualifying shares, of eight institutions, the exchanges being based upon the actual value of the stock of the Group company, the stock of the bank to be acquired, and the earnings of both institutions.[30]

As of December 31, 1932, the units of the Guardian Detroit Group, Inc., were doing business in 16 communities in Michigan. In 11 of these 16 communities were Guardian units, which were the largest banking institutions in those communities; in 4 they were the second largest. Guardian Detroit Union Group, Inc., controlled 10 national and 10 State banks in various communities and controlled 7 security companies, 2 joint-stock land banks, 3 building companies, a title company, and a safe-deposit company.[31] As of December 31, 1932, the banking units in the Group had total resources of $369,880,361.51 capital, $40,755,000 surplus, and $290,075,433.75 deposits. These figures did not include the securities companies and other miscellaneous units.[32]

At the time of the hearings, December 19, 1933, there were issued and outstanding 1,544,088 shares, no par value, totaling $30,896,880, and the status of the banking units was as follows:[33]

Guardian Detroit Union Group, Inc., receiver.
One national bank, receiver.
Three national banks, conservator.
Four State banks, conservator.
One national bank, closed.
Five national banks, reopened.
Six State banks, reopened.

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[28] Frank W. Blair, Jan. 16, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4785–4786.

[29] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4213. A diagram of the organization of the Guardian Detroit Union Group, Inc., as constituted after the merger, is contained in the record opposite p. 4206.

[30] Peoples National Bank of Jackson, Mich.; City National Bank & Trust Co., Niles, Mich.; Capital National Bank of Lansing, Mich.; Grand Rapids National Bank, Grand Rapids, Mich.; First National Bank & Trust Co., Kalamazoo, Mich.; Grand Rapids Trust Co., Grand Rapids, Mich.; Second National Bank & Trust Co., Saginaw, Mich.; National Bank of Ionia, Ionia, Mich. (Robert O. Lord, supra, p. 4213.)

[31] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4249.

[32] Ibid., pp. 4584–85. (The growth of the Guardian Detroit Union Group, Inc., as reflected in the annual reports in the years 1930, 1931, and 1932, is contained in the record at pp. 4461–4471.)

[33] Ibid.

The status of the miscellaneous units which still survive is as follows:

Two securities companies, liquidating.
One security company, operating.
One building company, operating.
One safe-deposit company, operating.

(B) DETROIT BANKERS CO.

(1) *History and organization*.—The Detroit Bankers Co., the other group-banking company in Michigan, was incorporated under the laws of the State of Michigan on January 8, 1930.[34] The purposes of the company, as stated in article III of the articles of association, were as follows:

The purpose or purposes of this corporation are as follows:

"To acquire, own, hold, vote, and exercise all rights of ownership of and to sell and dispose of shares of the capital stock of banks and trust companies and of other corporations or associations engaged in purchasing, selling on their own account or as agents of others, underwriting or dealing in corporate and other securities, or of any other corporation engaged in any business or activity incidental to or related to or of assistance in the conduct of any such business aforesaid." [35]

The Detroit Bankers Co. was primarily organized as a holding company to obtain control, by the ownership of the capital stock, of five banking institutions, the Peoples Wayne County Bank, the First National Bank in Detroit, the Detroit & Security Trust Co., the Bank of Michigan, and the Peninsular State Bank, with their many branches—all located in the metropolitan area of the city of Detroit.[36] Originally, the plan included ownership of the Peoples Wayne County Bank and the First National Bank in Detroit, but was subsequently enlarged to include the five banking institutions.[37]

The authorized capital stock of the Detroit Bankers Co. was $50,000,000, which was divided into 2,500,000 shares of $20 par value common stock and 120 no par value trustee shares, which did not participate in dividends, assets, or subscription rights and were to be sold at $10.

Article V of the articles of association provided that until December 31, 1934, the trustee shares were to have exclusive voting power in the election and removal of directors, and all other voting power was vested in the common stock, except that no increase or decrease of the capital stock or change in the number or qualification of directors could be authorized, or other class of stock created, or the sale of all of the property or business of the company, or the sale of any substantial part of the stock, property, or business of the five institutions owned by the Group company, unless two-thirds of the common-stock and trustee shares approved. On December 31, 1934, the trustee shares were to be redeemed and canceled on the payment of $10 per share, and on and after January 1, 1935, all of the voting power was to be vested in the common stock. The term of the corporation was fixed at 30 years, and the total amount of actual capital which the corporation owned at the time of the execution of the

[34] Committee Exhibit No. 1, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5127–5131, contains the articles of association of the Detroit Bankers Co.
[35] Committee Exhibit No. 1, supra, pp. 5060, 5127.
[36] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, p. 5065.
[37] John Ballantyne, supra, pp. 5058–5059

articles of association was $1,200—the amount of cash paid for the trustee shares.[38]

Article IX provided for the assumption by the holder of the common stock of his proportionate part of the statutory liability imposed upon the Detroit Bankers Co. by reason of its ownership of the capital stock of any bank or trust company.[39]

The officers of the Detroit Bankers Co., at its inception, were Julius H. Haass, president and a director; McPherson Browning, vice president and a director; and E. R. Lewright, secretary-treasurer. The 12 incorporators were the 12 original directors, and each was also the owner of 10 trustee shares.[40] The dominant spirit at its inception was Julius H. Haass, who, at his demise, was succeeded by John Ballantyne.

On October 9, 1929, the articles of association were signed by these 12 incorporators. On October 10, 1929, these individuals, who were the proposed board of directors of the Detroit Bankers Co. and the proposed owners of the 120 trustee shares, entered into a trustee agreement with reference to these trustee shares.[41]

The purpose of the trust agreement was to perpetuate proportionate representation among the trustees of each of the five institutions involved, during the 5-year period of the trust. There was allocated 5 trustees to the Peoples Wayne County Bank, 2 to the First National Bank in Detroit, 2 to the Detroit and Security Trust Co., 2 to the Bank of Michigan, and 1 to the Peninsular State Bank.[42]

John Ballantyne testified that by means of the holding company it was intended to strengthen the unit banks of the Detroit Bankers Co. by writing off all the furniture-and-fixture accounts, totaling approximately $1,600,000; charging off all defaulted bonds, decreasing the numerous branches of these institutions; and eliminating unwise competition between these institutions. Ballantyne testified that it was originally intended that each institution should continue to be conducted as units, and it was never contemplated that all the institutions be placed into one "hopper."[43]

Mr. PECORA. Well, isn't that the very thing that this holding company, called the "Detroit Bankers Co.", was virtually authorized to do by its articles of association, namely, to acquire these various banks and to control their operation?

Mr. BALLANTYNE. Really, Mr. Pecora, I can only speak from memory, and my honest belief was that no such thought was given to that at the time. It was contemplated that these banks should run as units, and to eliminate necessarily unwise competition as between them. You have got really to know Detroit in order to understand what I am trying to tell you.

The CHAIRMAN. How could you eliminate unwise competition if each unit was to operate just as it was?

Mr. BALLANTYNE. How could we?

The CHAIRMAN. Yes.

Mr. BALLANTYNE. Oh, I don't know. Perhaps you could have more influence over them as against unwise prejudices.[44]

At the time of the incorporation of the Detroit Bankers Co. on January 8, 1930, the Guardian Detroit Union Group, Inc., the other Michigan group-banking company, had already been in existence as

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[38] Committee Exhibit No. 1, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5127–5128.

[39] Committee Exhibit No. 1, supra, pp. 5129–5130.

[40] Committee Exhibit No. 1, supra, pp. 5128–5129, and p. 5061 contains the names of the original directors and owners of the trustee shares and the officers of the corporation.

[41] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5066–5067. Committee Exhibit No. 2, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5131–5133.

[42] Committee Exhibit No. 2, supra, p. 5132.

[43] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5058–5059, 5064–5065.

[44] John Ballantyne, supra, p. 5064.

the result of a consolidation of the Guardian Detroit Co. with the Union Commerce Investment Co. in December 1929.[45]

The Detroit Bankers Co. contemplated the acquisition of the outstanding capital stock of the five banks to be controlled by means of exchange of stock.[45]

The plans for the creation of the Detroit Bankers Co. were completed in October 1929, about 3 months before the actual incorporation. The stockholders of each of the five banks were apprised on October 5, 1929, by a circular letter, that the boards of directors of each of these banks, at meetings held on September 27, 1929, had adopted resolutions recommending to their respective stockholders the exchange of their bank stock for the stock of the proposed Detroit Bankers Co.

The letter stated that the Detroit Bankers Co. affiliating these five banks would have a combined capital, surplus, and undivided profits of $90,000,000, resources of $725,000,000, representing approximately 60 percent of the total banking resources of Detroit, with 192 branches, and serving approximately 900,000 depositors and clients. The new institution was to be the largest of its character in Michigan and between New York and Chicago.[46]

The letter further stated that $35,000,000 of the $50,000,000 authorized capital would be exchanged for the stock of the four banks and the trust company, the $15,000,000 balance remaining in the treasury of the company. The exchange of stock was to be effected upon the following basis: One and one-half shares of the new company stock for each share of the Peoples Wayne County Bank, $20 par value stock; 4.466 shares for each share of the First National Bank in Detroit $100 par value stock; 10 shares for each share of the Detroit & Security Trust Co. $20 par value stock; 3 shares for each 4 shares of the Bank of Michigan $20 par value stock; and 4.1 shares for each 5 shares of the Peninsular State Bank $20 par value stock.[46]

The letter informed the stockholders that dividends in the aggregate amount of 17 percent annually, payable quarterly, were to be paid on the common stock of the new company, and that it was the plan of the holding company that each unit institution carry on as then organized.[46]

Although Ballantyne testified that the elimination of unwise competition was one of the primary reasons for the organization of the Detroit Bankers Co., yet the stockholders were informed that each institution would be carried on as then organized. Ballantyne admitted that the articles of association and the trustees agreement necessarily had to substantially affect the organization of the unit banks, for the stockholders of these units were deprived of the right to elect directors of the Detroit Bankers Co., which was granted exclusively to the trustees for a period of 5 years.

Mr. PECORA. Mr. Ballantyne, prior to the acquisition of the capital stock of these five banks by the Detroit Bankers Co., the stockholders of each one of those banks, as such stockholders, had the power to elect the boards of directors of their respective banks, did they not?

Mr. BALLANTYNE. Yes; I believe so.

Mr. PECORA. And that is an important power and right attaching to a stockholder of any corporation, and particularly a banking corporation, is it not?

Mr. BALLANTYNE. Yes.

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[45] John Ballantyne, supra, p. 5069.
[46] Committee Exhibit No. 3, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5069–5071.

Mr. PECORA. By the scheme or plan upon which the Detroit Bankers Co. was created, these stockholders of the constituent banks that became the units of this holding company were deprived, at least for the first 5 years, of the right to elect directors of their own banks, were they not?

Mr. BALLANTYNE. I think not. They were electing them when I left the Bankers Co.

Mr. PECORA. Elected by whom?

Mr. BALLANTYNE. Of course, they were elected by the Detroit Bankers Co.

Mr. PECORA. And the Detroit Bankers Co. elected these directors through the control vested in the 12 trustees?

Mr. BALLANTYNE. Yes.

Mr. PECORA. Who had all the voting power of the first 5 years.

Mr. BALLANTYNE. I fancy that is true, Mr. Pecora.

Mr. PECORA. So that the stockholders of these banks that became units of the holding company were given no voice either in the election of the directors of the holding company or in the election of the directors of the unit banks, at least for the first 5 years.

Mr. BALLANTYNE. I fancy that is true.

Mr. PECORA. That was a radical departure from the scheme of operation of those unit banks prior to the merger, was it not?

Mr. BALLANTYNE. Well, in the law it would be.

Mr. PECORA. Wasn't it in fact as well as in law?

Mr. BALLANTYNE. I think not, Mr. Pecora. I think the directors that were operating those banks when I left the Bankers Co. were practically the same people.

Mr. PECORA. But whenever changes were made they were made upon the judgment and decision of the holders of the 120 shares of trustee stock, worth $1,200, issued by the holding company; isn't that so?

Mr. BALLANTYNE. To some extent I think maybe that is true.

Mr. PECORA. Is there any doubt that it is true?

Mr. BALLANTYNE. I cannot recall right at this moment any changes.

Mr. PECORA. I will show you later that there were changes.

Mr. BALLANTYNE. There were changes?

Mr. PECORA. Yes.

Mr. BALLANTYNE. There probably were. I do not recall them.[47]

The Detroit Bankers Co., shortly after its incorporation on January 8, 1930, by exchange for its own shares acquired substantially all of the outstanding capital stock of the Peoples Wayne County Bank, the First National Bank in Detroit, the Detroit & Security Trust Co., the Bank of Michigan, and the Peninsular State Bank, thereby acquiring control of ownership of the capital stock of these five institutions with a combined capital, surplus, and undivided profits of approximately $90,000,000, resources of $725,000,000, and with 900,000 depositors and clients, principally in the city of Detroit.[48]

The Detroit Bankers Co. subsequently acquired various other banking and nonbanking units.[49]

The combined resources of the banking units of the Detroit Bankers Co., as of December 31, 1930, were a capital of $26,960,000, surplus of $47,650,000, and undivided profits of $17,218,579.71, or a total capital, surplus, and undivided profits of $91,828,579.01. As of December 31, 1931, the captial stock was $29,410,000, surplus $29,-190,000, and undivided profits $9,859,912.03, or a total capital, surplus, and undivided profits, as of that date, of $68,459,912.03. The total capital, surplus, and undivided profits as of December 31, 1931,

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[47] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5075-5076.
[48] John Ballantyne, supra, p. 5077.
[49] Committee Exhibit No. 6, Jan. 24, 1934, Detroit Bankers Co., pt. 11, opposite p. 5084, shows the organization of the Detroit Bankers Co., the various acquisitions and consolidations, and the status of each of the units as of the date of the hearing, Jan. 24, 1934.

was $23,368,667.98 less than the total capital, surplus, and undivided profits as of December 31, 1930.[50]

As of December 31, 1932, the combined resources of the banking units of the Detroit Bankers Co. were a capital of $29,910,000, surplus of $29,140,000, and undivided profits of $3,329,267.03—a total capital, surplus, and undivided profits of $62,379,267.03. Although at the inception of the Group the combined resources were approximately $750,000,000, as of December 31, 1932, the total resources of the Group were $559,736,802.98. The total deposits as of December 31, 1932, were $484,733,367.97.[51]

At the date of the hearings, January 24, 1934, the status of the banking units of the Detroit Bankers Co. was as follows: Detroit Bankers Co., receiver; 3 national banks, receiver; 2 State banks, receiver; 5 State banks, conservator; 6 State banks, reopened; 4 State banks, reorganized.[52]

The status of the miscellaneous units of the Detroit Bankers Co. was as follows: Three securities companies, 1 safety deposit company, liquidating; 1 security company, 1 building company, 1 garage, operating.[53]

(c) CIRCUMVENTION OF THE LAW

Besides the board of directors, which was composed of the senior executive officers and operating heads of the units of the Group, and the officers, the Guardian Detroit Union Group had an advisory committee, an executive committee, and an operating committee. The advisory committee was a policy committee to discuss and formulate policies to recommend to the unit banks for their consideration, or to the board of directors of the Group corporation. The executive committee corresponded to an executive committee of a corporation, to act on behalf of the board of directors in the intervals between board meetings. The operating committee was an educational committee.[54]

Section 1207 of the General Banking Laws of the State of Michigan provided:

> Every director must own and hold in his own name shares of the capital stock of such company the aggregate par value of which shall not be less than $1,000.
>
> That he (meaning a director) is the owner in good faith of stock in the trust company as required to qualify him for such office, standing in his name on the books of the trust company, and that such stock is not pledged as security for any debt.[55]

Under this section, a director or officer of a unit bank was required to own stock aggregating at least $1,000. The Guardian Detroit Union Group corporation, however, compelled these directors and officers of the unit banks and the Group corporation, except the Saginaw unit, to deposit their qualifying certificates subject to the terms of an agreement which provided that upon termination of his directorship in the unit, the director would exchange his quali-

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[50] John Ballantyne, Jan. 25, 1934, Detroit Bankers Co., pt. 11, pp. 5166–5167.
[51] Committee Exhibit No. 130, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5449.
[52] Committee Exhibit No. 6, Jan. 24, 1934, Detroit Bankers Co., pt. 11, opposite p. 5084.
[53] Committee Exhibit No. 6, supra, opposite p. 5084.
[54] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4226, 4221–4228.
[55] Robert O. Lord, supra, p. 4237.

fying unit stock for 50 shares of the Guardian Detroit Union Group, Inc., stock, which was issued and deposited by the Group pursuant to the deposit agreement. In the interim all dividends, including dividends on the Group stock, were to be paid to the director, and all dividends on the unit stock deposited by the director were assigned to and were payable to the Group.[56]

Mr. PECORA. Now, one who was the unqualified owner of shares of stock upon which dividends were paid would receive such dividends, wouldn't he?

Mr. LORD. I did not hear the first part of your question.

Mr. PECORA. A person who is the unqualified owner of——

Mr. LORD (interposing). What do you mean by "owner"?

Mr. PECORA (continuing). Of shares of stock.

Mr. LORD. I do not know what you mean by "unqualified owner."

Mr. PECORA. An absolute and outright owner for his own beneficial right and interest.

Mr. LORD. Yes, sir; unless he assigned those dividends.

Mr. PECORA. Yes. Now, in case of persons who received from the Group the necessary shares to qualify them to act as directors of unit banks, those persons did not receive the dividends paid upon that stock by the unit banks, did they?

Mr. LORD. No, because they assigned the dividends.

Mr. PECORA. Exactly. In other words, they turned over all their dividends to the Group under this exchange plan.

Mr. LORD. Without changing the ownership of the stock, or affecting their ownership in any way.

Mr. PECORA. It left the ownership in their names, but divested them of some of the attributes of unqualified ownership.

Mr. LORD. Of the dividends, yes." [57]

3. ABUSES IN GROUP BANKING

(a) UNDUE CONCENTRATION OF CONTROL

(1) *Guardian Detroit Union Group, Inc.*—Theoretically, the unit groups were bodies independent as to management and policy of the board of directors of the Group corporation.

As was stated by Robert O. Lord:

From its inception Guardian Detroit Group and, in turn, Guardian Detroit Union Group, endeavored to preserve the local management and to follow the policy of developing the standing and prestige of that management, of the local institutions and placed the responsibility of such management upon the local boards of directors and local officers.[58]

The basic policy, as set forth in article VI of the bylaws of the Group corporation, was—

Whenever at any meeting of the stockholders of a bank or trust company of which corporation shall at the time own 75 percent or more of the outstanding stock, an election of such board of directors is held, the shares of such bank or trust company owned by this company shall be voted in favor of the election of a board of directors of which at least 75 percent shall consist of directors residing in the municipality where said bank or trust company is located or within a radius of 50 miles thereof.[59]

To further carry out these policies, the board of directors of the Guardian Detroit Union Group, Inc., adopted the resolution:

Resolved, That credit based upon the deposits in a local bank, which is a unit member of Guardian Detroit Union Group, Inc, shall be controlled wholly by the board of directors and the officers of the local unit bank.[60]

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[56] Robert O. Lord, supra, p. 4234.
[57] Robert O. Lord, supra, p. 4241.
[58] Robert O. Lord, supra, p. 4213.
[59] Robert O. Lord, supra, pp. 4213–4214.
[60] Robert O. Lord, supra, p. 4214.

Mr. Lord stated:

* * * The selection of directors in the unit institutions was left to the unit directors who had previously been in charge of these institutions, and such changes as occurred after the acquisition of the stock of the unit institution by the Group Co. were very largely on account of death or on account of resignation for some other reason.

* * * * * * *

In brief, it was the principal function of the Group Co. to act purely in an advisory capacity and as any stockholder would act in an institution where his funds were invested.[60]

The practical and actual operation, however, did not conform with this expressed intention of function and purpose.

By virtue of its total or majority ownership of the stock of the units, the Group corporation had complete control over the selection and tenure of the directors of these units. Robert O. Lord testified that in the Group corporation, except in the instance of the Flint unit where defalcations had occurred, this controlling power was not exerted over the boards of directors of the units.[61]

The fact is that before every annual meeting of the units, the heads of these units would discuss all the plans for the boards with Lord or other officers of the Group corporation.[61] When there was a vacancy on the board of directors of a local bank or unit, the local heads would consult with the Group heads the advisability of selecting a particular substitute director.[62]

Not only were these general discussions had, but the Group corporation actively suggested that certain directors be not reelected and others elected in their stead.

On July 24, 1931, Robert O. Lord, as president of the Guardian Detroit Union Group, Inc., wrote to L. H. D. Baker, director of the Michigan Industrial Bank, as follows:

My Dear Lee: As you may know, Mr. D. F. Valley is giving a very considerable amount of his time toward the affairs of the Michigan Industrial Bank. In order to accomplish what we want, I think he should be a director in this bank and I am going to ask you if you will be good enough to send me your resignation as a director so that we can have the Board elect Mr. Valley in your place.

This is no reflection whatever upon you or your service to that institution. I do not think it wise to ask any of our outside directors to resign and am, therefore, taking the liberty of asking this favor of you.[63]

Mr. Baker duly resigned, and Mr. Valley was elected director in his stead.[63]

In an "intra-group memorandum" addressed to Joseph H. Brewer, president of the Grand Rapids National Bank, from B. K. Patterson, executive vice president of the Guardian Detroit Union Group, Inc., it was stated:

I anticipate that it is going to be necessary to make a few changes in the members of the board of directors of the National Bank of Ionia, but we will not do so until the next meeting. What would you think of the advisability of your going on the board in place of one man who we think has served his purpose to the institution (I do not refer to either Messrs. Green, Robinson, or Chapman)? Inasmuch as the bank is located only a short distance from you it probably would not require a great deal of your time, and I apprehend

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[60] Robert O. Lord, supra, p. 4214.
[61] Robert O. Lord, supra, p. 4227.
[62] Robert O. Lord, supra, pp. 4232–4233.
[63] Committee Exhibit No. 4, Dec. 4, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4228.

that your presence on the board would give it the right kind of balance, and as time goes on I am certain that the people of Ionia would more and more look to you for advice in their major matters. I have not mentioned the matter to Mr. Lord, except in a very general way, about the Ionia suggestion, and will not do so until I get your reaction to the suggestion.[64]

Mr. Brewer accepted and was elected a director of the National Bank of Ionia.[65]

The domination of these units by the Group corporation was obvious.

Mr. PECORA. Those local banks had membership on the board of directors of the Group, did they not?

Mr. LORD. They did; yes, sir.

Mr. PECORA. And in that way they became Group-minded, so to speak, did they not?

Mr. LORD. We tried to educate them along sound banking lines.

Mr. PECORA. As those sound banking lines existed in the minds of the members of the board of the Group or the officers of the Group?

Mr. LORD. Yes.[66]

(2) *Detroit Bankers Co.*

The Detroit Bankers Co., unlike the Guardian Detroit Union Group, Inc., aimed to establish a strong organization in the metropolitan district of Detroit rather than throughout the State of Michigan. The five banking units of the Detroit Bankers Co. at its inception had a combined capital, surplus, and undivided profits of $90,000,000 and resources of $725,000,000, serving approximately 900,000 depositors, with control of approximately 60 percent of the total banking resources of Detroit.

Twelve men, with a total investment of $1,200, the cost of the 120 no-par-value trustee shares, assumed control as trustees for a period of 5 years of all these resources and capital. John Ballantyne, when interrogated upon the wisdom and efficacy of this set-up, testified that, in retrospect, he had not satisfied himself as to the wisdom of the plan.

Senator COUZENS. In that connection, Mr. Ballantyne, I would like to ask you if you think it was a well-considered policy to put $725,000,000 in resources and $90,000,000 of capital in the hands of 12 men for a period of 5 years on an investment of $1,200?

Mr. BALLANTYNE. I think——

Senator COUZENS. I am asking him as a policy. I am not asking him for facts, and I do not care to have anybody else's views about that.

Mr. BALLANTYNE. Do I think it was wise?

Senator COUZENS. Yes.

Mr. BALLANTYNE. I thought at the time it was. I do not know whether I do today or not.

Senator COUZENS. To put in the hands of 12 men the handling of over $800,000,000 for an investment of $1,200?

Mr. BALLANTYNE. Better 12 than 100, Senator.

Senator COUZENS. Better 12 than 100?

Mr. BALLANTYNE. Yes.

Senator COUZENS. And for an investment of $1,200?

Mr. BALLANTYNE. Of course, that does not——

Senator COUZENS. That is all these trustee stocks amounted to.

Mr. BALLANTYNE. I am not defending this thing. I was not the author of it at all. I do not know that it was wise.

Mr. PECORA. You thought it was wise at the time you lent yourself to it.

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[64] Ibid., pp. 4228–4229.
[65] Ibid., p. 4229.
[66] Robert O. Lord, supra, pp. 4232–4233.

Mr. BALLANTYNE. I thought it was wise at the time to have those banks form a mutuality of interest and eliminate unnecessary costs and unnecessary wildcat competition, of which there was a lot in the city of Detroit. But we are always wise afterward, you know.

Mr. PECORA. At the present time you have some doubts as to the wisdom of the plan?

Mr. BALLANTYNE. Mr. Pecora, if I were asked my viewpoint at the present time, I would say to you that I do not think anything has been proven in Detroit.

Mr. PECORA. You do not think anything has been what?

Mr. BALLANTYNE. Proven. I do not think the wisdom or unwisdom of group banking, or of branch banking, or of unit banking has been demonstrated in Detroit.

Mr. PECORA. You think the events since January 8, 1930, have shed no light upon the wisdom or lack of wisdom of this plan?

Mr. BALLANTYNE. Not in Detroit.

Mr. PECORA. This plan was operative in Detroit?

Mr. BALLANTYNE. Yes; but it was conceived rather hastily, and there were unknown factors at the time it was consummated. One has to experience such an operation to learn.[67]

* * * * * * *

Senator COUZENS. So, for the mere putting up of $1,200—which the facts show they did not put up, as a matter of fact—they got control of nearly one billion dollars, and that is what is generally referred to as the handling of other people's money. By the mere acquisition of $1,200 worth of trustee shares these men got control of nearly one billion dollars to do as they pleased with for a period of 5 years. I would just like to know if you, as an old-time banker in Detroit, endorse that as a principle?

Mr. BALLANTYNE. Not just the way you put it, Senator.

Senator COUZENS. I am putting it as a fact.

Mr. BALLANTYNE. Maybe it means that in substance. I do not know. I am not very well versed in legal phraseology.[68]

The organizers of the Detroit Bankers Co. stated that it was intended to "carry on each institution as at present organized." The very corporate structure of the Detroit Bankers Co. controverted this expression of intention. The incorporators were the same individuals as the holders of the trustee shares for a period of 5 years, and had the exclusive voting power in the election and removal of directors. These trustees reserved a veto power on basic changes in the capital structure or business of the group.

In article IX of the articles of association, the board of directors reserved the power to issue and dispose of the original capital stock, or to increase the capital stock to acquire other institutions on an exchange-of-stock basis, upon such terms as the board of directors in their discretion might determine, and in such instances the stockholders of the Detroit Bankers Co. waived their preemptive right.

Until December 31, 1934, no substantial part of the shares of capital stock owned by the Detroit Bankers Co. of each of the five unit banks could be mortgaged or sold, except by the concurring vote of two-thirds of the trustee shares.

Article IX further provided that the board of directors of the Detroit Bankers Co. might sell to persons the minimum number of shares required to qualify such persons as directors of any of the five institutions; but such persons then had to sign an option or agreement whereby the Detroit Bankers Co. had the absolute right to reacquire these shares at any time when the persons ceased to be

[67] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, p. 5078.
[68] John Ballantyne, supra, p. 5082.

directors or officers.[69] Each of the trustees, under the trust agreement, had to endorse his trustee shares in blank and deposit them with the Detroit & Security Trust Co., which was appointed agent of each trustee to transfer the stock so deposited in the event of the death, resignation, removal, or inability of the trustee. The trustees and directors were thereby empowered to exercise pressure upon any director who insisted upon exercising independent judgment.[70]

The Detroit Bankers Co. dictated the election of members of the boards of directors of the various unit banks. Typical of such dictation was the resolution of the board of directors of the Detroit Bankers Co., adopted on December 23, 1930, which designated persons as proxies of the Detroit Bankers Co. to vote at the annual meetings of the various units the shares of stock of each respective unit held by the Detroit Bankers Co. on the election of directors and other business that might come before these meetings. Among the individuals designated to represent the Detroit Bankers Co. were John Ballantyne at the meeting of the First National Bank in Detroit, Ralph Stone at the meeting of the Detroit Trust Co., and Julius Haass at the meeting of the Peoples Wayne County Bank, who were all directors of the Detroit Bankers Co. and holders of trustee shares.[71]

On January 12, 1931, the Group board of directors adopted a resolution instructing each of the proxies to nominate specified persons as directors of each unit bank. The resolution provided:

> Under date of December 23, 1930, various individuals were authorized by the board to vote the shares owned by this company at the several annual meetings of stockholders. For the purpose of instructing these proxy holders to nominate directors in each instance, the following resolution, were offered and moved for adoption:
>
> "*Resolved*, That John Ballantyne, who has heretofore been appointed proxy to attend the annual meeting of the stockholders of the First National Bank, be and he is hereby directed to nominate the following as directors of the bank."[72]

* * * * * * *

A list of the names of these persons then followed.[73]

Practically all of the officers and directors of the Group were also officers and directors of one or more of the unit banks.[74] The directors of the Detroit Bankers Co., at the annual meetings of officers of the different banks, made up the slates of officers and directors to be chosen at those meetings of the various banks.[74]

At the time of the creation of the Detroit Bankers Co., John Ballantyne was a director of one unit bank, the Bank of Michigan. At the annual meeting of the Group board of directors held on January 12, 1931, Ballantyne was designated to be nominated by the Group proxies as director of the First National Bank in Detroit, the Peoples Wayne County Bank, the First Detroit Co., and the Detroit Trust Co., and was elected to these boards.[75]

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[69] Committee Exhibit No. 1, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5062, 5120–5130.
[70] Committee Exhibits Nos. 1 and 2, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5127–5133.
[71] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, p. 5087.
[72] John Ballantyne, supra, p. 5089.
[73] John Ballantyne, supra, pp. 5089–5090.
[74] John Ballantyne, supra, p. 5088.
[75] John Ballantyne, supra, p. 5096.

B. DRAINAGE OF UNIT RESOURCES TO MAINTAIN GROUP DIVIDEND POLICY

(1) *Guardian Detroit Union Group, Inc.*—The principal source of income of the Guardian Detroit Union Group, Inc., was the dividends on the stock that it owned of the unit institutions.[76]

The Group corporation, in order to pay dividends to its stockholders, had to receive dividends from the unit banks.[77]

As was the case with election of directors of the units, the Group corporation "suggested" every dividend date the amount of the dividend that the boards of the unit banks should consider declaring.[78] These suggestions to the unit banks by the Group corporation were almost invariably accepted.[79]

On June 4, 1930, Robert O. Lord wrote to John N. Stalker, president of the Union Guardian Trust Co., as follows:

DEAR MR. STALKER: To provide for the dividend requirement of the Guardian Detroit Union Group, Inc., on the basis of an annual disbursement of $3.20 per share, a dividend should be declared at the June meeting of your board of directors. I would suggest, therefore, that it would be in order for your Board to declare a quarterly dividend equal to 20 percent annually.

This dividend should be payable not later than June 27, 1930, to stockholders of record, June (it appears to be) 16, and a check for $248,024 covering the shares standing in the name of Guardian Detroit Union Group, Inc., as well as directors qualifying shares, the dividends on which have been assigned to us, should be in the hands of Mr. B. K. Patterson, treasurer, Penobscot Building, Detroit, Mich., on the 27th instant or on the day following.

Please be good enough to promptly confirm this arrangement and advise me upon the declaration of your dividend.[80]

Stalker replied:

DEAR MR. LORD: We have your letter of the 4th instant with respect to the 5-percent quarterly dividend, which you suggest that we pay this month. I presume a dividend of this amount is necessary to the fulfillment of your plan and the officers are prepared to recommend it to the board. However, as you are aware, a dividend of this amount has not been earned. In addition to that, the Trust Co. is setting up no reserves and we feel that is not as it should be. There is no doubt in my mind that the company will suffer some losses.

I want to bring up at this time, so that it will not be overlooked, the fact that in turning over our bond department to the Guardian Detroit Co. we lost a very important source of earnings, which even under present conditions would mean over $300,000 per year. Were our earnings sufficient to justify dividends at the annual rate of 20 percent, we would not raise a question of the loss in income from the bond department, but under the circumstances we feel that the Trust Co. is entitled to and must have some relief the latter part of the year.[81]

Despite the fact that Stalker stated that the Union Guardian Trust Co. had not earned such a dividend and that no reserves were being set up, the unit trust company accepted the suggestion and declared a quarterly dividend of 5 percent, Stalker writing to Lord as follows:

MY DEAR BOB: I commented in a recent letter on the matter of the dividends which should be paid by the Union Guardian Trust Co. the latter half of this year. The loss of our bond department affects our earnings very seriously. For the 5 years from 1925 to 1929, inclusive, the net earnings of that department, after the payment of expenses, average a trifle over $296,000 a year. If we had those earnings today, I believe we could pay a 20-percent dividend, or

[76] Robert O. Lord, supra, p. 4250.
[77] Robert O. Lord, supra, p. 4251.
[78] Robert O. Lord, supra, pp. 4250–4251.
[79] Robert O. Lord, supra, p. 4252.
[80] Committee Exhibit No. 6, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4252.
[81] Committee Exhibit No. 7, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4253.

$1,000,000 a year. We do not in any way question the transfer of the bond department to the Guardian Detroit Co. This seems to us logical and proper. The effect on our earning capacity, however, cannot be ignored.

As against $500,000 in dividends which we are paying the first 6 months of this year, our earnings will probably not run over $425,000, and this without setting up any reserves at all. Our policy in the past has always been to set up liberal reserves, although we were fortunate enough to need them only to a very limited extent. At the present time we feel that reserves are rather urgently required, and find ourselves unable to provide them.

Mr. Blair and I are of the opinion that for the last half of this year dividends aggregating $400,000, or at the annual rate of 16 percent, is the maximum that this company should undertake to pay. This would make 18 percent for the year. As our accruals for the next dividend period should commence the first of next month, we would be glad to get your opinion and advice on this subject.[82]

On March 4, 1930, in a letter to Henry H. Sanger, president of the National Bank of Commerce, Lord, as president of the Group, suggested a quarterly dividend of 5 percent.[83] On March 11, 1930, Sanger replied.

DEAR MR. LORD: Your letter of March 14, suggesting that the board of directors of the National Bank of Commerce declare a quarterly dividend of 5 percent, at $250,000, was submitted to our board meeting today.

In view of the fact that our earnings for the present quarter, from present indications, will little more than cover our regular dividend of 4 percent, they felt that only our regular dividend should be declared for this quarter. However, if this will upset your calculation to pay the regular quarterly dividend of 80 cents a share on the group stock, they will be glad to consider the declaration of an additional 1 percent at the next meeting of our board, March 18.

Will you please let me have your views on the matter?[84]

On March 13, 1930, Lord wrote to Sanger:

DEAR MR. SANGER: I have your letter of the 11th advising me of the action of your board in declaring a regular 4-percent dividend instead of 5 percent as suggested. We are counting on the 5-percent dividend and I hope, therefore, you will have your board declare an additional 1 percent at the next meeting on March 18. The fact that they are declaring a dividend at this rate for the present quarter does not necessarily mean that the same rate will continue throughout the year. I think each situation will have to be studied to determine what dividend it is advisable to declare for each quarter.

Trusting the suggestion is satisfactory, I am,[85]

Sanger replied to Lord on March 18, 1930:

DEAR BOB: Your letter of March 13, in re extra dividend, was submitted to our directors at a meeting held today, and an extra dividend of 1 percent, or $50,000, was declared payable March 27, out of undivided profits.[86]

Similarly, on March 4, 1930, Robert O. Lord, in a communication to Frank M. Brandon, president of the City National Bank & Trust Co., in precisely the same phraseology as the letters to John N. Stalker and Henry H. Sanger, suggested that a quarterly dividend of 2½ percent be declared.[87]

On June 11, 1931, in a memorandum to Herbert S. Reynolds, president of the Union and Peoples National Bank, from A. A. F. Max-

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[82] Committee Exhibit No. 8, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4257.

[83] Robert O. Lord, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4264.

[84] Committee Exhibit No. 12, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4265.

[85] Committee Exhibit No. 13, Dec. 19, 1933, Guardian Detroit Union Group, Inc, pt. 9, p. 4265.

[86] Committee Exhibit No. 14, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4267.

[87] Committee Exhibit No. 9, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4259.

well, secretary of the Guardian Detroit Union Group, Inc., a quarterly dividend of 5.9 percent was suggested.[88] Reynolds, in accepting the suggestion, replied:

DEAR PAT: During this year we paid in to the group the following dividends:
March, $31,500.
June, $41,500.
September, $50,000.
We are accruing at the rate of $31,500 and with the payment of this amount will pay $154,500 for this year, or at the rate of $4.41 plus on our 35,000 shares.
I would like very much not to go beyond this amount unless you feel it is absolutely necessary, but of course will do our part.[89]

Although economic conditions were becoming worse, dividends of $173,000 were declared.[90]

Stalker admitted that had the Union Guardian Trust Co. been an independent institution and not a member of the Group, he would not have recommended the 5-percent dividend declared.[91]

The Group corporation had determined upon a dividend at the rate of $3.20 per annum on its $20 par value stock.[92] Since the outstanding shares of the Group stock was 1,500,000, $1,200,000 in dividends was necessary for such purposes, and the allocated 5 percent of the Union Guardian Trust Co.'s capital was $250,000.

When interrogated as to his reasons for recommending acceptance of the suggestion of the declaration of a 5-percent quarterly dividend, Stalker testified:

Mr. STALKER. Of course, we were relying on our undivided profits account. You see, the earnings of any institution vary from year to year, and from quarter to quarter, and such portions of earnings as are not paid out in dividends accumulate in the undivided profits account, which are available for dividends if it is desired to pay them.

Mr. PECORA. Well, the undivided profits account is also available for the setting up of reserves, and so forth, against losses, and against depreciation in the portfolios of banks, isn't it?

Mr. STALKER. Yes, sir.

Mr. PECORA. And in the midsummer, or rather in June of 1930, economic conditions and banking conditions were such that you, as an experienced bank officer, felt that those undivided profits should be very carefully conserved, didn't you?

Mr. STALKER. Yes. Of course, I was trained for a good many years along lines that were rather conservative in the matter of payment of dividends. Back in the old Union Trust Co. we used to figure that paying out about half of our earnings was what we should do. I think that is a fair statement in general.

Mr. PECORA. And you have never had occasion to regret the caution of the atmosphere in which you were trained in banking circles, have you?

Mr. STALKER. Nobody these days regrets any conservatism he ever had.[93]

Stalker admitted that one of the motivating causes for the declaration of the 5 percent quarterly dividend was a desire to cooperate fully with the Group corporation.

Mr. PECORA. Now, isn't it a fact that one of the considerations, and perhaps the most important and the most persuasive consideration, that actuated your board in adopting the suggestion of the group in June 1930 to declare a dividend at the rate of 5 percent for that quarter, was that it was felt by you

[88] Committee Exhibit No. 16, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4287.
[89] Committee Exhibit No. 17, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4289.
[90] Robert O. Lord, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4289.
[91] Ibid., pp. 4416–4417.
[92] John N. Stalker, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4409.
[93] John N. Stalker, supra, pp. 4407–4408.

and your officers and your board that you were more or less under the duty of carrying out the suggestion of the group?

Mr. STALKER. I would not put it quite that way.

Mr. PECORA. To what extent would you tone that statement down?

Mr. STALKER. I would say this, sir, that the officers and directors of the Union Guardian Trust Co. desired to cooperate fully in the work of the Group Co.

Mr. PECORA. That is another way virtually of stating what I said, isn't it?

Mr. STALKER. Well, there may be that much difference.[94]

* * * * * * *

The CHAIRMAN. Wasn't it one of your ideas that you wanted to retain such a status with the group that, in case you needed any assistance from them, you would be able to command it, and therefore you wanted to declare the dividends they desired?

Mr. STALKER. Well, I think I would rather express the situation in this way, Senator Fletcher: That our unit, as I believe all units, desired to cooperate fully with the group. We believed, or I believed, at that time that the group idea was a good one, that it was making for the strength of the units. We desired to cooperate fully. We believed, and we were right in believing, that the group would do all it could to assist us if we needed help.[95]

* * * * * * *

Mr. PECORA. Well, your letter of June 5, 1930, addressed to Mr. Lord, was really designed by you as a protest mildly expressed against your bank being required to declare a 5-percent quarterly dividend, wasn't it?

Mr. STALKER. I would have preferred to have seen that dividend less.

Mr. PECORA. Was that the thought you intended to convey by a gentle intimation to Mr. Lord in your letter?

Mr. STALKER. Yes; I think that is a fair statement. I believed that we should build up reserves more fully than we then were.

Mr. PECORA. Apparently at that time, as I understand your letter, your company was not setting up any reserves.

Mr. STALKER. That is true as of the first half of the year.

Mr. PECORA. And you thought it was an unwise policy?

Mr. STALKER. Yes, sir.

Mr. PECORA. Why didn't it set up reserves at that time?

Mr. STALKER. Well, our earnings were not sufficient at that time. But we hoped that we would be able to set up reserves in the latter half of the year.

Mr. PECORA. Didn't you as an experienced banker believe it wiser to take enough of the earnings and put them in your undivided-profits account as would be the basis for the setting up of reserves, rather than to pay dividends?

Mr. STALKER. If we had been operating as a sole and independent unit, there is no doubt but what that would have been true. Of course, we were a part of the group picture, and at the time we believed—and I still believe—added greatly to the strength of the units. We also had savings in the matter of expenses resulting from the merger, which we believed—and we were right in believing—would be made effective in the latter part of the year.[96]

* * * * * * *

Mr. PECORA. Mr. Stalker, would you, as the executive head of your bank in June 1930, on your own judgment and feeling with respect to what the dividend rate should have been, have recommended to your board or would you have favored the declaration of a 5 percent quarterly dividend by your board if you had been left to the exercise of your own untrammeled judgment?

Mr. STALKER. If we had been an independent institution I would certainly have not.

Mr. PECORA. You would have recommended a declaration of a dividend at a rate lower than 5 percent at that quarter?

Mr. STALKER. Yes, sir.[97]

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Mr. PECORA. Then, dividends were declared at a rate not justified by the earnings partly to bolster up public confidence or the confidence of your depositors in your bank?

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[94] John N. Stalker, supra, p. 4421.
[95] John N. Stalker, supra, p. 4409.
[96] John N. Stalker, supra, pp. 4410–4411.
[97] John N. Stalker, supra, p. 4416.

Mr. STALKER. I would not say they were not justified by earnings, sir. I do not think the Group Co., for instance, declared dividends which were not covered by earnings. In the particular case that you mention the Trust Co. had to draw on undivided profits to pay a portion of that dividend.

Mr. PECORA. It would not have done that normally if it had been an independent bank instead of a unit in a group, would it?

Mr. STALKER. I can only speak for myself. I would not favor it.[98]

Prior to the declaration of the 5 percent quarterly dividend in June 1930 the dividend of the Union Guardian Trust Co. was four quarterly dividends of 4 percent each, or 16 percent.[99] The dividend had been increased to 5 percent quarterly, although the dividend had not been earned and no reserves were being set up. The June 1930 5 percent dividend was the last 5 percent dividend paid; the next quarterly dividend was 4 percent, and following that 2½ percent.[1] The last dividend declared by the Union Guardian Trust Co. was for the quarter ending March 31, 1932, and amounted to $50,000.

Mr. PECORA. Did the condition of the bank at that time justify the payment of any dividend?

Mr. STALKER. Looking back now——

Mr. PECORA. No; the conditions as you knew those conditions to be then?

Mr. STALKER. You get there the question of loss of public confidence through a drastic change in dividend action.

Mr. PECORA. Was it because of the fear of the public or the fact that the confidence of your depositors in the bank would be seriously affected that the bank in March 1932 declared that dividend?

Mr. STALKER. I cannot speak for our directors, Mr. Pecora, but I know that that was certainly in my mind.

Mr. PECORA. Was it the moving factor in your mind in favor of the declaration of the dividend in March 1932?

Mr. STALKER. It was.[2]

* * * * * * *

Mr. PECORA. * * * Is this the fact, Mr. Stalker, that in view of the set-up of the group and the relationships of the unit banks to that group it was considered imperatively necessary in order to sustain the confidence of the public and of the depositors in the various unit banks of the group as well as in the group itself, for the group to continue to pay dividends and hence for the unit banks to continue to pay dividends to the group?

Mr. STALKER. It was considered desirable.[3]

During the period from July 1, 1929, to April 1, 1932, the Guardian Detroit Union Group, Inc., paid out in regular and special dividends the aggregate sum of $9,293,639.90. During the period from July 1, 1929, to January 2, 1932, in addition to the regular 50-cent dividend, special dividends were paid. For the year 1929, $886,104 in regular and special dividends were paid; in 1930, $4,933,496.40 in regular and special dividends were paid; in 1931, $3,088,017.50 in regular dividends were paid; the last dividend of $386,022, a regular dividend of 25 cents, being paid on April 1, 1932.[4]

The Guardian National Bank of Commerce, which was a consolidation of the Guardian Detroit Bank and the National Bank of Commerce, for the period from 1929 to 1932, paid in dividends to the Group corporation a total of $4,021,761.

The Union Guardian Trust Co., in the period from 1929 to 1932, paid $1,623,032.50 in dividends to the Group corporation.

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[98] John N. Stalker, supra, p. 4417.
[99] John N. Stalker, supra, p. 4419.
[1] John N. Stalker, supra, p. 4416.
[2] John N. Stalker, supra, p. 4424.
[3] John N. Stalker, supra, p. 4426.
[4] Committee Exhibit No. 33, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4831. (Committee Exhibit No. 33 contains a detailed itemized statement of each regular and special dividend paid.)

The last dividend paid by the Union Guardian Trust Co. was on March 30, 1932, in the sum of $50,000.[5]

These dividends were being paid by the units to the Group corporation, and, in turn, by the Group corporation to its stockholders, although the officers and directors of the Group corporation had been apprised by the Comptroller of the Currency of the fact that the units were in such condition that current profits should be used not for dividends but to take care of depreciation in the securities accounts.

On September 17, 1931, in an intra-Group memorandum addressed by F. M. Brandon, president of the City National Bank & Trust Co., to A. A. F. Maxwell, secretary of the Guardian Detroit Union Group, Inc., it was stated:

DEAR MR. MAXWELL: Your memorandum of July 16 concerning the dividend requirements of units of the Guardian Detroit Union Group, Inc., is received.

The September meeting of our board of directors was held yesterday and the matter of dividends was discussed and no action taken. This is in harmony with the request of the Comptroller of the Currency that current profits be used instead to take care of depreciation in the securities account.

If for any reason the management of the Group feel that different action should be taken and will promptly advise us, we shall call a special meeting of the board of directors for further consideration of the subject and will, therefore, appreciate hearing from you promptly.[6]

On September 19, 1931, Henry F. Quinn, national bank examiner, wrote to B. K. Patterson, vice president of the Guardian Detroit Union Group, Inc., as follows:

DEAR MR. PATTERSON: I have completed an examination of the City National Bank & Trust Co., of Niles, Mich., today, and there exists a problem in the bank which I believe you would be most interested in, before the report is submitted to the Comptroller's office.

I shall be in Detroit, Saturday, this coming week, and I have suggested to Mr. Brandon that he, your own good self, and I, have a conference in your office on that date, preferably right after noon.

Will you please advise me, as well as Mr. Brandon, if this suggestion meets with your pleasure.[7]

In a memorandum dated September 24, 1931, from A. A. F. Maxwell to F. M. Brandon, it was stated:

DEAR MR. BRANDON: Your letter of September 17 has been received and referred to Mr. Patterson.

Undoubtedly there will be adjustments to be made after the conference with the national bank examiner, but Mr. Patterson feels that these charges should be taken care of through the surplus account. Will you, therefore, arrange to call a special meeting of your board for the purpose of declaring the dividend as outlined in our previous memorandum of July 16.[8]

In a memorandum dated September 28, 1931, from F. M. Brandon to A. A. F. Maxwell, it was stated:

DEAR MR. MAXWELL: Your memorandum of September 24 with reference to quarterly dividends at this bank is received, and wish to advise that the writer explained the reason for our failure to pay September dividends to Mr. Patterson while in his office on September 26.[9]

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[5] Committee Exhibit No. 32, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4331. (Committee Exhibit No. 32, contains an itemized statement of the dividends paid by each of the units for each of the years 1929 through 1933.)

[6] Committee Exhibit No. 23, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4307.

[7] Committee Exhibit No. 24, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4307–4308.

[8] Committee Exhibit No. 25, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4308.

[9] Committee Exhibit No. 26, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4309.

In a letter dated September 29, 1931, from A. A. F. Maxwell to F. M. Brandon, it was stated:

DEAR SIR: Your memorandum of September 28 is received, from which we note that you have discussed the dividend matter with Mr. Patterson. We assume, however, that you are calling a special meeting of your board for the purpose of declaring the regular dividend as originally requested.[10]

This communication bore the notation "No dividend paid this quarter."

This correspondence indicated that although the officers of the unit bank had advised the Group that it should not declare the dividend requested by the Group because of the position taken by the Comptroller of the Currency, the Group persisted in asking the bank's board to call a special meeting in order to declare the dividend suggested.

On October 8, 1931, F. M. Brandon wrote to B. K. Patterson, vice president of the Guardian Detroit Union Group, Inc.:

In compliance with your telephone request a special meeting of our board of directors was held last evening to further consider the matter of quarterly dividend. The directors are hesitant about declaring a dividend at this time, having been recently advised by Examiner Quinn that the same would be illegal if made. However, they want to comply with the request of stockholders if the same can be done in a legal manner, and therefore requested me to advise you of the situation, and to ask the management of the Group to request the dividend by letter, and to indicate that the Group Co., as stockholders, will take care of any requirements of the Comptroller of the Currency without in any manner changing the capital and surplus account of the bank.

I am assured by a majority of the board of directors that if this is done the dividend will be promptly declared, and I hope to hear from you tomorrow.[11]

Patterson replied, under date of October 12, 1931:

Answering your letter of October 8 in regard to the matter of quarterly dividend: After giving further consideration to this matter it is believed inadvisable to ask that the City National Bank & Trust Co., of Niles, pay to the Guardian Group the dividend which was requested for the third quarter.[12]

In January 1932 it was necessary to take out a total of $148,491 of doubtful assets of the Niles bank,[13] yet in the fall of 1931 the Group was insisting upon a dividend declaration being made in September 1931.

On October 21, 1931, John L. Proctor, Deputy Comptroller of the Currency, wrote to the board of directors of the City National Bank & Trust Co., stating that a report of the examination of the bank completed September 19 had showed that the bank's capital was impaired to the extent of $34,638.27, and recommending that the bank's capital be restored immediately by voluntary cash contributions on the part of the directors and other stockholders. Proctor further stated that losses aggregating $68,458.90 should be charged off or otherwise removed, and that while the present conditions prevail in your bank "it is not in a position to pay any dividends."[14]

Although Robert O. Lord had consistently testified that the general procedure pursued by the Group in making suggestions to the bank with regard to dividend declarations was to determine the con-

[10] Committee Exhibit No. 27, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4309.

[11] Committee Exhibit No. 28, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4311.

[12] Committee Exhibit No. 29, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4312.

[13] Robert O. Lord, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4313.

[14] Ibid., p. 4313.

dition of the bank, the report of the Deputy Comptroller showed that the capital of the bank had been impaired and that it was in no position to declare any dividends. Yet the Group was insistent upon the declaration of a dividend.

The report of Bank Examiner Walker, dated May 16, 1932, on the Guardian National Bank of Commerce showed that losses of approximately $1,200,000 were to be charged off at that time with the consent of the executive committee. The charge-offs were fixed at that amount, although they were considered nominal in comparison with the actual existing losses, because a further charge-off would have been ruinous to the demoralized condition of the bank.[15] The report severely criticized the management of the bank by Lord, who assumed a laissez faire attitude instead of a strong dominant position of immediate corrective measures. Salaries were characterized as excessive, and were evidently continued to supply the officers and employees with the means to meet the interest payments on loans obtained from the bank. The report pointed out that 40 percent of the bank's capital was invested in real-estate mortgages, which were going regularly into foreclosure. The bank on May 16, 1932, had loans aggregating $4,085,015.71 on real estate, as compared with a capital of $10,000,000. Loans secured by collateral of the bank were grossly undercollaterialized, for the market value of the stock of the Group had catapulted from $350 to a nominal quotation of $5.50 a share, and no material amount of the stock could be liquidated even at that price.[16] A condition existed where 30 percent of the bank's deposits were concentrated in 11 accounts, presenting a dangerously weak situation in the event that these large depositors withdrew their funds.

The most serious difficulty was that the parent company could not acquire any justified earnings in the form of dividends from its various affiliated banks, yet it was incumbent upon the Guardian Detroit Union Group, Inc., with liabilities of approximately $14,500,000, together with operating expenses of approximately $130,000 a year, to derive revenues of approximately $850,000 a year to meet interest charges and expenses. The report stated:

> * * * In other words, in the ordinary unit bank the double liability feature is a source of some strength as a rule, whereas here we have not only no strength from the principal stockholder, the Guardian Detroit Union Group, but in addition the parent company must derive, as stated above, some $850,000 a year to keep its own head above water.
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> From this angle it will be readily seen that the situation is a serious one, and I would not care to hazard a guess as to the future of this bank and the others in the group, few if any of which could keep their doors open if this bank found it impossible to carry on.[17]

Despite this appalling condition, the Guardian National Bank of Commerce declared a dividend amounting to $200,000 for the first quarter of 1932 to enable the parent company to declare a dividend aggregating $386,022 for that period.

Bert K. Patterson, executive vice president of the Guardian Detroit Union Group, Inc., admitted that the examiner's report portrayed an accurate picture of the condition of the Guardian National Bank of Commerce.

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[15] Bert K. Patterson, Jan. 3, 1934, Guardian Detroit Union Group, Inc., pt. 9, pp. 4506–4507.
[16] Bert K. Patterson, supra, p. 4508.
[17] Bert K. Patterson, supra, p. 4509.

The report of National Bank Examiner W. A. Reagan on the Guardian National Bank of Commerce as of November 9, 1932, showed slow loans aggregating $5,388,682.52, doubtful loans of $18,692,876.22, and a loss of $546,942.07. The doubtful loans alone, independent of slow loans, exceeded the entire capital funds of that bank, which aggregated $17,945,433.93.[18] The report stated:

* * * The real-estate situation in the bank is serious, and at the present time it is very difficult to determine values of any Detroit property. It is felt that eventually substantial losses will develop in some of these assets. The concentration in collateral of Guardian Detroit Union Group and Detroit Bankers Co. stocks is outrageous, and little if any value is given to either of these stocks by the examiner. * * *

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The condition of this bank is very unsatisfactory, and the stock ownership by the Guardian Detroit Union Group adds nothing to strengthen the picture. The Group has heavy debts of its own, approximately $14,000,000, and it is necessary for them to find ways and means to liquidate some of their own debts and have no funds nor assets with which to assist the member banks. The Group assets consist almost entirely of bank stocks which are not productive of dividends. * * *[19]

Yet a dividend amounting to $150,000 was declared by the Guardian National Bank of Commerce for the final quarter of 1932.[18] Patterson admitted that the declaration of this dividend was wrong.

Mr. PECORA. Do you think, under those circumstances, that the officers did their full duty to the depositors in declaring that dividend, with the bank in that condition?

Mr. PATTERSON. Viewing it strictly as a bank operation, you are right.

Mr. PECORA. Do you know why the dividend was declared by the bank?

Mr. PATTERSON. Only, as I said before, it was used to pay some of the current indebtedness of the Group Corporation.

Mr. PECORA. What interest did the depositors of the bank have in taking care of the Group Corporation?

Mr. PATTERSON. Well, the Group Corporation was the stockholder of bank stock, and, I believe, had a right to declare earnings out of that bank.

Mr. PECORA. Even though the earnings of the bank itself, considering the bank as a separate entity, were not sufficient to make the declaration of a dividend advisable?

Mr. PATTERSON. I do not believe there was any legal objection to declaring dividends, even though the profit account is used or some of the surplus.

Mr. PECORA. I am not talking about a legal objection; I am talking about the practical consideration of principles of sound banking.

Mr. PATTERSON. As a practical consideration it was wrong.[20]

Mr. PECORA. * * *

Under the circumstances reflected by this report, do you think the declaration of a dividend for the final quarter of 1932 by this bank was advisable or justifiable?

Mr. PATTERSON. No, sir.[21]

(2) *Detroit Bankers Co.*—In the letter of October 5, 1929, addressed to the stockholders of the units which the Detroit Bankers Co. holding company contemplated unifying, it was stated:

It is proposed that dividends be paid upon the common stock of the new company in the aggregate amount of 17 percent per annum, payable quarterly.[22]

At that time the stock-market crash had not occurred, and Ballantyne attempted to justify this 17-percent dividend on the basis of the sound business conditions existing throughout the country.[23]

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[18] Bert K. Patterson, supra, p. 4511.
[19] Bert K. Patterson, supra, pp. 4515–4516.
[20] Bert K. Patterson, supra, pp. 4512–4513.
[21] Bert K. Patterson, supra, p. 4516.
[22] Committee Exhibit No. 3, Jan. 24, 1934, Detroit Bankers Co., pt. 11, p. 5071.
[23] John Ballantyne, Jan. 24, 1934, Detroit Bankers Co., pt. 11, p. 5079.

Mr. PECORA. I am talking about the fact that fully 3 months before the Detroit Bankers Co. actually came into legal existence, this circular, marked "Committee's Exhibit No. 3", was issued, addressed to the stockholders of the five banks in question, and they were advised in this circular that the Detroit Bankers Co. would pay an annual dividend at the rate of 17 percent, payable quarterly.

Mr. BALLANTYNE. Yes.

Mr. PECORA. And your name is signed to this circular.

Mr. BALLANTYNE. Yes.

Mr. PECORA. Which was addressed to the stockholders of the bank which you served as chairman of the board at that time.

Mr. BALLANTYNE. Yes; I know all of that.

Mr. PECORA. I want you to tell the committee, if you please, by what process of reasoning, calculation, or otherwise, the 12 founders of the Detroit Bankers Co., fully 3 months before that company came into official being or legal existence, fixed the dividend rate which the company would pay to its stockholders at 17 percent per annum.

Mr. BALLANTYNE. I would like to answer you, Mr. Pecora, but I cannot.[24]

The Detroit Bankers Co. was organized on January 8, 1930. The securities crash had already occurred, the business depression had commenced and had given every indication of continuing, yet the 17 percent dividend rate, or $3.40 on each $20 par value share, was continued by the Group during 1930 and 1931.[24]

The only source of earnings of the Detroit Bankers Co. from which dividends could be paid upon its stock were dividends received from the unit banks whose stocks the Group company owned.[25] The 17 percent dividend rate was predicated upon the Group company's expectation of receipt of sufficient dividends from the unit banks to enable them to make these dividend payments.

The strain placed upon the unit banks by the dividend policy of the Group company is clearly demonstrated by the amount of dividends that the unit banks were compelled to declare, even in the face of the known perilous condition of these banks and the apprehensive business conditions throughout the country. The First National Bank in Detroit, one of the largest unit institutions in the Group, for the 5-year period from 1925 to 1929, prior to the organization of the Group company, paid an average yearly dividend amounting to $975,000 a year.[25] During the year 1930, after its affiliation with the Group company, the First National Bank paid to the Detroit Bankers Co., as the owner of its capital stock, dividends aggregating $1,137,307, or an excess of approximately $150,000 over the average dividend paid during the preceding 5-year period before the depression occurred.[25] In 1931, although business conditions became progressively worse, the First National Bank paid to the Detroit Bankers Co., as the owner of its capital stock, dividends aggregating $4,649,642, which was more than four times the amount of dividends paid by the First National Bank to the Group company in 1930! John Ballantyne, as a member of the board of directors of the bank, could offer no explanation or justification for the declaration of this dividend.

Mr. PECORA. Had this dividend of over four and a half million dollars been earned?

Mr. BALLANTYNE. I am not prepared to say.

Mr. PECORA. What is that?

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[24] John Ballantyne, supra, p. 5080.

[25] John Ballantyne, Jan. 26, 1934, Detroit Bankers Co., pt. 11, p. 5235.

Mr. BALLANTYNE. I am not prepared to say.

Mr. PECORA. What can you tell us about the declaration of these dividends of over four million six hundred thousand in the year 1931?

Mr. BALLANTYNE. I cannot tell you a thing.

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Mr. PECORA. Did you consider, Mr. Ballantyne, that a director of a bank could exercise any single duty or function of any greater importance than declaring dividends for the bank?

Mr. BALLANTYNE. I doubt it.

Mr. PECORA. Appreciating, then, as I am assuming you did, the importance of that function and of that duty, did you, as a director of the First National Bank in Detroit, vote for the declaration of these dividends with full knowledge of the facts and circumstances, including earnings, and as to whether or not those facts and circumstances warranted the declaration and payment of those dividends?

Mr. BALLANTYNE. I do not know whether I voted or not; but, in any event, my recollection is not very clear on that; and, in any event, Mr. Pecora, I was informed and believed they were earned.

Mr. PECORA. Who informed you that they were earned?

Mr. BALLANTYNE. The officers of the bank.

Mr. PECORA. Who?

Mr. BALLANTYNE. The president, I presume.

Mr. PECORA. Have you a clear recollection of that?

Mr. BALLANTYNE. No; I have no clear recollection of anything concerning it.[26]

During the year 1932, although business conditions had reached their lowest ebb, the First National Bank paid to the Detroit Bankers Co., as the owner of its capital stock, dividends aggregating $2,838,955, or nearly three times the average yearly dividend paid by that bank during the 5-year period from 1925 to 1929.[27]

The report of the national bank examiner on the condition of the First National Bank as of February 21, 1931, showed that the total surplus fund, net undivided profits and reserve account amounted to $17,298,821.70. The aggregate amount of slow loans were $16,-229,000, doubtful loans $1,687,000, and estimated losses $1,828,660, which in the aggregate exceeded by approximately $2,000,000 the total amount of surplus, undivided profits, and reserve account of the bank at that time.

The report of the national bank examiner on the condition of the First National Bank as of September 25, 1931, stated:

This report reflects a very unsatisfactory condition, showing classified loans and doubtful paper aggregating approximately the surplus and profit of the bank, without taking into consideration a large amount of slow assets. This condition has been brought about by two major causes, namely, the general business depression, and the shrinkage in the inflated value of real estate, and poor management.[28]

The report further stated:

A very unsatisfactory condition existed with regard to classified loans and doubtful paper, aggregating approximately the surplus and profit of the bank without taking into consideration a large amount of slow assets.[29]

Ballantyne admitted that the national bank examiner's reports accurately described the bank's condition and agreed with the observations therein contained.[30]

The officials of the Detroit Bankers Co. were fully cognizant of the precarious condition of the banking units and local banking

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[26] John Ballantyne, supra, pp. 5237-5238.
[27] John Ballantyne, supra, p. 5239.
[28] John Ballantyne, supra, p. 5242.
[29] John Ballantyne, supra, p. 5246.
[30] John Ballantyne, supra, p. 5245.

situation. On October 17, 1931, Wilson W. Mills, chairman of the board of the Group Co., wrote to Eugene Meyer, Governor of the Federal Reserve Board, as follows:

DEAR MR. MEYER: I am enclosing copy of a letter that I wrote to the President under date of October 14. In this part of the country, at least, I believe the situation is very serious indeed, and I fear for any long delay. The banks all complain of people hoarding—I am wondering as to whether the reverse is not also true—that the banks are hoarding. * * * The confidence in our banking institutions is so rapidly waning that I fear the time element as much as anything else and believe delay will very materially lengthen the task of reestablishing that confidence.

I trust you will pardon my writing you, but I could not resist the temptation.[31]

Ballantyne, although disclaiming any knowledge of the actual condition of the Group company and the unit banks, admitted that he was apprehensive of the conditions of the bank and the general situation.[32]

Mr. PECORA. Having those apprehensions, did you think it was sound for the bank in 1931 to pay dividends of over $4,600,000, or more than four times the amount of dividends that it paid in 1930 and more than five times the average annual dividends it had paid for the 5-year period prior to the depression?

Mr. BALLANTYNE. Mr. Pecora, I did not know they were paying in that proportion, frankly.[33]

During the year 1931 the national bank examiners severely criticized the declaration of these substantial dividends and indicated that they would have to stop the payment of dividends if the condition of the bank did not improve. Nevertheless, in the face of that criticism, the Detroit Bankers Co. paid 17 percent dividends without any reduction.

Mr. PECORA. Do you recall that toward the latter part particularly of the year 1931 national bank examiners found fault with the liberality of the dividends that were being declared?

Mr. BALLANTYNE. In 1931?

Mr. PECORA. Yes; in 1931.

Mr. BALLANTYNE. At the close of 1931?

Mr. PECORA. Before the close of 1931; during the year 1931, in fact.

Mr. BALLANTYNE. During my office in the First National Bank or later?

Mr. PECORA. Also during the time that you were president of the Detroit Bankers Co.

Mr. BALLANTYNE. Well, I have a recollection that bank examiners criticized the situation; yes.

Mr. PECORA. What was the basis of their criticism?

Mr. BALLANTYNE. Well, I think, if I recall it correctly, they indicated that they might have to stop the payment of dividends if the improvement was not greater.

Mr. PECORA. Nevertheless, in the face of that criticism of national bank examiners, the Detroit Bankers Co. paid 17 percent dividends in the year 1931?

Mr. BALLANTYNE. Yes, sir.

Mr. PECORA. And it made no reduction in dividends?

Mr. BALLANTYNE. No.[34]

In order to enable the Group company to pay the 17 percent dividend in 1931, some of the units had to declare special dividends in addition to their regular dividends, the First National Bank paying in 1931 a special dividend of $2,000,000.[35]

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[31] Committee Exhibit No. 146, Feb. 6, 1934, Detroit Bankers Co., pt. 12, p. 5564.
[32] John Ballantyne, Jan. 26, 1934, Detroit Bankers Co., pt. 11, p. 5240.
[33] John Ballantyne, supra, p. 5240.
[34] John Ballantyne, supra, pp. 5240–5241.
[35] John Ballantyne, supra, p. 5241. Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, pp. 5385–5386.

For the first quarter of 1932 the First National Bank declared a dividend at the rate of 16 percent per annum—a reduction of merely 1 percent per annum under 1931.[36]

The first examination made by the national-bank examiners of the First National Bank in Detroit, after its consolidation with the Peoples Wayne County Bank which consolidated bank was known as the First Wayne National Bank, was as of May 6, 1932, and concluded June 3, 1932. In the examiner's report to the Comptroller of the Currency, the contents of which were really orally disclosed to the governing committee of the board of directors of the First National Bank, it was disclosed that the bank had at least $70,000,000 in slow assets, $50,000,000 in doubtful assets, and approximately $49,000,000 in losses. The losses were considerably more than estimated in the examiner's report to the bank, the actual estimated amount not being disclosed to the directors for fear that they would become completely demoralized. In order to be helpful in the tense situation the examiners did not include in the doubtful loans loans secured by the Detroit Bankers Co. stock, although these loans properly belonged in that category.

On June 10, 1932, Chief Examiner Alfred P. Leyburn, at a meeting with the entire governing committee of the bank, made a complete disclosure to this committee of the conditions reported by the examiners to the Comptroller of the Currency. Among those present at this meeting were Edward D. Stair, Mark Wilson, and Wilson W. Mills. Although these individuals denied that they were apprised by Chief Examiner Leyburn of the precarious condition of the bank as outlined in the report to the Comptroller of the Currency, Leyburn testified that at this meeting with the governing committee he reported that the First National Bank had $49,000,000 in losses, $79,000,000 in slow assets, and $54,000,000 in doubtful assets.

Leyburn criticized the concentration of 256,370 shares of Detroit Bankers Co. stock in the bank as collateral and the officers and employees loans of $3,083,000, on which there was a loss of $2,000,000. The real-estate loans had commenced to go into default, with approximately $8,000,000 subject to foreclosure, and the bank, in addition, was confronted with a heavy loss on its guarantee of the losses of the American State Bank. Leyburn testified that he informed the governing committee that he estimated the bank's losses at $49,000,000, and the members of the committee admitted that the losses would be the almost unsurmountable amount of $15,000,000, as compared with this $49,000,000 estimate. Leyburn estimated the liquidity of the bank at about 28 percent at that time and recommended that the bank dividend be cut from 16 percent to 8 percent, which was even more than unjustified by the earnings and assets. Although the members of the governing committee admitted the unsatisfactory condition of the bank, they refused to consent to that cut in dividend so soon after the consolidation of the two banks.[37]

The minutes of the meeting of the governing committee of the First Wayne National Bank, held on June 10, 1932, stated:

> Messrs. Leyburn and Utt, chief national bank examiner, and examiner in charge, were present and reported the result of their examination. They

[36] John Ballantyne, supra, p. 5251.
[37] Alfred P. Leyburn, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5764.

recommended that the bank do not declare a quarterly dividend in excess of $2.10 per share upon its stock. The general matter of organization of the bank and the like were discussed.

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Upon motion, duly made and seconded, it was determined to recommend to the board of directors of the bank that a quarterly dividend be declared in the sum of $2 per share.[38]

Leyburn testified that the minutes were inadequate and incorrect in that the minutes failed to incorporate the fact that he disclosed to the governing committee the $49,000,000 estimated loss. Leyburn unequivocally controverted the statement contained in the minutes that he recommended a dividend not in excess of $2.10 and testified that he definitely informed the committee that they would have to assume the responsibility for any dividend declared and that the legality of such dividend would be questioned.[39]

The examiner's report of the condition of this unit bank as of November 18, 1932, showed this institution in a precarious condition.

The enormous amount listed as doubtful cannot but help reveal the extent of losses which this bank will be called upon to absorb, and I am frank to admit that the classifications are most lenient and have been made not from the standpoint of segregating bankable assets from collectible assets, but with the thought of ultimate collection at most any future date. A real analysis of the mortgage loans, together with additional funds on collateral mortgages, would unquestionably present a most deplorable picture. The real-estate speculators have subdivided the country within a radius of 30 to 35 miles, and the freedom with which these banks, subject banks and amalgamations of several banks, both State and National, passed out money for real estate and stock speculation is incomprehensible. Most every loan in the bank depends either on real estate or upon an upturn in the automobile industry, and the real-estate situation depends on the latter. Loan after loan in sizable amounts was made to persons who had no license whatever to borrow money and who are so badly involved that it is useless to even consider that they can ever attempt to pay.[40]

The report itemized the various types of doubtful and unsound loans which the bank made, such as "policy" loans, loans secured by Detroit Bankers Co. stock, and loans to directors, officers, and employees which were undercollateralized or unsupported by statements, the reduction of which loans was disproportionate both as to amount and groups.[41]

Real-estate mortgages held by the bank exceeded 50 percent of savings deposits. In view of the demoralized real-estate market in Detroit at the time, eventual substantial losses were inevitable.

The report stated that with the potential losses which the First National Bank faced, any dividend would be entirely unwarranted. Dividends and losses, less recoveries, of the First National Bank over the 5½-year period ending June 30, 1932, exceeded its earnings by $14,951,459.

In view of the fact, however, that the Detroit Bankers Co., the parent company, had bank loans to meet, and its principal source of income was the First National Bank dividends, the examiners did not attempt to discontinue the dividend at that time. It was distinctly understood, however, that no further dividends would be paid on Detroit Bankers Co. stock without first obtaining the permission of the Comptroller of the Currency.

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[38] Committee Exhibit No. 181, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5768.
[39] Alfred P. Leyburn, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5768.
[40] Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5412.
[41] Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5410.

Edward Douglas Stair, successor to John Ballantyne as president of the company from June 1932 to March 1933, defended payment of the 1932 dividends, claiming these dividends were earned. In ascertaining, however, whether the dividend was earned, there had been eliminated from consideration the losses that had been charged off.[42]

Mr. PECORA. In basing a declaration of dividend upon your knowledge or information of earnings did you eliminate from consideration losses that had been charged off?

Mr. STAIR. That was my understanding.

Mr. PECORA. Whether the losses were charged off out of undivided profits or surplus or not?

Mr. STAIR. Always. That was my understanding always.

Mr. PECORA. That those losses were eliminated from consideration?

Mr. STAIR. Yes, sir.[43]

The minutes of the meeting of the governing committee held on December 30, 1932, stated:

The comments and recommendations of the examiners, covering the second regular examination of the bank for the year 1932, were read to the committee and thoroughly discussed.

It was recommended by Mr. Leyburn, and approved by the committee, that an immediate charge-off be made of bad and doubtful assets, totaling $6,000,000. Of this amount, $818,206.43, was to be applied against defaulted bonds and the remainder against loans, the selection of which was to be made by the bank officers and reported to the examiner.

Mr. Leyburn recommended, and the recommendation was approved by the committee, that no further public dividends be declared without the prior approval of the Comptroller of the Currency.[44]

Leyburn impugned the accuracy of these minutes in that they failed to disclose his discussion of the precarious condition of the bank.

The payment of dividends by this unit was suspended only after the strenuous insistence of the bank examiners.

(c) "WINDOW DRESSING" AND FALSE REPORTS

In order to maintain public confidence in the units of the Group corporation and to support the market quotations on the Group stock, it was essential that the Group corporation present statements that superficially reflected a sound financial condition.

(1) *Employment of bank examiners.*—To accomplish that purpose, the Guardian Detroit Union Group, Inc., adopted the policy of engaging for important positions former bank examiners. Bert K. Patterson, who was executive vice president of the Guardian Detroit Union Group, Inc., since August 1929, shortly after its incorporation, had been at one time chief national bank examiner for the seventh Federal district, which included Detroit.[45] R. L. Hopkins, vice president of the unit bank, Union Industrial & Savings Bank of Flint, had been a national bank examiner, and it was he who examined the Guardian Detroit Bank and the National Bank of Commerce at the time of the merger of these two institutions.[46] C. A. Bryan, vice president of the unit bank, Capital National Bank at Lansing, had also been a national bank examiner; as had been W. J. Penningroth, who was vice president of the unit bank, First National Bank & Trust Co. of Niles.[46]

[42] Edward Douglas Stair, supra, pp. 5416–5420.
[43] Edward Douglas Stair, supra, p. 5419.
[44] Committee Exhibit No. 180, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5767.
[45] Robert O. Lord, December 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4229
[46] Robert O. Lord, supra, p. 4230.

(2) *Statements and reports*—(i) *Elimination of "Bills payable"*—(*a*) *Guardian Detroit Union Group, Inc.*—Robert O. Lord, in an intragroup memorandum addressed to the directors of the Guardian Detroit Bank under date of January 21, 1931, stated:

On January 2, 1931, there appeared in the Detroit newspapers a brief news item to the effect that the deposits of Guardian Detroit Bank had increased by $9,500,000 during the past 3 months to a new peak of $124,096,976.65. Clippings of this news item were sent to all bankers with whom Guardian maintains banking relationships—with the additional information that all of the 23 banks and trust companies comprising Guardian Detroit Union Group, Inc., showed on December 31, 1930, "Bills payable—None." [47]

Following this statement there were extracts from letters of executive officers of banks or other corporations, and from the commissioner of banking of the Michigan State Banking Department, lauding the financial condition of the unit, as reflected in this statement, and particularly emphasizing the praiseworthy fact that all 23 banks and trust companies comprising the Guardian Detroit Union Group, Inc., showed on December 31, 1930, "Bills payable—None." [48]

In the annual report of the Guardian Detroit Union Group, Inc., as of December 31, 1930, under the caption "Aggregate Resources and Liabilities of Banks and Trust Companies Affiliated with Guardian Detroit Union Group, Inc., as of December 31, 1930", appeared the following: "Liabilities: Bills payable, none." [49]

When questioned upon the practice of the group as to the item of "Bills payable", Lord testified:

Mr. PECORA. Now, Mr. Lord, will you tell this committee whether or not there was a settled policy on the part of the Group to have its unit banks show no bills payable at any time in their statements or reports?

Mr. LORD. I would say it was a settled policy of the banks to show no bills payable, or to keep them at a minimum, at all times.

Mr. PECORA. Was that settled policy of a kind which enabled the unit banks to make in their reports the statement of no bills payable at any time, because bills payable which were in existence were temporarily taken care of by some process or device?

* * * * * * *

Mr. LORD. I would say it was the policy of the Group that the units should make a satisfactory showing on the date of the statements.

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Mr. PECORA. I will make it as simple as I possibly can. From time to time, Mr. Lord, your unit banks were required to publish reports of condition, were they not?

Mr. LORD. Yes, sir.

Mr. PECORA. At any of those times did any of those unit banks have bills payable which were taken care of temporarily in some fashion so as to make it unnecessary to show those bills payable in published reports of condition?

Mr. LORD. Yes, sir.[50]

Two methods or devices were employed to eliminate these "bills payable." When it was expected that a call would be made for a statement of the condition of the unit bank by the Comptroller of the Currency, letters would be sent to the unit banks substantially as follows:

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[47] Committee Exhibit No. 35, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4821, 4833.

[48] Ibid., pp. 4833-38.

[49] Committee Exhibit No. 36, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4824.

[50] Robert O. Lord, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4324-4826.

MR. ALEXANDER ROBERTSON,
Vice president, National Bank of Ionia, Ionia, Mich.

DEAR ALEX: From now until after next call date will you please wire me promptly each morning giving me your deposits in thousands of dollars, and also your bills payable in thousands of dollars. I think there will be no need to mention either the word "deposit" or "bills payable" in the message, but merely use two sets of figures, with the word "stop" between, as follows:

"James L. Walsh, vice president, Guardian Detroit Bank, Detroit, Mich. $7,770,000. Stop. $100,000. Alexander Robertson."

Please do not fail to wire me just as early in the morning as possible, and certainly not later than 10 a.m. Even if you do not need any additional deposits to offset bills payable, it is extremely important that I be informed accordingly, as I may be holding up several other moves awaiting to hear from you." [51]

Where one unit bank loaned money to another unit bank, this loan would appear on the statement of the borrowing unit bank as a "bill payable." As the "call dates" approached, the lending bank would make deposit with the borrowing bank, which would pay the loan. This transaction would be reflected on the statement of the borrowing unit bank by the elimination of the item "bills payable" and an increase in the item of "Amount on deposit with other banks." On the statement of the lending unit bank it would be reflected by the elimination of the item "Bills receivable" and an increase in the item "Amount on deposit with other banks." In this manner the statements of both unit banks were "improved" both as to "Deposits" and "Bills." Immediately after the examination by the Comptroller of the Currency, the lending unit bank would withdraw the deposit it had made in the borrowing unit bank and reloan the amount of this deposit to the borrowing unit bank, thereby restoring the item of "Bills payable." [52]

Mr. PECORA. Then, in its report, in response to the Comptroller's call for a report, that loan, or rather that indebtedness, would not appear in the debtor bank's report of condition as a bill payable, would it?

Mr. LORD. No; but it would appear in the debtor bank's, or in that bank's obligation to its depositors.

Mr. PECORA. Which is something entirely different from its appearance as a bill payable, is it not?

Mr. LORD. Yes; it is different.

Mr. PECORA. This whole thing was simply done to enable the unit banks, in making out their reports of condition pursuant to the call of the Comptroller of the Currency, to avoid reporting to the Comptroller that they actually owed bills payable, was it not?

Mr. LORD. It was done in order to pay off the bills payable.

Mr. PECORA. Were the bills payable entirely liquidated, and the debtor bank entirely freed of the obligation?

Mr. LORD. So far as I know they were, sir.

Mr. PECORA. Was not another obligation substituted for the original obligation?

Mr. LORD. The obligation to a depositor; yes.

Mr. PECORA. Yes. But that obligation so substituted was of a character that made it unnecessary to report it or make it appear as a bill payable, was it not?

Mr. LORD. It was unnecessary to report bills payable when there were no bills payable. [53]

Not only was the cooperation of the unit banks sought in making deposits to be used to eliminate the item of "Bills payable", but

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[51] Committee Exhibit No. 37, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4348.

[52] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4342–4347.

[53] Robert O. Lord, supra, pp. 4354–4355.

the aid of officers was sought to make deposits deliverable for these "Bills payable."

In an intra-Group memorandum dated September 18, 1931, from H. S. Reynolds, president of the Union & Peoples National Bank of Jackson, to James L. Walsh, executive vice president of the Guardian Detroit Union Group, Inc., it was stated:

DEAR JIM: We will be very glad to wire you daily regarding our deposits and loans. I have been hoping to hear from you every day about a deposit. I think it is very important that we do not show any bills payable and that our deposits are increased between now and the time of the call. I have been hoping every day to get some outside money, and I sincerely trust that you will do something for us in the next 3 or 4 days.[54]

This letter clearly showed the dual purpose of these deposits, one objective being to eliminate the item of "Bills payable", and the other to temporarily increase the amount of deposits until after the completion of the report to the Comptroller of the Currency.

Mr. PECORA. Doesn't this letter suggest to you that another settled policy of the Group and its unit banks was to do that which would serve to show an increase in deposits?

Mr. LORD. I don't think so. I think the purpose of Mr. Reynolds was the liquidation of these bills payable.

Mr. PECORA. There is not any mention of liquidating bills payable in this letter, is there?

Mr. LORD. So we will not show or have any bills payable.

Mr. PECORA. It says:

"I have been hoping to hear from you every day about a deposit. I think it is very important that we do not show any bills payable and that our deposits are increased between now and the time of the call."

There were two purposes he had in mind, two objectives: One, to take care by certain methods of bills payable, and, secondly, to increase the deposits between the date of this letter and the time of the next call?

Mr. LORD. Mr. Pecora, every bank was striving to increase its deposits in the face of the constant seepage of deposits. There is nothing wrong about that, trying to increase your deposits. We were going after new business for ourselves and for our unit banks constantly.

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Mr. PECORA. Wasn't it the settled policy of the Group to do that which would enable unit banks from time to time and whenever considered strategically important and necessary for them so to do, to have one or more of the banks in the Group to make deposits with another unit bank in the Group, so as to enable that other unit bank in the Group to make a good showing by way of increase of deposits?

Mr. LORD. No, sir.

Mr. PECORA. What?

Mr. LORD. No, sir.

Mr. PECORA. That was not the policy of the bank?

Mr. LORD. No, sir. The purpose of those deposits was to liquidate the bills payable.

Mr. PECORA. Well, would you say that as a result of the way by which bills payable were offset by deposits one of the effects created by the method was to enable the debtor bank not only to show no bills payable but to show an increase of deposits?

Mr. LORD. That was the effect; yes. That was not the purpose. The purpose was to liquidate the bills payable.[55]

A communication addressed to Herbert S. Reynolds, president of the Union & Peoples National Bank of Jackson, by James L. Walsh,

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[54] Committee Exhibit No. 41, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4858.

[55] Robert O. Lord, Dec. 21, 1938, Guardian Detroit Union Group, Inc., pt. 9, pp. 4859–4360.

executive vice president of the Group, under date of December 31, 1930, it was stated:

DEAR HERB: It begins to look as if none of the banks or trust companies in the Group will be borrowing at the close of business December 31, 1930. Some of the banks have made a point of showing bills payable none in order to emphasize this particular point. In Guardian Detroit Bank we are going to set up our statement with the word " none " instead of 0.00. I am passing along this information to you for what it may be worth.

Please send me at least one-half a dozen of your printed statements as soon as they are ready, because I have some time deposits under negotiation concerning which I will get in touch with you as they develop.[56]

* * * * * * *

This letter disclosed that it was the practice of the officers of unit banks to attempt to induce depositors to distribute their deposits in other unit banks where they would be most helpful to the individual units that belonged to the Group.[57]

Another method employed to eliminate the item of " Bills payable " was to have the debtor unit issue to the creditor unit a demand certificate of deposit before the call dates.

In an intra-Group memorandum dated September 16, 1931, from F. M. Brandon, president of the City National Bank & Trust Co. of Niles, to James L. Walsh, executive vice president of the Group, it was stated:

DEAR COLONEL: Confirming our telephone conversation today, we have borrowed $50,000 of the Federal Reserve bank on Government securities and believe we will need possibly another $50,000, and knowing your desire to avoid, if possible, bills payable, it occurred to us that you might arrange a deposit which would automatically eliminate bills payable at this time, when we are all looking for a call to report from the Comptroller.

This loan is in no sense occasioned by a local loan demand, but is only because of a very decided decline in time deposits, which you know we have faced since June 15 this year, and I shall depend upon your cooperation in arranging for funds in the best way you think desirable at this time.[58]

On September 19, 1931, Alexander Robertson, vice president of the National Bank of Ionia, wrote to James L. Walsh, vice president of the Group, as follows:

DEAR COLONEL: Your letter of September 17 requesting daily wires as to our deposits and bills payable was received. The only bills payable we have are the amounts advanced on certificates of deposit by the Guardian Bank, which at present is $400,000, so I think there is no need to mention this in our wires. If there is, you can advise me.[59]

It is manifest from this letter that the certificate of deposit was used to eliminate the item of " Bills payable." In fact, Alexander Robertson, the vice president of the Ionia Bank, characterized the certificate of deposit as a bill payable.

Mr. PECORA. * * * It is not apparent to you, from this correspondence, what the purpose of it all was?

Mr. LORD. Of that deposit?

Mr. PECORA. Of this whole policy.

Mr. LORD. Mr. Pecora, I have told you the purpose of the policy, namely, to get the banks out of bills payable.

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[56] Committee Exhibit No. 42, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4301.

[57] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4362.

[58] Committee Exhibit No. 30, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4352.

[59] Committee Exhibit No. 40, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4350.

Mr. PECORA. Wasn't that done for the purpose of enabling the banks in their reports submitted in response to calls to create a better appearance than they atually had?

Mr. LORD. I would say to put them in a stronger financial position.

Mr. PECORA. Were they actually put in a stronger financial position?

Mr. LORD. They had the deposits.

Mr. PECORA. Were they actually put in a stronger financial position?

Mr. LORD. I would think so.

Mr. PECORA. They owed $400,000 under the certificate of deposit?

Mr. LORD. To a depositor; yes.

Mr. PECORA. Does that put the bank in a stronger position than if they owed the $400,000 as a bill payable?

Mr. LORD. It does not make their liabilities any less, no; but I consider that it puts a bank in a stronger position to have its liabilities in the form of deposits rather than bills payable. Certainly the public thought so.[60]

A typical instance of the manipulation of certificates of deposit for the purpose of eliminating bills payable was in connection with the Union Industrial Trust & Savings Bank of Flint.

On December 30, 1930, James L. Walsh, vice president of the Group, wired Herbert R. Wilkin, executive vice president of the Union Industrial Trust & Savings Bank, as follows:

Wire me early Wednesday morning your total bills payable, if any, and will endeavor to secure deposit for you to offset.[61]

On December 31, 1930, Mr. Walsh, in an intra-Group memorandum to Wilkin, stated:

DEAR HERB: Agreeable with our telephone conversations today, we have credited your account $1,800,000, representing your certificate of deposit for $1,200,000 received by messenger and a transfer of $600,000 received through the Federal Reserve bank.

In accordance with your instructions, we have charged your account with your notes to the Guardian Detroit Bank aggregating $1,800,000, plus accrued interest to date amounting to $155.55. We are enclosing duplicate deposit ticket in acknowledgment of above credit, debit advice, and your canceled notes.

You will be gratified to know that none of the units of the Guardian Detroit Union Group will show $1 of bills payable in their annual statements to be published shortly.[62]

The bills payable of the Union Industrial Trust & Savings Bank were $2,100,000. Wilkin, who was the operating head of the bank in December 1931, testified that he had been informed that a credit of $600,000 had been placed to the account of the Union Industrial Trust & Savings Bank with the Guardian Detroit Bank, which was to be used to liquidate $600,000 of bills payable of the Union Industrial Trust & Savings Bank. The fact is that this certificate of deposit did not clear and the $600,000 was not deposited with the Guardian Detroit Bank.[63] The statement of the condition of the Union Industrial Bank as at December 31, 1931, signed by Wilkin on January 8, 1932, showed bills payable in the sum of $1,500,000, instead of $2,100,000,[64] although Wilkin knew at the time he signed that statement that the certificate of deposit in the sum of $600,000 had not cleared and that the money had not been deposited to the account of the Union Industrial Bank. Wilkin had ascertained this

[60] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4857.
[61] Committee Exhibit No. 45, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4866.
[62] Committee Exhibit No. 46, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4866.
[63] Herbert R. Wilkin, Jan. 19, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 5001, 5004.
[64] Ibid., p. 5011.

fact on January 3, 1932; and in order to cover up this transaction the necessary entries were made on the books of the Union Industrial Bank.[65]

Mr. WILKIN. I couldn't help it, Mr. Pecora. If this had been deception, I would have put in $2,100,000 of C.D. and wiped out my bills payable. There was no deception as far as I am personally concerned with this matter.

Mr. PECORA. Because you did not wipe out the entire amount of bills payable, $2,100,000, but only wiped out $600,000 thereof, it was no deception?

Mr. WILKIN. Not on my part.

Mr. PECORA. On whose part?

Mr. WILKIN. I don't think on anyone's part.

Mr. PECORA. It would have been deception if the entire amount of $2,100,000 bills payable had been wiped out?

Mr. WILKIN. I might so construe it; yes.

Mr. PECORA. If you go all the way in wiping out those items of bills payable, it is deception; but if you only go part of the way, it is not deception? Is that your philosophy?

Mr. WILKIN. Oh, no, no; providing you do it by soliciting funds and wiping out $2,100,000 in this instance—yes; I would say it was deception. The $600,000 came in unsolicited and went to pay off bills payable.

Mr. PECORA. On January 2, 1932, that certificate of deposit, as appears from the record here, was withdrawn and canceled, was it not?

Mr. WILKIN. That is right.

Mr. PECORA. And that restored that $600,000 to the bills payable account, did it not?

Mr. WILKIN. That is right.

Mr. PECORA. You signed this statement of condition of the bank marked in evidence here as "Exhibit No. 103" on January 8, 1932, did you not? Look at the exhibit and see the date of it.

Mr. WILKIN. Yes, sir.

Mr. PECORA. When you signed that on January 8, 1932, it showed bills payable amounting to only $1,500,000 instead of $2,100,000, and you knew that 6 days before you signed that report, namely, on January 2, 1932, the certificate of deposit by which you were enabled to reduce the bills-payable item from $2,100,000 to $1,500,000 had been withdrawn or canceled?

Mr. WILKIN. I knew it at that time, and should have, of course, checked this statement, which I did not do.[66]

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Mr. PECORA. That statement of the condition of the bank as of December 31, 1931, was dated, as appears from the evidence introduced here last week, January 8, 1932. Do you recall that?

Mr. WILKIN. That is right.

Mr. PECORA. In other words, it was 6 days after it was known that this certificate of deposit had not cleared?

Mr. WILKIN. Yes, sir.

Mr. PECORA. If it was known then that it had not cleared, why was the statement of condition of the bank made out so as to report bills payable at $1,500,000 instead of $2,100,000?

Mr. WILKINS. I cannot answer that question, Mr. Pecora. I did not make out the statement.

Mr. PECORA. You signed it as executive vice president and cashier of the bank?

Mr. WILKINS. Yes; without checking it. As I say, that is a purely routine matter in a bank.[67]

Not only were the bills payable carried at $1,500,000 in the statement of condition of the bank, which was signed on January 8, 1932, but they were also carried at that figure in the printed annual report issued by the Group corporation to its stockholders under date of January 26, 1932.[68] Not only was the item of "bills payable" im-

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[65] Ibid., p. 5004.
[66] Ibid., pp. 5011–5012.
[67] Ibid., pp. 5019–5020.
[68] Ibid., p. 5020.

properly reduced in the sum of $600,000, but the amount of deposits incorporated in the printed report was improperly increased $600,000.

Mr. PECORA. Don't you know that the amount of such deposits were increased in that statement of condition by $600,000 because of this certificate of deposit even though it had not cleared as you say?

Mr. WILKINS. Well, that is obvious; yes, sir.

Mr. PECORA. Why was that done? In other words, why was the bank at Flint crediting itself with a deposit of $600,000, represented by a certificate of deposit that had not cleared?

Mr. WILKINS. I do not understand that question. I do not want to appear evasive about it, but we did not know, Mr. Pecora, that it had not cleared. There was no way for us to know until January 2, when we received our statement from the Detroit bank.

Mr. PECORA. Then, on January 2 did you know that this certificate of deposit had been canceled?

Mr. WILKIN. I did; yes.

Mr. PECORA. Because of the failure on the part of the Guardian Detroit Bank to fulfill its part of the transaction?

Mr. WILKIN. Yes, sir.

Mr. PECORA. Well, if you knew that then, why was the statement of condition, which was made on January 8, 1932, as of December 31, 1931, so made as to show a reduction of bills payable, on account of this certificate of deposit, from $2,100,000 to $1,500,000?

Mr. WILKIN. I cannot tell. I did not make up the statement.[69]

(b) *Detroit Bankers Co.*—The Detroit Bankers Co. units not only solicited deposits and manipulated certificates of deposits to create the impression of sound financial condition,[70] but engaged in a series of reciprocal deposits between the First National Bank, the Peoples Wayne County Bank, the Detroit Savings Bank, and the Detroit Trust Co.

In the letter of September 18, 1931, of R. A. Carroll, examiner, to the Detroit Trust Co., it was stated:

This department frowns upon the plan of building up your reserves through a reciprocal deposit arrangement with other Detroit banks. We realize the present plan of setting up reserves was recently inaugurated, however, the plan of reciprocal deposits should be discontinued as fast as the necessary reserves are built up.[71]

The plan devised by the Detroit Bankers Co. to add a superficial aspect of strength to the financial statements of the units was to have the trust unit, the Detroit Trust Co., make deposits of trust funds with the banking institutions of the Group, which units in turn would simultaneously make deposits in the Trust Co. in an amount equal to the deposits made by the Trust Co. Specifically, on August 8, 1931, the Detroit Trust Co. made deposits aggregating $6,700,000 in the three unit banks.[72]

Simultaneously with the making of these deposits of trust funds by the Detroit Trust Co. in the three unit banks aggregating $6,700,000, the 3 banks, in turn, made deposits with the Detroit Trust Co. in an amount equal to the deposits in each respective bank. These deposits were reciprocal, except that the deposits made by the Detroit Trust Co. with the banks were fiduciary accounts, while the

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69 Ibid., pp. 5020–5021.

70 For testimony relating to manipulating certificates of deposits issued to Ford Motor Co., see Ralph Stone, W. J. Thomas, and McPherson Browning, Jan. 31, 1934, Detroit Bankers Co., pt. 11, pp. 5359–5374.

71 Committee Exhibit No. 109, Jan. 31, 1934, Detroit Bankers Co., pt. 11, p. 5336.

72 Committee Exhibit No. 108, Jan. 31, 1934, Detroit Bankers Co., pt. 11, p. 5335.

deposits made by the 3 banks in the Detroit Trust Co. were ordinary deposits. They corresponded exactly in amount and in time.[73]

When the Detroit Trust Co. solicited a deposit from one of the unit banks, the Trust Co. promised to make a deposit of trust funds in an equal amount in the unit bank. The testimony clearly demonstrates that these deposits were reciprocal, despite Stone's resistance to that characterization.

Mr. PECORA. And according to committee's exhibit 108, the aggregate amount of those deposits on August 8, 1931—or rather, that was the date when they were opened—was $6,700,000, distributed through those three banks, the Peoples Wayne County Bank, the First National Bank of Detroit, and the Detroit Savings Bank.

Mr. STONE. That is correct.

Mr. PECORA. Now, at the time of the making of these deposits by the Detroit Trust Co. in those three banks of trust funds aggregating $6,700,000, did those three banks, in turn, make reciprocal deposits corresponding to the respective deposits opened with them?

Mr. STONE. They made deposits, but not reciprocal deposits.

Mr. PECORA. What kind of deposits did they make?

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Mr. STONE. They were not reciprocal, because these deposits in exhibit no. 108, $6,700,000, were fiduciary accounts. The deposits which were made by the banks with us were on certificates of deposit, ordinary deposits. They were not reciprocal.

Mr. PECORA. What was the amount of those deposits made with the Detroit Trust Co. by those 3 banks at the time of the opening of these 3 deposit accounts with those 3 banks?

Mr. STONE. They were the same amounts.

Mr. PECORA. They corresponded exactly, did they not?

Mr. STONE. Yes.

Mr. PECORA. $6,700,000 in the aggregate?

Mr. STONE. That is correct.

Mr. PECORA. You say they were not reciprocal deposits?

Mr. STONE. No, sir.

Mr. PECORA. How do you account for the absolute correspondence in amount? That was not a mere coincidence, was it?

Mr. STONE. No; not at all. We found it advisable to segregate our trust balance; that is, to make deposits in other banks separately, as to fiduciary accounts.

Mr. PECORA. Yes.

Mr. STONE. We had not sufficient cash balances at the time to do that, so we solicited deposits from the First National Bank of Detroit, the Peoples Wayne County Bank, and the Detroit Savings Bank, those three banks mentioned there.

Mr. PECORA. And you got deposits in response to your solicitations from those three banks?

Mr. STONE. Yes.

Mr. PECORA. In amounts exactly corresponding to the amounts of deposits of fiduciary funds that the Detroit Trust Co. made in those three banks?

Mr. STONE. That is correct.

Mr. PECORA. And you got them at the same time that you made those deposits in those three banks of fiduciary funds, did you not?

Mr. STONE. That is correct.

Mr. PECORA. You say those are not reciprocal deposits?

Mr. STONE. No, sir.

The CHAIRMAN. They are reciprocal in amount.

Mr. STONE. They are equal in amount and equal as to date.

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Senator COUZENS. Now, look here. When you asked the Detroit Savings Bank, for example—I am just using that because that was not one of your subsidiaries or group units—when you asked them for a deposit of half a

[73] Ralph Stone, Jan. 31, 1934, Detroit Bankers Co., pt. 11, p. 5344.

million dollars, didn't you promise to put half a million dollars back as a trust fund?

Mr. STONE. Yes.

Senator COUZENS. That is what I am trying to get at.

Mr. STONE. Certainly.

Senator COUZENS. Is not that reciprocity?

Mr. STONE. It is not a reciprocal account. It is reciprocity.

Senator COUZENS. Certainly. What is the difference between a reciprocal account and reciprocity? You told the Detroit Savings Bank that if they would put in half a million dollars with you, under a certificate of deposit, you would, in turn, put half a million dollars back with them.

Mr. STONE. The difference is——

Senator COUZENS. You do not deny that, do you?

Mr. STONE. No; that is all right. The difference is that the fiduciary account belonged to the trusts.

Senator COUZENS. We understand that. But you know that you did not have the money that you ought to have had for your fiduciary account. You had used it for other purposes and, therefore, did not have your fiduciary cash that was required by law, so you borrowed it, in effect, from these other units to make good your fiduciary account. You cannot deny that. That is a fact.

Mr. STONE. We did not borrow it.

Senator COUZENS. No; you got it as a deposit.

Mr. STONE. Yes.[74]

(ii) *Nondisclosure of hypothecation of United States Government, State, and municipal bonds.*—In the report of the Guardian National Bank of Commerce made to the Comptroller of the Currency as of November 9, 1932, it appeared that as of that date the bank had United States Government bonds pledged to an amount of $11,021,144.25, and United States Government bonds unpledged in the amount of $3,596,145.[75] Although the United States Government bonds were generally regarded as most liquid in character, a substantial amount of these bonds were not available for immediate use since they had been hypothecated or pledged. In the condensed report that was issued in behalf of the Guardian National Bank of Commerce as of December 31, 1932, the pledging of 75 percent of the United States Government securities owned by that bank was not shown.[76]

Mr. PECORA. The condensed report showed the ownership of these Government securities by the bank, as though they were unpledged.

Mr. LORD. No; I would not say that. It showed that those bonds were among the assets of the bank.

Mr. PECORA. And no mention was made of the fact that they were pledged to the extent of about 75 percent thereof?

Mr. LORD. No mention made of it.

Mr. PECORA. Does not that operate to give an inaccurate picture to one reading that condensed report?

Mr. LORD. I think it does, but it is the customary form of publication by banks of their condensed statements, Mr. Pecora. I think it is a mistake that banks should have published their statements in that way.

Mr. PECORA. Do you know what prompted the bank to do that?

Mr. LORD. I suppose many years of custom with many of the banks.

Senator COUZENS. I see that the banks have changed that in some respects.

Mr. LORD. They have; and I think it is a very good thing, Senator.[76]

(iii) *Inclusion of customers' securities held for safe-keeping.*—It was formerly the practice to include in the Group's statement the item "Customers' Securities, Safe-keeping." While this item was offset on the liability side, its inclusion still had the effect of swelling

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[74] Ralph Stone, supra, pp. 5344–5346.
[75] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4379.
[76] Robert O. Lord, supra, p. 4379.

the total resources and "window dressing" the financial condition of the Group corporation.

In the 1929 annual report of the Guardian Detroit Union Group, Inc., under the caption "Aggregate Resources and Liabilities of Banks and Trust Companies Affiliated with Guardian Detroit Union Group, Inc., as of December 31, 1929", on the asset side under the caption "Resources" there was the item "Customers' Securities, Safe-keeping, $12,594,330.16", and an offsetting item under the caption of "Liabilities" characterized the same way.

Mr. PECORA. Do you know why this statement of aggregate resources of unit banks, as a consolidated statement, showed that item?

Mr. LORD. I suppose because that consolidated statement was made up by adding the items of the various separate unit banks. That item is along the lines of just what I was speaking about this morning in connection with the Niles bank, where they took out of each side the trust assets. In other words, some of the banks in the group, as I recall it, following an old-fashioned custom, had included in their statements the safe-keeping bonds, which, when you include them in the total resource figures, unduly inflate the totals.

Mr. PECORA. It builds up the picture of the bank's size.

Mr. LORD. It builds up the picture, and I assume it is in that particular statement, because that statement was made up by adding all the separate statements. I know of no other reason why it should have been in there, and personally I do not think it means anything in the statement and should be left out of all statements.[77]

Although this practice of including customers' securities for safe-keeping was abolished in the consolidated statements of the Group corporation, the practice was continued in the statements of some of the unit banks.[78]

(iv) *Inclusion of trust funds and funds for safe-keeping.*—Some of the unit banks included in the asset side of their statements funds held in trust or in safe-keeping, with a corresponding offsetting item on the liability side.[79]

The CHAIRMAN. As a matter of fact, funds that were held simply for safe-keeping were not resources of the bank at all?

Mr. LORD. Senator Fletcher, the items referred to there were securities that were held subject to safe-keeping, not dollars and cents.

The CHAIRMAN. Not owned by the bank? They were not owned by the bank?

Mr. LORD. No, sir; indeed, they were not. And it showed not only on the asset side but an offsetting item on the liability side, which was just a wash item.

Mr. PECORA. But they did not have any part in the bank's resources?

Mr. LORD. Absolutely none.

Mr. PECORA. And should not have been shown at all?

Mr. LORD. Absolutely no. You cannot argue with me about it. I am for it a hundred percent. They should have been out.[80]

(v) *Inclusion of resources of banks not affiliated with the Group as of the date of the report.*—In the printed annual report of the Guardian Detroit Union Group, Inc., as of December 31, 1929, there was included the resources of seven national banks which actually were not units of the Group as of that date. The aggregate resources of these seven national banks was $63,552,000. These seven national banks were taken into the Group on January 28, 1930. The report which was captioned "Annual Report, 1929" was mailed to the stockholders with a letter dated January 28, 1930. The report failed to disclose that these seven national banks, whose resources were

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[77] Robert O. Lord, supra, pp. 4380–4381.
[78] Robert O. Lord, supra, p. 4381.
[79] Robert O. Lord, supra, pp. 4382–4383.
[80] Robert O. Lord, supra, pp. 4382–4383.

included in the annual report as of December 31, 1929, were not part of the Group during 1929.[81]

(vi) *Nondisclosure of the condition of security and nonbanking units.*—In accordance with the laws of the State of Michigan, the Guardian Detroit Union Group, Inc., reported to the Michigan Securities Commission for each of the calendar years 1930, 1931, and 1932. The Group report for the year 1930 filed with the Michigan Securities Commission showed a deficit of $39,387.57 after dividends of $4,930,991.28 had been paid.[82] The Group report for the year 1931 showed a deficit of $288,930.33 after dividends of $3,085,416.38 had been paid.[83] The Group report for the year 1932 showed a deficit of $714,331.26 after dividends of $375,134 had been paid.[84]

In the annual report sent by the Group Corporation to stockholders in 1930 it was stated:

> The policy of maintaining a highly liquid position is naturally reflected in reduced earnings. Nevertheless your company earned more than sufficient to pay during 1930 regular quarterly dividends at the rate of $2 per annum and an extra dividend at the rate of $1.20 per annum.[85]

Although this statement was literally correct, the inference was plain that in paying those dividends no loss was incurred, while the fact was that the Group did incur a loss.[86]

So, too, in the annual report sent by the Group Corporation to stockholders in the year 1931 it was stated:

> For the year ended December 31, 1931, the net earnings of the banks and trust companies of the Group, after all expenses of operation and after setting aside adequate reserves for taxes and depreciation of banking quarters and equipment, but before charge-offs, were $3,887,052.86, or at the rate of $2.51 per share on the 1,544,844 shares of the Group stock $20 par value outstanding.[87]

This report to stockholders showed a net earning, while the fact is that the report to the Michigan Securities Commission showed a loss for that year.

Robert O. Lord attempted to justify the statements contained in the annual reports sent to stockholders upon the ground that these reports referred only to the bank and trust-company units in the Group and did not include security and other affiliate units of the Group.[88] Mr. Lord was compelled to admit, however, that the annual reports sent to stockholders were reports of the Group Corporation, and he could not justify the omission of the condition of the nonbanking units and the exclusion of the deficit of the Group Corporation for these years.

> Mr. PECORA. Is there anything in this annual report to the stockholders for the year 1931 that informs the stockholders of the fact that for the year the Group sustained a deficit or loss of $288,930.33?
>
> Mr. LORD. I do not recall any such statement in that report; no.
>
> Mr. PECORA. Why was that information, then, withheld in this annual report to the stockholders from the Group?

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[81] Robert O. Lord, supra, p. 4387.

[82] Committee Exhibit No. 54, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4461–4462.

[83] Committee Exhibit No. 55, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4463–4464.

[84] Committee Exhibit No. 56, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4468.

[85] Committee Exhibit No. 86, Dec. 20, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4435.

[86] Robert O. Lord, supra, pp. 4435–36.

[87] Ibid., p. 4436.

[88] Ibid., p. 4436.

Mr. LORD. I suppose it never occurred to us to put it in. I do not know the reason. I would have to go back into the details and study the figures.

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Mr. LORD. I do not know of any reason for not telling them. Perhaps it should have been put in the report.

Mr. PECORA. Why was it not put in the report?

Mr. LORD. I do not know why it was not.

Mr. PECORA. If you do not know, who would know? You were the executive head of the group. Now, if you do not know, who would know?

Mr. LORD. The report was sent out after a full discussion of the details of it and the form of it, by the executive committee.

Mr. PECORA. And you participated in such discussion.

Mr. LORD. I assume I did; yes, sir.

Mr. PECORA. Then, why can you not tell us why the deficit incurred for the year was not stated in the annual report issued by the Group to its stockholders?

Mr. LORD. I do not know why it was not.

Senator ADAMS. Mr. Lord, I had assumed that the purpose of the formation of the Group was to make profits. It had no other purpose than that?

Mr. LORD. I suppose that is the purpose of every business.

Senator ADAMS. Would it not seem, then, that the accomplishment, or failure to accomplish the specific purpose, would be one of the things the stockholders would be interested in?

Mr. LORD. I would think so; yes. Probably we were at fault in not including that detail.

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Mr. PECORA. And you are utterly unable to give this committee a single reason why, in the annual reports issued to the stockholders for each of those 3 years, 1930, 1931, and 1932, no mention whatsoever was made of the loss sustained by the Group in each one of those years?

Mr. LORD. I do not know why it was omitted.

Senator ADAMS. I think, Mr. Pecora, we can infer why. I think we do not advertise our losses.

Mr. PECORA. I would say that is a studious concealment.

Senator ADAMS. Yes.

Mr. PECORA. But this witness denies that.

The CHAIRMAN. For each of those years the Group paid a dividend?

Mr. LORD. Yes, sir.[89]

Mr. W. A. Eubank, in charge of accounting of the Guardian Detroit Union Group, Inc., testified that the reason that the deficits were not shown in the annual reports sent to stockholders was because they would have had a reactionary effect on the public and might have caused a collapse of the banking institutions of the Group.[90]

Mr. PECORA. What was the principal purpose of making any report annually to the stockholders of the Group?

Mr. LORD. To advise the stockholders of the condition of their assets.

Mr. PECORA. And to advise them of the condition of the company and the business of the company, wasn't it?

Mr. LORD. I would think so.

Mr. PECORA. And the principal thing that a stockholder would be interested in knowing is whether or not his company conducted business at a profit or at a loss for the year, is it not?

Mr. LORD. I think it was one of the things he should know; yes.

Mr. PECORA. Then why wasn't he told that in the annual report, if you think it is one of the things he should have known?

Mr. LORD. Mr. Pecora, I have attempted this morning to answer that question.

Mr. PECORA. I don't think you have answered it yet. You have not yet given a single reason why no mention was made of the deficit incurred in any one of these years in the annual reports issued to the stockholders, have you?

Mr. LORD. I have not.

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[89] Ibid., pp. 4436–4438.

[90] W. A. Eubank, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4448.

Mr. PECORA. Then why do you say you have told me that already?
Mr. LORD. I said I had attempted to answer your question.
Mr. PECORA. Now, will you please make another attempt, and this time see if you can't answer it?

* * * * * * *

Mr. LORD. Mr. Pecora, I don't know, unless the form of the report as it was prepared by the committee was the form in which they thought it should be prepared.

Now, let me say this, that if these reports did not include information that the stockholder should have, we were unquestionably subject to criticism. I will admit that.

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Mr. PECORA. Well, did you ever see a report, compilation of figures, that showed definitely that the company for the year had operated at a loss?
Mr. LORD. I assume I did; yes, sir.
Mr. PECORA. Is that anything more than an assumption?
Mr. LORD. Well, yes; I did. It was my duty to do it.
Mr. PECORA. If you did, why didn't you, as the executive head of the company and as the man who signed the report to the stockholders, see to it that mention of the deficit was made in the report issued to the stockholders?
Mr. LORD. I suppose I should have, Mr. Pecora.[91]

(vii) *Confusing and unintelligible statements and reports.*—The Guardian Detroit Union Group, Inc., deliberately planned to issue its statements and reports in such form as to be unintellible to the average layman.

The minutes of the meeting of the public relations committee held on June 25, 1931, stated:

(*a*) A discussion followed of the consolidated Group statement, which is to be printed in poster form 3 or 4 days after the unit statements are available. It was finally decided that this consolidated statement would be printed in the standard form rather than in the understandable form, as it had been originally set up. It was felt that the understandable form was devised at a time when conditions warranted such a statement, whereas the situation is now entirely different, and it will be much better to use the same type of statement for the newspapers, for printed statements, and for posters.[92]

* * * * * * *

It was thought particularly wise at this time to stress the names of the various units together with the cities in which they are located, so that the public will know exactly what banks are in our Group in the various cities.

At a later date it may be advisable to use the understandable consolidated statement form, and it was decided to hold it in reserve for the time being.

Mr. Paterson brought out the point of using the phrase "total resources in excess of $500,000,000", and it was decided to leave this off for the time being, inasmuch as we do not have much leeway with respect to this figure. Later on, if we find there is a wider margin, this phrase can be used.[93]

* * * * * * *

(*6*) A discussion followed regarding the strength of group banking as contrasted to individual banks, and it was suggested that we should take advantage of this as much as possible in a subtle way, pointing out that very few, if any, group banks had failed and were ranked with our strongest institutions, whereas individual banks have been dropping by the wayside in small towns throughout the country. This is especially true in the lower Michigan district, where within the past month bank failures occurred in Pontiac, Birmingham, Royal Oak, and other small towns.[94]

It is apparent that all the efforts of the public relations committee were devoted to supplying statements and publicity that would suppress the real condition of the bank and create a financial mirage.

[91] Robert O. Lord, Dec. 22, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4449–4450.
[92] Ibid., p. 4367.
[93] Ibid., p. 4370.
[94] Ibid., p. 4371.

In an intra-Group memorandum from F. M. Brandon, president of the City National Bank & Trust Co. of Niles, to James L. Walsh, vice president of the Group, under date of January 8, 1931, it was stated:

DEAR COLONEL: Your letter of January 6 enclosing copy of a suggested newspaper article is received, and the copy was delivered to the local editor. However, the fact that we had a slight decrease in commercial deposits between the September 24 and December 31 call necessitated some change so that the article was finally prepared and, at the suggestion of the editor, was published as an interview with the writer in order to divest the item from the appearance of advertising, and we are enclosing herewith a copy of the clipping.[95]

(*d*) LOANS ON GROUP STOCK AS COLLATERAL

(1) *Guardian Detroit Union Group, Inc.*—The Michigan banking law, as does the National Banking Act, prohibits a bank from holding or purchasing any of its capital stock, unless such purchase is necessary to prevent loss upon a debt previously contracted in good faith. Neither State nor National banks may make loans secured by their own stock as collateral.

In April 1929 William Taylor, bank examiner, who made an investigation of the National Bank of Commerce, in referring to the stock of the Union Commerce Investment Co., which was the investment or securities affiliate of the National Bank of Commerce, stated:

Loans aggregating $2,021,015 secured entirely or in part by 2,583 shares of stock of this company, are subject to criticism on two occasions: First, the concentration is regarded as excessive; and, secondly, for the reason that the investment company owns practically all the stock in the subject bank, and the pledged stock as collateral for loans amounts to a circumvention of the law.[96]

At that time Bert K. Patterson, who subsequently became vice president of the Guardian Detroit Union Group, Inc., was chief examiner of the seventh Federal district, and he signed this report as such chief examiner before forwarding it to the Comptroller of the Currency.[97] He disclaimed any knowledge of or responsibility for the criticism of circumvention of the law, stating that he signed the report as chief examiner as a matter of office routine.[98]

On January 10, 1929, in a communication from John S. Proctor, Deputy Comptroller of the Currency, to Earl W. Moon, national bank examiner, the Deputy Comptroller ruled that since the Union Commerce Investment Co. was in reality a holding company for the stock of the National Bank of Commerce, the Union Trust Co., and the Griswold-First State Bank, the stock of the Union Commerce Investment Co. was not the capital stock of the bank within the meaning of section 5201, United States Revised Statutes, even though a part of its assets consisted of stock of the bank.

Mr. Proctor further stated:

* * * The matter of accepting stock of the company as collateral to a loan is one for the determination of the management of the bank, although this office does not look with favor on loans secured by stock of a company

[95] Committee Exhibit No. 47, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4373.
[96] Robert O. Lord, supra, pp. 4477, 4479.
[97] Bert K. Patterson, Jan. 8, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4484.
[98] Bert K. Patterson, supra, p. 4481.

so closely allied to the bank and having little or no assets other than stock in banks, National and State.[90]

The examination of the National Bank of Commerce made by the examiner as of September 15, 1930, which was after Bert K. Patterson became vice president of the Group, showed that 48,431 shares of the stock of Guardian Detroit Union Group, Inc., were being held as collateral for loans, and that new loans with the stock as collateral were unfavorably regarded. Numerous loans based on this stock were presently lacking collateral coverage.

Instead of allaying this condition of using Group stock as collateral, the condition became aggravated.

In the report of Examiner Hopkins of March 2, 1931, it was stated:

Loans secured by the capital stock of the Guardian Detroit Union Group. The management should seriously consider the possibility of an unwarranted concentration being brought about through an apparent liberal policy in extending loans predicated on shares of an affiliated or parent concern. Many of the loans classified as slow in this report are secured by this stock and now show a deficit due to the reduction in market value. * * *[1]

The number of shares of Group stock held by the bank as collateral for loans had increased to 57,531 shares, and the report stated:

Your examiner is of the opinion that the loans secured by the stock of the Guardian Detroit Union Group constitute an unwarranted concentration. The bank is handicapped in liquidating its debt from the sale of this stock for the reason that the most of its shareholders acquired the stock at a period when it was selling on the market anywhere from $100 to $300. At the beginning of the examination the market value of the stock was $50, and at the time the examination closed the market value had dropped to $40 due to the closing of the American State Bank.

Your examiner has no opinion as to the recovery of the stock, but it is surmised that a long period will be required before the bank is in position to eliminate many of these losses.[2]

As of May 16, 1932, 149,574 shares of the Group stock were held as collateral for loans—an increase of nearly 100,000 shares over the number of shares held as collateral on March 2, 1931.[3]

The practice of the unit banks carrying the stock of the Group as collateral in large amounts was frequently severely criticized by the national bank examiners.[4] The Comptroller of the Currency, in the report of January 28, 1933, to the board of directors, stated:

Attention is also called to the special schedules on page 9-A and continuing sheets which show the extent to which loans have been granted on stock of the Guardian Detroit Union Group, which is to all intents and purposes equivalent to loaning on the bank's own stock, as the Group owns all of the bank's stock except the qualifying shares of the directors.

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Mr. PECORA. That was not the first time this kind of criticism had been made, was it?

Mr. LORD. It is the first time I recall any written criticism from the Comptroller's Office. I think we discussed with the examiners the advisability of getting it out, though.

Mr. PECORA. Had there not been criticism expressed to you or to the board by the Comptroller's representatives on prior occasions on this score?

Mr. LORD. Possibly in personal conversation. They knew our attitude. We were trying to get it out just as fast as we could.[5]

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[90] Committee Exhibit No. 58, Jan. 3, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4518.
[1] Supra, p. 4491.
[2] Ibid., p. 4501.
[3] Ibid., p. 4508.
[4] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4390.
[5] Robert O. Lord, supra, p. 4898.

Mr. PECORA. Now, the national bank examiners criticized that frequently, did they not?
Mr. LORD. They did.[6]

Bert K. Patterson, former vice president of the Group, admitted that these loans on Group stock were in circumvention of the law and almost tantamount to a violation of the law.

Mr. PECORA. What do you think was the purpose of the enactment which prohibited national banks from making loans secured by their own stock?
Mr. PATTERSON. I do not believe I could answer that question either.
Mr. PECORA. Why not?
Mr. PATTERSON. Well, it was, perhaps, for the purpose of preventing the lending of the bank's own capital.
Mr. PECORA. That is sound public policy, isn't it?
Mr. PATTERSON. Yes, sir.
Mr. PECORA. Now, where a bank's own capital is owned by another corporation, not organized under the banking laws but practically whose sole asset is the bank's capital, don't you think a loan made by such a bank secured by the stock of the holding company is in effect a loan secured by the stock of the bank?
Mr. PATTERSON. No; I do not.
Mr. PECORA. What are the differences?
Mr. PATTERSON. I think you are lending against entirely different collateral.
Mr. PECORA. Well, of course it is different collateral in form, but the value of the collateral upon which the loan is made is dependent upon the value of the bank's stock, which is the sole asset of the company whose security in the shape of stock is taken as collateral. Isn't that a fact?
Mr. PATTERSON. Yes, sir.
Mr. PECORA. You still see a difference between the two?
Mr. PATTERSON. As to form, I think there is a difference.
Mr. PECORA. Oh, there is no doubt that there is a difference as to form; but why do you ignore the substance?
Mr. PATTERSON. Well, I suppose you would have to recognize that, too.
Mr. PECORA. Well, do you recognize it?
Mr. PATTERSON. Yes.
Mr. PECORA. And recognizing the substance, do you still say that there is fundamentally a difference between the two acts?
Mr. PATTERSON. I think if you followed it right on through you would trace it on to a violation.
Mr. PECORA. Do what?
Mr. PATTERSON. That you would probably trace it on to a violation.[7]

(2) *Detroit Bankers Co.*—The concentration of the Group company stock as collateral for loans by the unit banks existed also among the units in the Detroit Bankers Co.

It was disclosed in the examiner's report of the First National Bank in Detroit, made as of May 6, 1932, that the stock of the Detroit Bankers Co. had dropped from over $300 per share to $20 per share at the commencement of the examination, and to $9 per share at the close of the examination. Approximately 250,000 shares of Detroit Bankers Co. stock were held by the unit bank as collateral for the larger commercial loans. The report further stated:

* * * Certainly this was a dangerous act on the part of the directors in allowing such a condition to take place and does not speak much safety for the group-bank plan. The bank contains a loan of $4,000,000 of this company, which, of course, is not collectible at the present time; in fact, is in reality a loss to the bank on the present basis.[8]

In November 1932, the First National Bank in Detroit had $25,000,000 in loans secured either in whole or in principal part by the stock of the Detroit Bankers Co.

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[6] Robert O. Lord, supra, p. 4390.
[7] Bert K. Patterson, Jan. 8, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4499.
[8] Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5397.

The examiner's report again criticized the large concentration of stock as collateral for loans and reported that the securities market could only absorb a small amount of the stock. The report emphasized the fact that little value could be placed upon the Group stock for collateral purposes.[9]

The practice of the units making loans on the stock of the Detroit Bankers Co. was criticized from almost the very inception of the Group company. In the letter of Examiner Carroll, dated September 18, 1931, to the Detroit Trust Co. it was shown that loans by that unit secured by Detroit Bankers Co. stock aggregated $1,640,544.86, which, when totaled with a loan to the Detroit Bankers Co., comprised 31.5 percent of the total loans and discounts of the Trust Co. The report stated:

> This department recommends that in the future no additional loans be extended which are predicated upon Detroit Bankers Co. stock and that your present loans be gradually eliminated whenever possible.[10]

Although the officers of the Detroit Bankers Co., to meet the examiner's criticism of the concentration of Group stock as collateral, may have desired to decrease these holdings of the various units, the basic financial structure of the group system militated against substantial liquidation.

The Detroit Bankers Co. stock, like the Guardian Detroit Union Group, Inc., stock, was listed on the Detroit Stock Exchange.[11] Any substantial liquidation of Group stock collateral would immediately be reflected in the market quotation of the stock, with a resultant impairment of confidence of the public in the Group company and its various units. Any decrease in the market quotation of the Group stock would proportionately depreciate the collateral value of the stock and undercollateralize the loans secured by Group stock.[12]

Loans to directors, officers, and employees were usually secured by Detroit Bankers Co. stock, and the units could not liquidate that collateral.[13]

The most undesirable aspect of this concentration of Group stock as collateral was that the unit banks were compelled to continue declaring dividends. A cessation of dividends would occasion a decrease in the market price of the stock, with a resultant decrease in value of the collateral held by the unit banks.

Mr. PECORA. Through this policy of the unit banks having these heavy concentrations of collateral against loans, consisting of Detroit Bankers Co. stock, were not the unit banks put in a position whereby in order to prevent any depreciation in the market value of that Detroit Bankers Co. stock, they had to extend themselves to the utmost in paying dividends to the Detroit Bankers Co. so as to enable the latter, in turn, to meet its dividend requirements of 17 percent on the par value of its own capital stock?

Mr. STONE. I do not think that influenced them in the payment of dividends or fixing the rate. I can speak for myself. It would not influence me.

Mr. PECORA. Would not that have been the effect, a necessary effect and consequence, of these heavy concentrations of collateral consisting of Detroit Bankers Co. stock?

Mr. STONE. To what effect do you refer? That the higher the dividends the——

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[9] Edward Douglas Stair, supra, pp. 5397, 5418.
[10] Committee Exhibit No. 109, Jan. 31, 1934, Detroit Bankers Co., pt. 11, p. 5386.
[11] Ralph Stone, Jan. 31, 1934, Detroit Bankers Co., pt. 11, p. 5341.
[12] Ralph Stone, supra, p. 5339.
[13] Ralph Stone, supra, p. 5339.

Mr. PECORA. No; that unless dividend requirements on the Group Co. stock were met by the Detroit Bankers Co., the market value of that stock would depreciate, and to that extent the loans secured by that stock in the various unit banks would become impaired as to the security to the extent of such depreciation?

Mr. STONE. Another way of stating that would be that as the dividends went down, the market value of the stock would go down, and its value as collateral would go down.

Mr. PECORA. Yes.

Mr. STONE. Yes; I think that is true.

Mr. PECORA. Did not that put the various unit banks under the burden, so to speak, of going the limit by way of declaration of dividends to the Detroit Bankers Co. to enable the Detroit Bankers Co. to meet its dividend requirements on its own capital stock, so as to support the market value of it?

Mr. STONE. The Detroit Bankers directors may have been subject to influences of that kind in their minds, but I do not think that it had any effect in fixing the dividends of the Detroit Bankers Co.

Mr. PECORA. Mr. Stone, if that influence would manifest itself on the directors of the Detroit Bankers Co., would it not also manifest itself on the boards of directors of the various unit banks, in view of the fact that there sat on the boards of the various unit banks, in every instance, officers or directors of the Detroit Bankers Co.?

Mr. STONE. I think naturally that whatever information they obtained from their membership, whatever opinions they formed from their membership on the Detroit Bankers Co., would be used, and would influence them in connection with their duties as directors of the constituent units.[14]

The principal source of earnings of the Group company from which dividends could be declared was the dividends declared by the unit banks on their capital stock, which was owned by the Group company.

The group-banking system brought about a condition of concentration of Group stock as collateral and compelled declarations of dividends by the unit banks to maintain the value of this collateral and the earnings of the parent company.

As was stated in the May 1932 report of the examiners:

> The first quarterly dividends were paid on the basis of 16 percent annually. This is entirely too large; and while the examiner feels that it should be eliminated entirely, the effect of so doing would probably cause them too much trouble. To eliminate dividends altogether would mean the Detroit Bankers Co. could not, in turn, pay dividends, and this would demoralize the market and perhaps cause a run on the bank. It is therefore suggested that they be allowed to pay up to 8 percent annually for the present.[15]

At the time of the Michigan bank moratorium, February 14, 1933, the First National Bank alone had approximately 300,000 shares of Detroit Bankers Co. stock as collateral for loans. This stock had no market value after the banking holiday.[16]

(e) LOANS TO OFFICERS AND DIRECTORS

(1) *Guardian Detroit Union Group, Inc.*—The Group banking system encouraged substantial loans to officers by the unit banks, a substantial part of which were secured by the Group stock.[17]

As of May 16, 1932, there were outstanding direct loans aggregating $4,416,451.66 and indirect loans of $3,338,910.75 to officers, directors, and employees of the First National Bank of Detroit.[18]

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[14] Ralph Stone, supra, p. 5340.
[15] Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5402.
[16] Wilson W. Mills, Feb. 7, 1934, Detroit Bankers Co., pt. 12, p. 5618.
[17] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4389–4390.
[18] Robert O. Lord, supra, p. 4392.

Fred T. Murphy, chairman of the board of the Guardian National Bank of Commerce, owed $606,250; Ernest Kanzler, chairman of the board of the Guardian Detroit Union Group, Inc., owed $382,190.52 on a direct loan and $350,000 on an indirect loan; and Phelps Newberry, an officer of the bank and a director of the Group, owed $579,970 on a direct loan and $5,000 on an indirect loan.[19]

As of November 9, 1932, the Guardian National Bank of Commerce had outstanding noncollateralized loans of $1,740,743 and collateralized loans of $1,741,625 to officers and directors. Loans were made to 52 of the 61 directors and to 33 of the 43 officers of the main branch. In addition, 55 loans were made to lesser employees of the bank.[20]

As of December 13, 1932, the officers and directors of the Union Guardian Trust Co. were liable to the bank on their respective individual accounts in an aggregate of $2,477,040.45, and as endorsers or guarantors in the sum of $136,010.

Robert Oakman, a director of the Union Guardian Trust Co., had a direct liability of $1,653,412.65 and a guarantor's liability of $105,000, exclusive of mortgage loans effected to him. As of September 14, 1931, the aggregate liability of $1,283,000 of Oakman to the Union Guardian Trust Co. had been classified by the State bank examiner as "slow"; yet during the year 1932 the liability of Oakman had been increased by approximately $400,000.

J. Walter Drake, a director, was indebted in the sum of $159,712.50, and Frank W. Blair and C. L. Ayres were jointly indebted in the sum of $124,640.34 to the bank.[21]

(2) *Detroit Bankers Co.*—The Detroit Bankers Co. presented the same condition as the Guardian Detroit Union Group, Inc., in relation to the loans to directors, officers, and employees.

As of December 17, 1931, direct loans to directors aggregated $22,165,461.49, less duplications of $1,423,438.79, or a net total of directors' loans of $20,742,022.70. The affiliated borrowings of these directors totaled $53,346,276.45, less duplications of $31,959,293.99, or a net total of affiliated borrowings of $21,386,982.46. The total of direct loans to directors and affiliated borrowings of directors was $42,129,005.16.[22]

As of December 31, 1932, there was owed to the First National Bank in Detroit by officers and employees the sum of $3,154,546, with 29,905 shares of Detroit Bankers Co. stock as collateral. As of the date of the closing of this institution, February 11, 1933, there were outstanding $3,119,490 in loans to officers and employees, collateralized by 29,792 shares of the Detroit Bankers Co. stock, and $20,568,554.39 in loans to directors, collateralized by 59,922 shares of Group stock; direct loans of $9,956,321.56, and indirect loans of $46.251.68 to corporations and enterprises of which directors of this unit bank were officers or directors.[23] According to the compilation

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[19] Robert O. Lord, supra, p. 4391.

[20] Robert O. Lord, supra, pp. 4391–4394.

[21] Clifford B. Longley, Jan. 17, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4860–4863. A detailed discussion of the loans to officers and directors is contained in the record: See Clifford B. Longley, supra, pp. 4860–4867.

[22] Wilson W. Mills, Feb. 7, 1934, Detroit Bankers Co., pt. 12, pp. 5627, 5629. Committee Exhibit No. 160, Feb. 7, 1934, Detroit Bankers Co., pt. 12, p. 5681, contains a detailed, itemized list of each loan to officers and directors, whether direct or indirect, the value of the collateral, and affiliated borrowings of each of these officers: See Exhibits Nos. 15H, 15I, and 15J, pp. 5692–5697.

[23] Wilson W. Mills, supra, p. 5619.

made as of the date of the banking holiday by C. L. Thomas, the receiver of the First National Bank, that unit bank had outstanding loans to directors, officers, and employees, both direct and indirect, aggregating $33,296,618.64.[24]

Although the loans to officers and directors had been repeatedly criticized by the bank examiners and efforts were allegedly being made to liquidate these loans, yet the aggregate direct loans to directors was $20,742,022.70 in January 1932, and $20,568,544.39 on February 11, 1933. During the period of more than 1 year, there was a reduction of less than $200,000 in these loans to directors.[25]

(*f*) VIOLATION OF FIDUCIARY DUTY BY TRUST UNITS

A most vicious practice facilitated and encouraged by the group banking system was the device whereby individual trusts were exploited by the unit trust companies for the benefit of the group. In the administration of individual trusts by the unit trust companies, either as executor, administrator, guardian or trustee, it was a common practice to sell to the trusts securities which were sponsored by the security unit of the Group company, or which the security affiliate had a substantial interest in disposing. The trust company, as trustee, was violating a fundamental fiduciary duty to the cestui trust in purchasing, as trustee, securities in which the trustee or the affiliated units of the Group company had a pecuniary interest. The activities of the Detroit Trust Co., the unit trust company of the Detroit Bankers Co., was a glaring example of this reprehensible conduct.

The Detroit Trust Co. had advised many clients and administered various trusts. In the administration of these trusts, the trust company charged the authorized statutory fees and commissions, and in many instances investment counsel fees.[26]

As trustee, the Detroit Trust Co. would purchase from the First Detroit Co., the investment affiliate of the Detroit Bankers Co., various securities for the investment of trust funds.[27]

On April 23, 1930, the First Detroit Co., the unit security affiliate of the Detroit Bankers Co., acquired Watson Realty Mortgage bonds at 93½, transferred these bonds to the Detroit Trust Co. at 95.759, and the Detroit Trust Co. in turn sold these mortgage bonds at par and at 97 to the various trusts which it was administering.[28]

Similarly, $100,000 Rex Clark mortgage bond gold notes were acquired by the First Detroit Co. at the unit cost of 95, and sold to the Detroit Trust Co. at 99½. $96,000 of that issue was then sold by the trust company to the trust clients at 100—a spread of 5 points between the cost to the First Detroit Co. and the cost to the trust clients of the Detroit Trust Co. The remaining $4,000 of these Rex Clark collateral gold notes were sold to the trust clients of the Detroit Trust Co. at 99½.[29]

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[24] Wilson W. Mills, supra, p. 5618.
[25] Wilson W. Mills, supra, pp. 5632–5638. Detailed testimony on the status of the loans to directors, as of the date of the banking holiday, is contained in the record. Wilson W. Mills, supra, pp. 5631–5652.
[26] Ralph Stone, Jan. 30, 1934, Detroit Bankers Co., pt. 11, p. 5294.
[27] Ralph Stone, supra, p. 5298.
[28] Ralph Stone, supra, p. 5295.
[29] Ralph Stone, supra, p. 5300.

M. J. Gallagher gold notes of $50,000 face value, acquired by the First Detroit Co. at 97½, were sold to the Detroit Trust Co. by the First Detroit Co. at 99, and $31,000 of these notes were sold to trust clients at 100 and $19,000 at 99.[30]

W. J. Thomas, treasurer of the Detroit Trust Co., admitted that these instances were not isolated cases, but that many sales of that character were made by the trust company.[31]

Ralph Stone, vice chairman of the trust company, did not consider this practice unethical in the trusts when the trustee was granted authority to purchase securities owned from the Detroit Trust Co. at the prevailing market prices. He admitted, however, that no disclosure was made to the cestui of the substantial spreads obtained by the units of the Group company. Where no active market existed for the securities, the trust company fixed the "prevailing market price."[32]

The viciousness of this practice is apparent. The Detroit Trust Co., the unit trust company, as trustee, was substantially, when purchasing from the unit security affiliate, purchasing securities from itself for the use of the trusts and making a profit on the transaction. The violation of duty was even more flagrant in those instances where the trust company resold the bonds to the trusts at a profit, in addition to the profit realized by the security affiliate. The trust estate was subjected to an expense charge for investing the trust funds and to the statutory fees and commissions, in addition to the profits of the units realized from the step-up of prices.

This practice had particular inimical potentialities where the trustee, under the trustee agreement, could change the securities in the corpus of the trust estate and purchase at will other securities for the trust estate without consulting the cestui que trust.[33]

This practice was absolutely indefensible.

Senator ADAMS. Mr. Stone, in these sales from the Trust Company to its trust clients, who represented the clients?

Mr. STONE. In the case of court trusts?

Senator ADAMS. No. I mean where you were the trustee.

Mr. STONE. Oh, yes.

Senator ADAMS. Who represented the seller of the securities?

Mr. STONE. The Trust Company itself.

Senator ADAMS. So the Trust Company was the buyer and the seller.

Mr. STONE. Are you referring to those cases of purchase through the First Detroit Co.?

Senator ADAMS. No; I am referring just to the cases where the Trust Company itself sold its own securities to trusts for which it was the trustee.

Mr. STONE. Yes.

Senator ADAMS. I understood from you that in those sales the Trust Company represented the trust as the vendee and represented itself as the vendor. In which capacity did it decide what was a reasonable spread?

Mr. STONE. Well, there was no spread. You are talking now about purchases direct from the Trust Company.

Senator ADAMS. In which capacity did it decide that it was a proper sale or a proper purchase?

Mr. STONE. In the case of what might be termed "cost trusts", where there was no provision such as you read there, prevailing market price provision, the securities were sold to the trusts at cost, and the Trust Company——

Senator ADAMS. But the Trust Company decided——

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[30] Committee Exhibits Nos. 102 and 103, Jan. 30, 1934, Detroit Bankers Co., pt. 11, pp. 5815–5817.

[31] W. J. Thomas, Jan. 30, 1934, Detroit Bankers Co., pt. 11, p. 5296.

[32] W. J. Thomas, supra, p. 5296.

[33] Ralph Stone, Jan. 30, 1934, Detroit Bankers Co., pt. 11, p. 5299.

Mr. STONE. Yes.
Senator ADAMS. The trust company decided, representing the trust, that it was a good purchase from itself. In other words, this Trust Company was on both sides of the transaction.
Mr. STONE. That is true. That was a practice that began with the organization of the company, and when any of the securities defaulted they were taken off the hands of the trust company. That practice continued for 30 years, up to the time of the beginning of the depression, so that it could be said there were no losses to the trusts.
Senator ADAMS. Burglary goes back further than that, but it has not become legitimate yet. It seems to me it is not only illegal but a vicious practice.
Mr. STONE. You refer, I suppose, to the common-law rule with respect to an individual dealing with himself as trustee.
Senator ADAMS. Yes; not only the common-law rule but the matter of ordinary ethics, that no man can deal fairly and represent both sides of a transaction.
Mr. PECORA. And make a profit therefrom.
Senator ADAMS. Or even without that, because, Mr. Pecora, he was selling his own stuff. Necessarily there was an interest more or less, in keeping or disposing of it, forgetting the profit.[34]

As was stated by the Supreme Court of the State of Michigan in Dollis S. Kelsey against Detroit Trust Co. et al.:

"A trustee has no right to act when duty is opposed to interest, fiduciary to cupidity, honesty to desire for personal gain. To act as trustee for dead men carries with it the duty to exercise honesty, good faith, and active diligence, the duty to disclose the beneficiaries and account for the estate, and, stringent as the law is in prohibiting trustees acting in violation of their trusts, the rules of law should be more strict rather than be relaxed. A trustee has no right to act in the double capacity of broker or purchaser to sell alleged securities at a profit to trust estates of which it is trustee or to unload upon such trust estates worthless securities. These methods of plundering the estates of dead men cannot receive the approval and commendation of this court. Honesty, good faith, and reasonable diligence within the limits of the trustee's authority are adequate protection to such trustees. Nothing else may be substituted therefor."

Mr. STONE. Yes; I am familiar with that opinion. That statement is what you lawyers call obiter dicti.
Mr. PECORA. It is pretty sound in principle, isn't it?
Mr. STONE. Yes; absolutely.
Senator ADAMS. It is good law also?
Mr. STONE. Yes; absolutely. * * *[35]

The Detroit Trust Co. indulged in the unprincipled practice of purchasing from itself, as trustee of various trusts, mortgage-participation certificates which were in default.

Commencing in January 1927, and up to and including April 1931, the Detroit Trust Co. issued 35 series of participation certificates, aggregating $25,000,000, in mortgage loans which were originally made by the Detroit Trust Co.[36] These mortgage-participation certificates, in denominations of $500 and $1,000, were not guaranteed either as to payment of principal or interest by the Detroit Trust Co. Approximately 20 percent of $5,000,000 of these participation certificates were sold by the Detroit Trust Co. to itself, as trustee of various trusts which it was administering. The Detroit Trust Co., when it had made the mortgage loans which underlay these participation certificates, collected from the mortgagor a service fee of approximately 2 percent of the loan. When the Detroit Trust Co. sold the participation certificates to itself, as trustee, a 1 percent

[34] Ralph Stone, supra, pp. 5300–5301.
[35] Ralph Stone, supra, p. 5311.
[36] Ralph Stone, Jan. 31, 1934, Detroit Bankers Co., pt. 11, pp. 5319–5320.

investment fee was charged, and the statutory fees and commissions were charged to the estates. In addition, the Detroit Trust Co. received as a servicing fee from the estates the differential between the rate of interest on the underlying mortgages and the rate of interest on the participation certificates.[37] $5,589,500 mortgage-participation certificates, face value, out of the aggregate $25,000,000 were purchased by the Detroit Trust Co. from itself, as trustee for trust accounts. The balance of the participation certificates of these 35 issues was sold to the general public at par or over.

As of January 1, 1934, of the 35 series of mortgage-participation certificates, aggregating $25,000,000, of which the trust company sold to itself, as trustee, $5,589,500, the underlying mortgages were in default aggregating $6,918,698.56 in principal and $823,639.74 in principal and interest. As of January 1, 1934, there was past due $8,176,700 principal amount and $1,168,104.01 interest on these certificates.[38] The Detroit Trust Co. collected $526,575.20 as service charges in connection with the mortgage loans underlying the certificates of these 35 series.[39]

The sale by the Detroit Trust Co. of these participation certificates to the trust estates cannot be condoned. Not only did the trust company sell to itself, as trustees, the participations in mortgage loans which the trust company had made, but in many instances the underlying mortgages behind the participation certificates were in default at the time the sales were effected to the trust estates. Participation certificates in certain six issues of a face value of $4,250,000, aggregating $1,508,900, were purchased by the Detroit Trust Co., as trustee; and at the time of these purchases for trust accounts, defaults had occurred in the payment of both principal and interest in the aggregate sum of $141,960.78 on the underlying mortgages.[40]

(*g*) LISTING OF GROUP STOCK ON SECURITY EXCHANGES

The listing of the Group stock on security exchanges created more peculiar, additional undesirable conditions than did the listing of ordinary bank stocks. The fluctuations in the market price of the Group stock affected the public confidence, not only in the Group as a distinct entity but in each and every banking unit of the whole, regardless of its own inherent soundness.

The Guardian Detroit Union Group, Inc., stock, like the stock of the Detroit Bankers Co., the other group banking organization in Detroit, was listed on the Detroit Stock Exchange. Ernest Kanzler testified that the fluctuations in the price of the Group stock undesirably affected the public confidence in the unit banks and was responsible for many deposit withdrawals.

In a letter dated December 21, 1931, to James L. Walsh, executive vice president of the Group, from R. P. Shorts, president of the Second National Bank & Trust Co., it was urged that the two Michigan banking groups, Guardian Detroit Union Group, Inc., and the Detroit Bankers Co., immediately remove the stock from listing on

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[37] W. J. Thomas, Jan. 31, 1934, Detroit Bankers Co., pt. 11, pp. 5321–5322.
[38] W. J. Thomas, supra, p. 5324.
[39] W. J. Thomas, supra, p. 5327.
[40] W. J. Thomas, supra, p. 5325.

the exchange. Depositors were withdrawing deposits, although they had faith in the bank as a separate institution, because the decline in the Guardian Group stock did not augur well for the Group as a whole.[41]

On April 28, 1932, Shorts wrote to Ernest Kanzler, chairman of the board of the Group, advising that the stock be taken off the market at least 30 days prior to July 1, 1932, the date on which the dividends were to be discontinued. He suggested that a letter be written to the stockholders, apprising them of the reasons and motives for this stock-listing removal and recommending that the Guardian Group operate a stock-trading department for the benefit solely of the stockholders desiring to buy or sell Guardian Group stock.[42]

On May 5, 1932, Fred T. Murphy, chairman of the board of the Guardian National Bank of Commerce, advised against the withdrawal of the Guardian Group units from stock listing unless the Detroit Bankers Group would simultaneously withdraw its stock from listing.[43]

On May 23, 1932, F. E. Gorman, president of the Capital National Bank of Lansing, wrote to Ernest Kanzler that there were persistent rumors that the Group must be in financial difficulty, with resultant daily withdrawals of deposits, because of the behavior of the Group stock on the exchange. Gorman suggested maintaining the price of the stock at a reasonable level.[44]

The directors of the Group refused to request the striking of the stock from listing, claiming that such removal would adversely affect the reputation of the bank in the community and result in further withdrawals of deposits and that a large amount of the Group stock held as collateral by the bank required the maintenance of the market.[45]

In October 1930 when conditions similar to April and May 1932 had prevailed, a syndicate composed of 112 directors of the various units was formed to purchase 60,000 shares of the Group units.[46] This purchasing syndicate operated for one year and a half, during which period it purchased Group stock in an aggregate amount of $3,200,000.[47]

Kanzler testified that the board of directors were motivated, in declaring the dividends, by the adverse conditions shown to have existed in the bank. In order to bolster up public confidence in the Group stock and curtail the withdrawals of deposits from the various units, the directors of the Group, according to Kanzler, declared the dividends although adverse financial conditions of the Group existed.

Mr. PECORA. You remarked before that in the public mind the group became identified inherently and unfortunately with the various banks that were units of the Group. You recall that, don't you?

Mr. KANZLER. No; I said that the stock, the price of the stock inherently and unfortunately——

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[41] Ernest Kanzler, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4602.
[42] Committee Exhibit No. 65, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4602–4604.
[43] Committee Exhibit No. 67, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4605.
[44] Committee Exhibit No. 68, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4606.
[45] Ernest Kanzler, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4607.
[46] Ernest Kanzler, supra, pp. 4608–4609.
[47] Ernest Kanzler, supra, p. 4609.

Mr. PECORA (interposing). Price of the stock of the Group?
Mr. KANZLER. Yes.
Mr. PECORA. Inherently and unfortunately was associated in the public mind with the banks that were units of the Group?
Mr. KANZLER. With the condition of the banks.
Mr. PECORA. With the condition of the banks that were units of the Group?
Mr. KANZLER. Yes, sir.
Mr. PECORA. Was that a factor in determining or shaping the dividend-paying policy of the Group?
Mr. KANZLER. I think it had a decided effect on the judgment of the individuals. I can speak for myself. It did in my case.
Mr. PECORA. Now, how did your mind operate in that respect?
Mr. KANZLER. On the Detroit Stock Exchange the bank stocks were listed. If the price of the stock might be 80 or 90 or 20 or whatever it might have been at the time, and from one day to the next dropped 10 points or 11 points or 5 points, depending on what the margin at that time was, that would immediately have a very unsettling effect on the public's mind as to the safety of their deposits in the various units, and there would be withdrawals and hoarding would commence.
Mr. PECORA. Then the policy of the group in declaring its dividends was shaped partly, if not entirely, by a consideration of the effect upon the public mind with respect to the condition of the banks that were units of the Group?
Mr. KANZLER. Yes, sir; I think that that had a decided influence in the mind of all of the individuals. I would say quite certainly that had a substantial effect upon the minds of the individuals declaring the dividends.
Mr. PECORA. Do you think that if that had not been the state of the public mind a different dividend policy would have been pursued by the Group?
Mr. KANZLER. I have no question of it.
Mr. PECORA. From that is it fair to infer or to conclude that the directors of the Group, in declaring the dividends which they did declare from time to time, fixed those dividends at a figure that was designed to bolster up public confidence in the banking units of the Group?
Mr. KANZLER. No, sir; I would put it the other way. I would say that they declared the dividends in such a way that they would not destroy the institutions by reason of the runs that might be incited by a lack of confidence.
Mr. PECORA. Isn't that another way of saying that it was fixed in a fashion that was designed to keep up confidence of the public in the banking units?
Mr. KANZLER. I don't think it is the same thing.
The CHAIRMAN. Were dividends declared in order to keep up the prices of the stock, the quotations on the stock?
Mr. KANZLER. The price of the stock was one of the problems, and in spite of the fact that the dividend was declared in lessening amounts the stock acted rather irregularly and affected the institutions.[48]

(h) DOUBLE LIABILITY OF HOLDERS OF GROUP STOCK

The question of the liability of Group stockholders for the payment of assessments levied against the unit banks has resulted in a legal controversy as to the enforceability of this obligation. Under the National Banking Act the stockholder in a national bank is liable to assessment to the amount of his stock at the par value thereof. The Michigan banking law, section 48, provides:

SEC. 48. The stockholders of every bank shall be individually liable, equally and ratably, and not one for another, to satisfy the obligations of said bank to the amount of their stock at the par value thereof, in addition to the said stock * * *. Such liability may be enforced in a suit at law or in equity by any such bank in process of liquidation or by any receiver or other officer succeeding to the legal rights of said bank.[49]

Since the Group companies were organized not under the banking laws but under the general corporation laws, the provisions of the

[48] Ernest Kanzler, supra, pp. 4600–4601.
[49] Michigan banking law, sec. 48 (act 66, P.A. 1929), 11945.

National Banking Act and the Michigan banking law, relating to assessment, imposed no liability upon the stockholders of the Group company as such. However, article 9 of the articles of association of the Guardian Detroit Union Group, Inc., provided:

> The holders of the stock of this corporation shall be individually and severally liable (in proportion to the number of shares of its stock held by them respectively) for any statutory liability imposed upon this corporation by reason of its ownership of shares of the capital stock of any bank or trust company. * * * [50]

On October 18, 1929, the articles of association of the Group were amended by adding the following clause to article 9:

> And the stockholders of this corporation by the acceptance of their certificates of stock of this corporation severally agree that such liability may be enforced in the same manner as statutory liabilities may now or hereafter be enforceable against stockholders of banks or trust companies under the laws of the United States or the State of Michigan. A list of the stockholders of this corporation shall be filed with the Banking Commissioner of Michigan and the Comptroller of the Currency whenever requested by either of these officers.[51]

A typical illustration of the confusion engendered by this provision is presented by the situation with regard to the Guardian National Bank of Commerce. B. C. Schram, as receiver of the Guardian National Bank of Commerce, and Alexander Groesbeck, as receiver of the Guardian Detroit Union Group, Inc., instituted actions in their representative capacity against stockholders of the Guardian Detroit Union Group, Inc., to enforce the double liability of such stockholders in favor of the Guardian National Bank of Commerce.[52] A bill in equity was filed against Schram, as receiver of the bank, and Groesbeck, as receiver of the Group, by various officers and directors, among whom were Fred T. Murphy, chairman of the board of directors of the bank and a director of the Group, and one of the founders of the bank, Phelps Newberry, an officer of the bank and director of the Group, and Carl B. Tuttle, one of the directors of the Guardian National Bank of Commerce and a director of the National Bank of Commerce at the time it was merged with the Guardian Detroit Bank, to restrain the receivers from enforcing this double liability on the Group stock.[53]

These litigations are pending, and no comment will be made in this report upon the validity, legality, or enforceability of this provision.[54] It is vital to note, however, that the ownership of stock in the Group company exposes the holder to greater danger of assessment than does the ownership of stock in a unit bank. There is a broader distribution of liability among the Group stockholders; so that in the instance of a weak unit bank, the stock of which has become subject to liability assessment, the pro rata amount required to be paid by a stockholder is less than the amount which he would have been assessed if he were a unit-bank-stock holder. Where, however, stockholders of a strong bank have surrendered

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[50] Committee Exhibit No. 1, Dec. 19, 1933, Guardian Detroit Union Group, Inc., pt. 9, pp. 4269, 4401.

[51] Robert O. Lord, Dec. 21, 1933, Guardian Detroit Union Group, Inc., pt. 9, p. 4402.

[52] Robert O. Lord, supra, p. 4402.

[53] Robert O. Lord, supra, pp. 4402–4403.

[54] Testimony relating to the enforceability of this double liability provision is contained in the record: See Charles S. Mott, Jan. 18, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4888–4897; Harry S. Covington, Jan. 18, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4910–4911.

their shares in exchange for Group stock, it is manifest that they subject themselves to the risk of contribution toward assessment imposed upon unit banks with which they formerly had no connection.

4. The Michigan Bank Moratorium and the Reconstruction Finance Corporation

On the night of February 13, 1933, Governor Comstock, of Michigan, declared a banking moratorium for all the banks in that State.[55]

On January 24, 1933, approximately 2 weeks before the bank holiday, the last stockholders' meeting of the Guardian Detroit Union Group, Inc., was held, and an oral report of the condition and activities of the Group was rendered by Ernest Kanzler, chairman of the Group board.[56] In his report to the stockholders, Kanzler stated:

> The pursuance of this sound policy of looking first to the stability and liquidity of our banks and trust companies necessarily affected our earning power—for liquidity can be maintained only at the expense of profits. For the year 1932, operating earnings of the banks and trust companies in the Group, after all expenses of operation, taxes, depreciation on banking houses and equipment, and losses on securities sold, but before reserves, were $2,619,443. On the same basis and for the same period, the consolidated net operating earnings of the Group company, banks, trust companies, and all other affiliated companies, amounted to $1,316,952.[57]

The fact is that the Guardian Detroit Union Group, Inc., as a separate corporate entity, during the calendar year 1932 had incurred a deficit of $714,331.26, which included the carrying over of deficits for the 2 preceding years, amounting in the aggregate to $288,930. No mention was made in Kanzler's report of this deficit. Kanzler justified this omission upon the ground that the stockholders were not interested in that deficit and that this report had to be considered in conjunction with the proposed balance sheet to obtain an accurate picture of the financial condition of the Group. This balance sheet, however, was never prepared or published, for the financial condition of the units was such that on January 25 Kanzler was compelled to commence negotiations with the Reconstruction Finance Corporation for immediate financial assistance for the unit banks.[58]

Kanzler further reported to the stockholders that the liquidity of the banks and trust companies of the Group had improved during 1932 over the preceding years, stating:

> Not less than 100 million dollars of assets of the banks and trust companies are held as cash or invested in United States Government securities against an aggregate of deposit liabilities of 290 million dollars.[59]

The estimate of $100,000,000 of cash and Government assets included the Government bonds that had been pledged by these unit banks.

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[55] Ernest Kanzler, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4554.

[56] Committee Exhibit No. 63, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, pp. 4545–4548, contains the notes of Kanzler which formed the basis of this report. Committee Exhibit No. 64, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, pp. 4582–4588, is a draft of the report that was to be sent to stockholders of the Group.

[57] Committee Exhibit No. 63, supra, pp. 4545–4546.

[58] Ernest Kanzler, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4550–4552.

[59] Committee Exhibit No. 63, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4556.

Kanzler, in reporting the net operating earnings of the Group, its banks and affiliates, at $1,316,952, made no deductions for reserves, mark-offs, or write-offs.

Mr. PECORA. Do you think that gives an accurate picture of the net earnings, without first deducting reserves, write-offs, and mark-offs?

Mr. KANZLER. Well, it was stated as being before reserves. But I might say, Mr. Pecora, that these paragraphs were given to me complete by our operating staff.

Mr. PECORA. I am asking you if you think that is the proper way of presenting an accurate picture.

Mr. KANZLER. Well, in those times everybody knew that there would be plenty of items that had to be written off.

Mr. PECORA. Everybody didn't know any such thing, because neither you nor I nor anyone else can tell what anybody else knew. That is so, isn't it? Aren't you assuming too much when you are assuming to tell this committee, or even to tell yourself, what everybody else knew?

Mr. KANZLER. Well, I knew, and everybody else knew, that there was a depression on, certainly, with the resulting effect of depreciation of assets.

Mr. PECORA. I wonder if the board of directors of the Group knew that there was a depression on when they were suggesting to the unit banks to pay dividends that could only be paid by recourse to capital funds in addition to earnings. Did they know that there was a depression on when they adopted that policy?

Mr. KANZLER. There was a general depression on throughout all banks.[60]

Kanzler further reported to the stockholders that the policy of liquidating securities values, which was initiated in 1931, continued during 1932 in an orderly manner and resulted in the sale of securities carried at $1,712,821 with a resultant loss of only $42,201.[61] These securities were not sold, but had been merely written down to that level.[62]

On January 15, 1933, 9 days before this stockholders' meeting, Kanzler informed Alfred P. Leyburn, chief national bank examiner of the seventh Federal district, which included Detroit, that it was imperative that considerable more money be loaned by the Reconstruction Finance Corporation to the Group, for the Union Guardian Trust Co., one of the unit banks, was in imminent danger of collapse.

The Reconstruction Finance Corporation loaned the Union Guardian Trust Co., on May 24, 1932, $4,250,000; on July 5, 1932, $8,733,000; on September 14, 1932, $2,767,000; and on October 7, 1932, $400,000, for a total of $16,150,000. There had been canceled of these loans $33,150.96 and $3,474,629.45.[63] To facilitate the loan by the Reconstruction Finance Corporation to the unit banks, a mortgage company was to be organized with a capital of $5,000,000, to which all the unit banks desiring to borrow money would sell their assets, and the mortgage company in turn would secure the loan from the Reconstruction Finance Corporation, pledging these assets as security. The Group officers thought at that time that the Henry Ford interests would subordinate its deposits of approximately $20,000,000 to $25,000,000 in the unit banks to guarantee any loan made by the Reconstruction Finance Corporation. The consensus of opinion of the Reconstruction Finance Corporation board was

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[60] Ernest Kanzler, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, pp. 4559–4560.

[61] Ernest Kanzler, supra, p. 4560.

[62] Ernest Kanzler, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4588.

[63] Committee Exhibit No. 79, Jan. 15, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4756. Clifford B. Longley, Jan. 16, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4813.

that it was incumbent upon the Ford interests, who they felt had a substantial financial interest in saving the unit banks to contribute to the fortification of the financial condition of these banks. The Reconstruction Finance Corporation requested the recommendation of the loan by Senator James Couzens, of Detroit. The Senator, on February 9, 1933, refused to recommend the loan upon the proffered collateral, which he deemed insufficient and inadequate.[64]

Various applications and modifications were made by the Group to the Reconstruction Finance Corporation. On February 6, 1933, the Group sought a loan of $50,000,000, in addition to the $15,000,000 credit which had already been extended to the Union Guardian Trust Co. unit, or a total of $65,000,000.[65]

On February 6, 1933, within 2 weeks after the report by Ernest Kanzler to the stockholders on the condition of the bank, Kanzler, according to the records of the Reconstruction Finance Corporation, stated to that body that $2,500,000 would be required to liquidate the deposits of the Union Guardian Trust Co.; that the assets available as security for such loan had a face value of only approximately $6,000,000, and that the immediate aid of the Reconstruction Finance Corporation was imperative to keep the Union Guardian Trust Co. from closing; that depositors, with the possible exception of the Ford interests, could not be induced to subordinate their claims; that the Ford interests, having aided the Group within the past 3 years to the extent of $16,000,000, in the form of loans of securities and endorsements, felt they had contributed sufficiently, but that Kanzler would attempt to convince the Ford interests to assist in raising $5,000,000 of new capital for the proposed mortgage company. According to the Reconstruction Finance Corporation records, Kanzler admitted to the board that there was a considerable gap between the value of the collateral to be pledged and the loan desired, but impressed upon the board the imminent danger of financial disaster affecting the entire State of Michigan and the country at large.

Kanzler testified that his report on February 6, 1933, of the condition of the Group units to the Reconstruction Finance Corporation was not inconsistent with his report at the last meeting of the stockholders held 2 weeks before, on January 24, 1933. Kanzler voluntarily read at the subcommittee hearings a prepared statement, attempting to reconcile the statements made to the stockholders at the last annual meeting and in the preliminary draft of the annual report to stockholders with the statements contained in the Reconstruction Finance Corporation application. When interrogated upon this prepared statement, Kanzler testified:

Mr. PECORA. When you prepared this statement was there some apprehension in your mind that anyone comparing your annual report to stockholders of January 24 last with the statement you made on February 6 last to the Reconstruction Finance Corporation would find an inconsistency between them?

Mr. KANZLER. No, sir; I thought it would be a reasonable question that would come up.

Mr. PECORA. Did you anticipate that anyone reading those two statements would find an inconsistency therein?

Mr. KANZLER. No; I thought that the position should be explained.

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[64] Alfred P. Leyburn, Jan. 5, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4627. Clifford B. Longley, Jan. 17, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4877.

[65] Committee Exhibit No. 78, Jan. 15, 1934, Guardian Detroit Union Group, pt. 10, p. 4755.

Mr. PECORA. At the very outset of this prepared statement which you have just read into the record you say:

"It might appear that certain remarks made to the stockholders at the annual meeting and the preliminary draft of the annual report in preparation for sending to stockholders seem to be inconsistent with statements contained in the Reconstruction Finance Corporation application."

So apparently you did fear that somebody, in comparing the two statements, might see an inconsistency between them.

Mr. KANZLER. I thought that somebody not fully familiar with the facts might think that there was an inconsistency.

Mr. PECORA. Do you say there is no inconsistency?

Mr. KANZLER. I am satisfied that there is not.

Mr. PECORA. No inconsistency in saying to the stockholders of the Group, for instance, among other things, that "The year 1932 was a year of notable improvement on the subject of the safety of funds which our depositors have intrusted to us"; or in saying that "Despite the generally depressed business conditions which prevailed, no less than $100,000,000 of assets of our banks and trust companies are held as cash or invested in United States Government securities against deposit liabilities of $290,000,000"; or in saying, "While bettering their liquid position our banks have at all times sought to render constructive, helpful service", and so forth; or in saying "Actual results, however, have developed an understanding in many quarters of the effectiveness of group banking as conducted and have made for our units many new friends and an enhanced reputation"?

Mr. KANZLER. Mr. Pecora, I cannot recall all of the details of that situation, but——

Mr. PECORA. I am reading to you certain extracts from your report to the stockholders.

Mr. KANZLER. Yes.

Mr. PECORA. You say that is not inconsistent with the statement to the Reconstruction Finance Corporation, in saying to the Reconstruction Finance Corporation Board on February 6, last, that $20,500,000 would be required to liquidate deposits of the Union Guardian Trust Co. of Detroit but that the assets which they could offer as security for such loan would have a face value of only about $6,000,000?

Mr. KANZLER. Mr. Pecora, that is after the R.F.C., with a corps of 15 men, had been working day and night over these assets. There were 10 or 12 million of assets that the R.F.C. never looked at. It was this $6,000,000 that they said qualified and there were 12 million of assets besides. What we were doing in that case was taking the Trust Co. entirely out of the banking business. That was the deposit liability of the Trust Co.

Senator COUZENS. You say the R.F.C. examiners did not examine the other 11 or 12 million dollars?

Mr. KANZLER. Did I say they did not examine it?

Senator COUZENS. Yes.

Mr. KANZLER. I misspoke myself. They did not accept it. It did not qualify under their various rules which I do not know. I think some of them were advances to trusts and things of that kind. They were receivables.

Senator COUZENS. Do you say now that they did qualify?

Mr. KANZLER. No; I say they did not qualify under the rules of the R.F.C.; but that does not mean that they were not assets.

Senator COUZENS. But I mean, do you think that they did qualify?

Mr. KANZLER. I think Mr. McKee was a capable man, and when his examiners decided they did not qualify, they probably did not qualify.[66]

The assets offered by the unit banks on February 6, 1933, had a face value of approximately $88,000,000.[67] John K. McKee, chief of the examining division of the Reconstruction Finance Corporation, testified that a liberal valuation of this collateral was a loan-value basis of $17,000,000 (a percentage of the appraised value of the property) and a liquidating value of $20,000,000 (the estimated

[66] Ernest Kanzler, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, pp. 4567–4568.

[67] John K. McKee, Jan. 12, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4726.

liquidation price of the property). Against these assets with a $20,000,000 liquidating value, the Group was seeking a loan of $49,600,000—approximately 2½ times the liquidating value of the available collateral.

The Reconstruction Finance Corporation on February 6, was prepared to loan to the Group $45,000,000, which included $20,000,000, the liquidating value of the collateral offered, and $31,000,000 of the assets of the Union Guardian Trust Co., which had been pledged for the previous $15,000,000 loan, provided this $15,000,000 was repaid.[68] This proposed loan did not meet the requirements of the Group, which were approximately $65,000,000. An attempt to "bail out" the Union Guardian Trust Co. alone was unsuccessful, since that Trust Co. had available only free assets of a face value of $7,940,000, with a liquidating value of $5,096,000, as compared with deposit liabilities of 20 to 25 million dollars.

On February 10, the last application of the Group with revamped assets was submitted to the Reconstruction Finance Corporation, which made a commitment of a loan of $37,720,000 on assets with a total face value of $64,871,000, and a liquidating value of $37,762,000. Under this new set-up, $49,600,000 was needed by the Group, leaving a deficiency of $11,880,000.[69]

The Group was to use this loan to liquidate $5,000,000 of class B trust funds and $20,000,000 of deposits of the Union Guardian Trust Co., which was to cease business; to repay the $15,000,000 Reconstruction Finance Corporation loan to the Union Guardian Trust Co., and the balance was to be employed in liquifying the Guardian National Bank of Commerce.[70] The Reconstruction Finance Corporation was induced to believe that $7,500,000 of this $11,880,000 deficiency would be made up by the Ford Motor Co. subordinating $7,500,000 of deposits, and consented to a reduction of the capitalization of the proposed mortgage company from $5,000,000 to $2,000,000. There remained a deficiency of only $6,380,000, which included a cash deficiency of $4,380,000 and $2,000,000 capital of the proposed mortgage company—all predicated upon the assumption that $7,500,000 of deposits would be subordinated.[71] The Ford interests, however, refused to supply the needed capital for the mortgage company and then refused to subordinate their deposits, and the deficiency was increased to $13,880,000.[72] The total deposits of the Ford interests in all the unit banks of the Guardian Group on February 14, 1933, was $32,500,000, in addition to $18,000,000 in the units of the Detroit Bankers Group.[73]

The Reconstruction Finance Corporation, empowered to make loans only on full and adequate security, refused to increase the loan, which it considered very liberal on the collateral offered, or permit other lenders to participate in this collateral.[74] An analysis of the liquidating value allocated by the Reconstruction Finance Corporation to the profferred collateral demonstrates the helpful and liberal attitude assumed by the Reconstruction Finance Corporation.

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[68] John K. McKee, supra, pp. 4725–4729.
[69] John K. McKee, supra, p. 4729.
[70] John K. McKee, Jan. 16, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4733.
[71] John K. McKee, supra, p. 4734.
[72] Edsel B. Ford, Jan. 12, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4695.
[73] Edsel B. Ford, supra, p. 4696. Edsel B. Ford, Jan. 11, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4657.
[74] John K. McKee, supra, p. 4736.

The Guardian National Bank of Commerce required a loan of $10,500,000. The Reconstruction Finance Corporation allocated to $3,200,000 of city of Detroit bonds, although the credit of Detroit was seriously impaired, a liquidating value of $2,893,000; to $1,100,000 of Fisher & Co. bonds a value of $1,007,000; to $2,300,000 of Simon Co. bonds a value of $2,115,000. The total face value of the securities collateral offered by the Guardian National Bank of Commerce was approximately $11,998,000, upon which the Reconstruction Finance Corporation was prepared to loan $10,798,000.[75]

The allotments out of the $37,500,000 Reconstruction Finance Corporation loan to this Group to the Union Industrial Bank of Flint, Grand Rapids National Bank, City National Bank of Battle Creek, and Jackson National Bank were to be secured by mortgages on the bank's real properties.

McKee testified that the Reconstruction Finance Corporation was prepared to loan on all the real-estate mortgages offered by the Group, with a face value of $12,466,000, the liberal sum of $11,224,000; on all the bonds, with a face value of $13,085,000, the sum of $8,192,000; on all securities, with a face value of $3,740,000, the sum of $2,649,000; on all unsecured notes, with a face value of $730,000, the sum of $313,000; and on the other assets, with a face value of $556,000, the sum of $393,000. The total face value of this collateral was $33,211,600, upon which the Reconstruction Finance Corporation was willing to loan $22,620,000, their full liquidating value.[76]

In addition, on the assets with a total face value of $31,659,000, the Reconstruction Finance Corporation had already made a commitment of $15,000,000 to the Union Guardian Trust Co. On all the collateral offered by the Group, with a face value of $64,871,000 and a total loan value of $37,762,000, the Reconstruction Finance Corporation made a commitment of $37,720,000, to include repayment of the $15,000,000 Union Guardian Trust Co. loan.[77]

All attempts to obtain the cooperation of General Motors Corporation, Chrysler Corporation, and of the First National Bank of Detroit, one of the largest competitive banks in the city, to meet this deficiency were unavailing.

On the night of Monday, February 13, 1933, the Governor of the State of Michigan declared the banking moratorium, effective February 14, 1933.

On February 18, 1933, the commitment of the Reconstruction Finance Corporation to loan $37,720,000 to the Guardian Detroit Union Group, Inc., was formally rescinded. The Guardian National Bank of Commerce paid a 5-percent dividend to depositors immediately, and another 5-percent dividend within 10 days thereafter. Conservators were appointed by the Comptroller of the Currency for each of the banks, who were subsequently replaced by receivers.[78]

During the period of the moratorium, various plans for the reorganization of the banks, organization of new banks, and applications

[75] John K. McKee, supra, p. 4742. Ernest Kanzler, Jan. 4, 1934, Guardian Detroit Union Group, Inc., pt. 9, p. 4554.

[76] John K. McKee, supra, pp. 4740–4741.

[77] A detailed itemization and discussion of the value of collateral is contained in the record, John K. McKee, supra, pp. 4740–4742.

[78] John K. McKee, Jan. 15, 1934, Guardian Detroit Union Group, Inc., pt. 10, p. 4748.

to the Reconstruction Finance Corporation for new loans for the various units in the Group were made, but did not materialize.[79]

As of December 19, 1933, the Reconstruction Finance Corporation authorized $80,382,000 of loans to the units of the Guardian Group, $16,150,000 of which amount had been authorized, and $3,507,780.39 canceled, to the Union Guardian Trust Co. up to September 14, 1932, prior to the banking moratorium in Michigan; $10,273,204.23 of these authorized loans had been canceled, and $59,472,236.19 of these authorized loans had been disbursed by the Reconstruction Finance Corporation to the Group, which had repaid $14,377,393.05, leaving a balance of $45,094,843.14. The collateral held against the loans had an aggregate face value of $147,239,849.10. As of December 19, 1933, the Guardian Group had paid interest of $251,822.91.[80]

5. Deficiencies in Group Banking

The most patent deficiency in group banking is that the group is only as strong as its weakest unit. During a period of prosperity, when public confidence in the unit institutions is adamant, the group may prosper consonantly with these units. When the shock of adversity, however, dislodges confidence in any of the units, the entire structure is destined to collapse. Unit banks which might otherwise have survived are doomed because of their affiliation in the public mind with the weaker units.[81]

The acquisition of a weak unit proportionately imperiled the entire structure. The Detroit Bankers Co., from its inception, faced an insurmountable obstacle when it was originally burdened with a $7,200,000 indebtedness of the First National Co., the security affiliate of the First National Bank.[82]

Similarly, the consolidation of the American State Bank with the unit Peoples Wayne County Bank developed a weakness in group that contributed materially to the demise of the Detroit Bankers Co.[83]

Loss of confidence in one unit necessarily occasions diminution of trust in the affiliated units, and the group company must strain every resource to maintain public faith in all the units, including the parent company.

The tendency among banking authorities is to analogize group banking to branch banking and chain banking.[84] Distinctions be-

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[79] A detailed discussion of these plans and applications is contained in the record; John K. McKee, supra, pp. 4745–4754.

[80] Committee Exhibit No. 70, Jan. 15, 1934, Guardian Detroit Union Group, Inc., pt. 10, pp. 4756–4757, contains a detailed, itemized statement of the status of the loans made by the Reconstruction Finance Corporation to the unit banks of the Guardian Detroit Union Group, Inc., as of Dec. 19, 1933.

[81] Edward Douglas Stair, Feb. 1, 1934, Detroit Bankers Co., pt. 11, p. 5407.

[82] Joseph F. Verhelle, Jan. 25, 1934, Detroit Bankers Co., pt. 11, p. 5153. Mark A. Wilson, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5745. (At the time of the receivership of the Detroit Bankers Co., this $7,200,000 indebtedness had been reduced to $3,800,000.) For detailed testimony relating to the acquisition of the First National Bank and the First National Security Co. with an indebtedness of $7,200,000, due to shrinkage of value of minority bank holdings acquired by the First National Co., see John Ballantyne and Joseph F. Verhelle, Jan. 24, 1934, Detroit Bankers Co., pt. 11, pp. 5095–5126; Joseph F. Verhelle, Jan. 25, 1934; Detroit Bankers Co., pt. 11, pp. 5135–5144, 5152–5153, and Thomas G. Long, Jan. 25, 1934, Detroit Bankers Co., pt. 11, pp. 5144–5152.

[83] For detailed testimony on the consolidation of the American State Bank and Peoples Wayne County Bank, see Wilson W. Mills, Feb. 6, 1934, Detroit Bankers Co., pt. 12, pp. 5522–5523.

[84] Committee Exhibit No. 173, 8, 1934, Detroit Bankers Co., pt. 12, p. 5733. Mark A. Wilson, Feb. 8, 1934, Detroit Bankers Co., pt. 12, p. 5733.

tween these systems of banking exist. The group-banking system failure, however, is a caveat in evaluating any systems of banking predicated upon the maintenance of unit banks.

6. Commercial Banking in Ohio

The inquiry by the subcommittee into the conduct of banking practices by the Guardian Trust Co. and Union Trust Co., of Cleveland, was limited to the introduction into evidence of reports and documentary evidence assembled by the committee, based upon an examination of the books and original records and documents of this banking institution.

An analysis of the documentary evidence adduced before this committee convinces that the closing of the Guardian Trust Co. and the Union Trust Co. was not attributable, as has been maintained by the officers of the institution, to the Michigan banking holiday, declared February 14, 1933, nor the national banking holiday, declared March 4, 1933. The evidence is overwhelming that the collapse of these institutions was a direct result of the unsound banking practices and mismanagement of the institutions over a period of years.

(*a*) GUARDIAN TRUST CO.

(1) *Organization and history.*—At the time of the closing of the Guardian Trust Co. in March 1933, this bank and its subsidiaries comprised 26 separate corporations.[85] From the time of the organization of the Guardian Trust Co. in 1894 until 1913 it operated as a bank only, but in 1913 it started on its campaign of acquiring and forming subsidiary companies, which occasioned its ultimate failure.[86] At the time of the closing of the bank the Guardian Trust Co. and its subsidiaries were engaged, besides conducting a banking business, in the operation of an office building, a chain of hotels, a coal mine, and residential and business properties; owned a produce market, vacant property, and conducted a speculative business in securities.[87]

The Guardian Trust Co., of Cleveland, owned five direct subsidiaries: The New England Co., organized to invest in a bank building in excess of the amount permitted by law; the Branch Investment Co., organized to evade the law against ownership of real estate by banks; the 4400 Superior Co., to conceal and attempt to recuperate a loss on an improvident loan; and the Harrison County Investment Co., to attempt to protect a loss on a bad investment in a coal mine.[85] The bank officials successfully employed these subsidiaries to conceal the losses and the evasions of the law from bank examiners. In 1928 the bank officials started the wholesale organization of subsidiaries to these subsidiaries; 4 subsidiaries being formed in 1928, 1 in 1929, 2 in 1930, 7 in 1931, and 6 in 1932, with the intent to make the detection of evasions and subterfuges more difficult.[88] These subsidiaries were financed by the Guardian Trust

[85] Pt. 18, p. 7978.
[86] Pt. 18, p. 7988.
[87] Pt. 18, p. 7979.
[88] Pt. 18, p. 7980.

Co. with depositors' funds by means of "loans" and "investments", which were carried on the various books at full value, although many of these loans and investments were obviously valueless.

(i) *New England Co.*—The largest and most important subsidiary was the New England Co., organized in 1913. The bank owned 4,995 of the original 5,000 shares of capital stock of this company, the remaining 5 shares being directors' qualifying shares.[88] The original purpose for the formation of this subsidiary was ostensibly to own the property occupied by the bank. It subsequently became apparent, however, that the real purpose of this subsidiary was to permit the bank, in circumvention of , law, to engage in semi-speculative real-estate ventures. From 1913 to 1926 the New England Co. did not acquire any subsidiaries.

In 1926 the Vincent Building Co. was formed for the purpose of building a hotel building to the east of the Hotel Hollenden, to be used by the Hotel Hollenden. To finance this, the New England Co. invested $619,500 in the Vincent Building Co. and guaranteed $800,000 of leasehold bonds.[89]

In 1928 the New England Co. purchased from the Guardian Trust Co. all of the capital stock of the Hotel Hollenden Co. for the sum of $750 and all promissory notes of the Hotel Hollenden Co. to the Guardian Trust Co. for the sum of $1,350,000. By this means the management of the Guardian Trust Co. was relieved of the embarrassment of showing a large loss on the Hotel Hollenden Co. loans and stock.

In order to consummate this deal, the New England Co. (or in other words the Guardian Trust Co.) mortgaged its building for $3,250,000 with the Metropolitan Life Insurance Co. and purchased the Hotel Hollenden Co. stock and notes from the bank. By this means the Guardian Trust Co. relieved its books of "sour" loans amounting to $1,350,000 which properly should have been written off, mortgaged what was in effect its building, bolstered its cash to the extent of the amount received from the New England Co., and continued to carry on the bank books at full value under the caption "Banking house" the $3,800,000 stock of its subsidiary, the New England Co., even though the management knew they had unloaded a potential loss of over a million dollars on the subsidiary.[89]

The New England Co. continued making loans to the Hotel Hollenden Co. until June 25, 1930, when the board of directors of the New England Co. refunded $1,546,189.23 of the $1,987,500 indebtedness by taking a second leasehold mortgage on the hotel property.

In order to relieve the New England Co. and the Guardian Trust Co., the parent company, of the embarrassment of this bad loan, the board of directors of the New England Co., on December 27, 1932, deliberately revalued the hotel property, increasing its appraised value by $1,958,793.79, which it credited to an account "appraised surplus", thereby eliminating this loss from the books of the New England Co. as cleverly as the Guardian Trust Co. had eliminated the loss by transferring it to the New England Co.[90]

The experience of the Guardian Trust Co. with the Hotel Hollenden Co. evidently did not have any deterring effect. The De Witt

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[88] Pt. 18, p. 7988.
[89] Pt. 18, p. 7990.
[90] Pt. 18, p. 7991; see also pp. 8090–8117.

Hotels Co. was formed March 2, 1931, for the purpose of owning, holding, managing, operating, and controlling hotels. All of its stock, 500 shares, was subscribed for by the New England Co. at $500 and $2,000 of surplus was paid in—making the total investment $2,500.[91]

In March 1931, the Guardian Trust Co., with its record cleared of its former losses in its hotel venture, oblivious to its previous experience, loaned $475,000 to the De Witt Hotels Co., its indirect subsidiary, this loan being collateralized by $500,000 bonds of the Neil House, Columbus, Ohio, which were to be purchased with the proceeds of the loan.[92] The Guardian Trust Co. was once more in the hotel business.

In addition to "camouflaging" the hotel activities of the bank, the New England Co. also served as the medium in managing real estate acquired by the bank through foreclosure. The charter privileges of the New England Co. were not sufficiently broad to permit these activities. To circumvent these provisions, the ever-present subsidiary idea was again invoked, resulting in the formation of the Valuation Service Co. in October 1929; capital stock, $500; paid-in surplus, $49,500; 100 no-par shares, all held by the New England Co. In addition to taking over properties acquired by the Guardian through foreclosure, it also acted as a manager for properties.[93]

The Valuation Service Co. purchased, in 1930, several parcels of property which the Guardian Trust Co. was foreclosing; in 1933, some 120 or 130 properties which the bank had foreclosed, payment being made by notes in the amount of $1,327,468.89. These notes were for 1 year, with interest at 6 percent, secured by mortgages on the property. As the financial responsibility of the Valuation Service Co. was practically nil, this subterfuge to evade the section of the Ohio banking code, directing the sale within 5 years of property bought in on foreclosure, is apparent.[93]

The Guardian Trust Co., in 1931, found that it would have to foreclose real-estate loans on allotment property. To avoid showing these properties among the bank's assets, the Land Development & Realization Co. was formed May 28, 1931, with a capital stock of 100 shares, no par value, all held by the New England Co., for the purpose of acquiring the capital stock of real-estate companies.[93]

The Guardian Trust Co. sold to the Land Development & Realization Co. approximately 130 to 140 parcels of property for notes amounting to $1,180,960.11. These notes were made for 1 year in the amount of the purchase price of the individual pieces of property and were secured by mortgages on these properties. As the Land Development & Realization Co. had no real financial stability, the "dummy" effect of the transaction is obvious.[94]

(ii) *The Guardian Securities Co.*—The Guardian Securities Co. was originally incorporated in 1917, as the Guardian Mortgage Co., as a mortgage company. In 1927 the management, apparently desirous of engaging in securities speculation, recapitalized the company for $250,000, all owned by the Guardian Trust Co. During the years 1927, 1928, and 1929 this company bought and sold stock

[91] Pt. 18, pp. 7991–7992.
[92] Pt. 18, p. 7992.
[93] Pt. 18, p. 7993.
[94] Pt. 18, p. 7994.

of a great number of stock issues, mostly listed stocks. Collateral loans were made by the Guardian Trust Co. ranging from $600,000 to $1,000,000 to finance these security purchases.[94]

As of December 31, 1932, the Guardian Securities Co. was indebted to the Guardian Trust Co. in the sum of $540,000, secured by collateral, the book value of which was $816,484.85, but the stated market value of which was $711,510.39. This collateral included an item of 10,000 shares of Cleveland Worm & Gear common at $500,000, which cost $180,759.25, and for which there were no bids in 1932.[95]

A reduction of the " market value " of $500,000 to the book value of $180,759.25 gives an excess of book value over market value of $424,215.01. The balance sheet of December 31, 1932, shows capital and surplus of $282,182.15. This proper evaluation of the securities would wipe out the entire capital and surplus and approximately $140,000 of the security on the loan. Yet the Guardian Trust Co. continued to carry the stock of the Guardian Securities Co. among its assets at full book value of $250,000. In 1932, the Guardian Securities Co. paid a $2,500 dividend to the Guardian Trust Co., even though the proper reduction of value would have more than wiped out the surplus.[95]

(iii) *The Branch Investment Co.*—The Branch Investment Co. was incorporated in 1920 with 1,000 shares no par common stock, all held by the Guardian Trust Co. This company, formed to assume a sublease of a branch of the bank, borrowed $125,000 from the Guardian Trust Co. in 1920. In 1921, approximately $75,000 was spent on improvements, and in 1928, the company purchased the lease for $257,812.50, and the stock of the Euclid Arcade Co. for a $38,273.84 balance on a loan.[95]

In 1930, the Euclid-One Hundred and Second Street Market and three vacant lots were acquired for $144,363.30. In 1931 and 1932, special alterations of $85,900.81 were made. As a result, the Branch Investment Co. owned a leasehold estate and three vacant lots costing $701,587.12, which, according to the 1932 tax bills, had an assessment valuation of $429,060.[95]

(iv) *The 4400 Superior Co.*—The 4400 Superior Co. was formed in 1930 to transfer from the bank to this company the loss sustained by the bank on a leasehold that it acquired in payment of a debt. The leasehold was conveyed to the 4400 Superior Co. at the face amount of the debt and carried at that figure on the bank's books.[88]

(v) *The Harrison County Investment Co.*—The Harrison County Investment Co. was incorporated on July 8, 1930, with 250 shares of no par common stock, $500, all of this stock being held by the Guardian Trust Co. In 1929 the Guardian Trust Co. held approximately $600,000 in bonds of the Short Creek Coal Co. In 1930 the property underlying these bonds was sold at a judicial sale and the Guardian Trust Co., through a former subsidiary, known as the " Smith Coal Co.", acquired the property. The Smith Coal Co. then transferred this mining property to the Harrison County Investment Co.; $600,000 of bonds were issued and turned over to the Guardian Trust Co., these bonds being carried on the Guardian books at $588,000.[96]

[94] Pt. 18, p. 7094.
[95] Pt. 18, p. 7095.
[96] Pt. 18, p. 7096.

As a result of investments in and loans to these various subsidiaries, the Guardian Trust Co., as of April 8, 1933, had over $11,000,000 in subsidiary companies. As the total resources of the bank were approximately $113,000,000, these investments and loans represented almost 10 percent of its total resources involved in deals extraneous to banking.[96]

(*b*) THE UNION TRUST CO.

(1) *Organization and history.*—The Union Trust Co. was organized December 31, 1920, by consolidation of the First Trust & Savings Co. and the Citizens Savings & Trust Co. (both Ohio companies). The capital stock of the Union Trust Co. was $13,333,333.33, the combined capital of the two institutions, divided into 133,333⅓ shares of $100 each.[97]

On January 17, 1921, the Woodland Avenue Savings & Trust Co. and the Broadway Savings & Trust Co. were consolidated in the name of the Union Trust Co., with an authorized capital stock of not less than $14,833,333.33, divided into 148,333⅓ shares of par value of $100 each.[97]

On March 11, 1921, the authorized capital stock was increased from $14,833,333.33 to $22,250,000, and a 50-percent stock dividend of 74,166⅔ shares ($7,416,666.67) was declared and distributed to stockholders, and the par value of shares so distributed transferred from the surplus to capital account. On December 31, 1921, $375,000 was transferred from undivided-profits account to surplus account, making the surplus $11,125,000.[97]

On April 17, 1926, the consolidation of the State Banking & Trust Co. was effected, and the capital stock of the Union Trust Co. was increased by $600,000 to $22,850,000, and surplus increased by $625,000 to $11,750,000. On January 8, 1927, the surplus was increased by $400,000 to $12,150,000 making a combined capital and surplus of $35,000,000.[97]

Subsequently, the par value of the Union Trust Co. stock was reduced from $100 to $25 per share, and 914,000 new shares were exchanged for 228,500 shares then outstanding.[97]

In February 1933, when the Union Trust Co. closed, there were approximately 4,250 stockholders. Affiliated with the Union Trust Co. were the Union Cleveland Corporation, the securities affiliate, the Union Lennox Co., a wholly owned subsidiary organized to hold title to the main bank building, the P. A. Frye Co., a wholly owned subsidiary organized to manage properties acquired by the bank through foreclosure, the Akers-Folkman Co., a wholly owned subsidiary organized to conduct a travel agency, and the Cleveland & Boston Co., owned 62 percent by the bank, organized to hold the assets of the Cleveland-Akron Bag Co. taken over by foreclosure.[98]

(i) *Union Cleveland Corporation.*—The Union Cleveland Corporation was organized on July 24, 1929, as a security and investment company of the Union Trust Co., with an authorized capital of 228,500 shares of no par value stock. The 228,500 shares of its capital stock were given a stated value of $10 per share and were set up on the books of the corporation as $2,000,000 capital and

[96] Pt. 18, p. 7996.
[97] Pt. 18, p. 8134.
[98] Pt. 18, pp. 8135–8137.

$285,000 surplus. The bank's stockholders supplied the $2,285,000 capital for the company in proportion to their stockholdings in the bank. Each bank stockholder owned Union Cleveland Corporation stock in an amount equal to one-tenth of his bank stock, ownership being evidenced by endorsement on the bank-stock certificate.[99]

On August 3, 1929, the bank stockholders approved the "plan and agreement" for the ownership of the Union Cleveland Corporation and vested the voting control of the Union Cleveland Corporation in five "voting trustees", who were all directors of the bank and some officers of the bank. The agreement provided:

The trustees and/or such other persons as they may designate shall constitute the first board of directors of the Securities Co. This board will name the officers and management and will direct the operations of the Securities Co. The charter, regulations and bylaws of said corporation will be as determined by the trustees.

THE TRUSTEES

Messrs. H. G. Dalton, G. W. Grandin, Warren S. Hayden, William G. Mather, and J. R. Nutt have been suggested by the officers, approved by the board of directors of the bank, and have agreed to act as trustees under this plan and the agreement herein referred to. There shall be five trustees. Any trustee may resign at any time, and in case of any vacancy in the number of trustees it shall be filled with the trustees remaining. No person shall be named a trustee who shall not be an officer or director of the bank and any trustee who shall cease to be a director or officer of the bank shall also cease to be a trustee hereunder. The trustees shall be under no liability whatever for their acts or the acts of others. The trustees in all cases may act by a majority of their number either at a meeting or by writing with or without a meeting.[1]

(ii) *The Union Lennox Co.*—The Union Lennox Co. was incorporated May 9, 1922, under the laws of the State of Ohio, with 1,000 shares of no par value. On May 11, 1922, a stated value of $200 per share was declared. The Union Trust Co., in consideration of the transfer of 995 shares of capital stock, conveyed to the Union Lennox Co. fee and leasehold interest to certain properties on which the bank building was to be erected and structural steel and materials to be used in the construction. On January 1, 1925, the capital stock of the Union Lennox Co. was reduced from $200,000 to $100,000.[2]

The Union Trust Co., in its bank earnings included the earnings from the Union Lennox Co. main bank building. The net profits from the operations of this building, as reflected in the financial reports of the Union Trust Co., were for 1926, $219,852.80; for 1927, $448,468.94; for 1928, $543,508.60; for 1929, $584,392.10; for 1930, $601,672.14; for 1931, $537,275.11; and for 1932, $402,996.81. The net profit from the building was a very material item in the earnings of the bank. Yet at no time does the $300,000 annual amortization of the principal of the mortgage appear as rent expense to the Union Trust Co., and nowhere on the records of the bank is there an account "Mortgage payable."[3]

(iii) *P. A. Frye Co.*—The P. A. Frye Co. was incorporated May 23, 1930, for the purpose of buying and holding, leasing and dealing generally in real estate, land contracts, and leaseholds. The true function of this company, however, was to manage, operate, and

[99] Pt. 18, pp. 8135, 8139.
[1] Pt. 18, pp. 8135–8136; pt. 19, pp. 8604–8605.
[2] Pt. 18, p. 8136.
[3] Pt. 18, p. 8144.

dispose of properties foreclosed by the Union Trust Co. and conveyed to this company.

The authorized capitalization of 50 shares of no-par-value stock was all subscribed for by the Union Trust Co. for $5,000.[2]

No dividends have ever been paid by this company. The losses which were sustained in each year of operation have been absorbed by the bank, so that the company's capital remains unimpaired.[3]

(iv) *The Akers-Folkman Co.*—The Akers-Folkman Co. was incorporated June 8, 1919, with an authorized capital stock of $10,000. The Union Trust Co. subscribed for $1,000, the total outstanding, and the actual amount paid in was $100. This company operated a travel bureau. As of December 31, 1932, a deficit of $4,217.24 existed in addition to an indebtedness of $2,000 to the Union Trust Co.[4]

(v) *The Cleveland-Boston Co.*—The Cleveland-Boston Co. was organized in Ohio on October 9, 1928, as a holding company for the assets of the Cleveland-Akron Bag Co. taken in foreclosure. It was capitalized at 500 shares of no par value, the value of which was declared to be $100 per share. The Union Trust Co.'s proportionate share represents fifty-three eighty-fifths of the balance of $740,183.88 remaining unliquidated as of December 31, 1931.[5]

In the report of January 20, 1933, the superintendent of banks stated:

> It is apparent that the liquidating value of the Cleveland-Boston Co. is almost entirely a slow work-out proposition of undeterminable value at this time.[6]

7. Abuses

The machinations and artifices of the officers and directors of the Guardian Detroit Union Group, Inc., and the Detroit Bankers Co., of Detroit, were not indigenous to Detroit, Mich., but were employed in a slightly variant manner, with the same temporary effectiveness, by the banking officials in Cleveland, Ohio.

The dominant personalities of the Guardian Trust Co. and the Union Trust Co., in Cleveland, did not obviously regard themselves as public depositaries burdened with the fiduciary duty of safeguarding the depositors' funds, but rather deemed themselves private bankers dispensing the funds of their institutions to themselves and other powerful interests whose favor they sought to incur, to finance speculative and doubtful ventures. In order to secrete and conceal the losses sustained by these branches of trust, incompetence, and mismanagement these banking officials resorted to a course of deception and prestidigitation, deluding and imposing upon depositors, stockholders, and Government bank examiners. To accomplish these frauds, these bankers sought and readily obtained the assistance and subvention of the banking institutions in the large commercial centers of the country. The utility of this surreptitious conduct was only transitory. The day of judgment could not be avoided.

The inquiry into the Guardian Trust Co. and Union Trust Co., in Cleveland, and the group-banking companies in Detroit, was most revealing and will be of incalculable aid in the promulgation of legislation directed to the eradication of banking abuses.

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[2] Pt. 18, p. 8136.
[3] Pt. 18, p. 8144.
[4] Pt. 18, pp. 8136, 8145.
[5] Pt. 18, p. 8137.
[6] Pt. 18, p. 8145.

(a) FALSE REPORTS AND "WINDOW DRESSING" (1) FALSE AND MISLEADING REPORTS (i) EXCLUSION OF SUBSIDIARIES FROM REPORTS

(1) (i) The failure of the Guardian Trust Co. was not the result of unusual economic conditions, but rather the result of many years of mismanagement. Leniency in the granting of credit and laxity in collection gradually forced this bank into activities beyond the legitimate scope of banking. The bank became, in effect, a real-estate company and the holder of worthless securities. The management, in order to conceal from shareholders the true state of the bank's condition, resorted to the formation of subsidiaries and to methods of accounting and preparation of reports designed to conceal losses which were being constantly sustained. Excessive earnings were reported; semiworthless assets were transferred to subsidiary companies at their book value to avoid showing losses due to write-offs; and report of earnings and the condition of the bank was misleading and contrary to sound accounting principles.[7]

While bank officials recognized the necessity for a combined statement of the earnings of the bank and subsidiaries, the consolidated statement prepared was distorted and falsified and did not present an accurate description of the combined operations. The statement of consolidated earnings contained in the bank's 1932 annual report showed combined earnings of $7,628,286.24, as follows:

1932	$1,359,054.83
1931	2,066,293.14
1930	2,115,578.84
1929	2,087,359.93
Total	[8] 7,628,286.24

The combined figures for this period, after eliminating intercompany transactions and dividends paid by subsidiary companies, amounted to only $6,535,161.39, as follows:

1932	$916,074.34
1931	1,692,679.22
1930	1,777,3[illegible]5.46
1929	2,149,082.37
Total	[8] 6,535,161.39

The difference in earnings before elimination of intercompany transactions of $7,628,286.24, and earnings after elimination of intercompany transactions of $6,535,161.39, or $1,093,124.85, represents the amount by which profits were misrepresented for a 4-year period by this method alone. This exaggeration of profit was accomplished by the simple expedient of including in this consolidated statement only the operation of those subsidiaries, such as the New England Co. and Branch Investment Co., which had substantial earnings and omitting subsidiaries, such as the Hollenden Hotels Co. and the many small real-estate holding companies, which had substantial losses.[9]

For the year 1931 the bank's report showed the consolidated earnings as $2,066,293.14, while in fact the combined earnings of the

[7] Pt. 18, p. 7998.
[8] Pt. 18, p. 7999.
[9] Pt. 18, pp. 7999–8000.

bank and subsidiaries, after eliminating intercompany dividends and transactions, were $1,692,679.22. The difference of $373,613.92 is composed of the losses and earnings of companies not listed in the bank's report of consolidated earnings. The $411,010.96 operating loss of the Hollenden Hotels Co. was completely ignored and was not included in the bank's statement read to stockholders. The operations of this company, which lost $1,001,704.27 in a 4-year period, were not inadvertently omitted from the consolidated statement. The omission was designed and deliberate.[10]

These falsifications were not only contained in this consolidated report in the bank's annual report but were spread upon the minutes of the annual shareholders' meeting held January 18, 1932, as follows:

> The president reported the gross and net earnings, also the gross expenses, by departments; the net earnings of the company, including its subsidiary companies and after eliminating intercompany dividends, being $2,066,293.14, compared with $2,115,578.34 for the year 1930.[11]

The true earnings for 1931 were $1,692,679.22.

The stockholders of the bank were misled not only by the omission of the subsidiaries' activities but by the statement of earnings for the bank.

(ii) *Inadequate reserves.*—In the operation of a bank it is necessary at times to write off losses due to unpaid loans, discounts, interest, etc., and to reserve for decline in securities, real estate, and other assets acquired. A "reserve for depreciation" is created by charging to current year's operations and crediting to the reserve for depreciation account a sum which past experience has indicated should be sufficient to cover losses which might reasonably be anticipated. If this sum is truly representative of these losses, the profits for each year as reported will be reasonably close to actual profits for the year.

In the case of the Guardian Trust Co., the term "Reserve for depreciation account" was a misnomer, as the account was at all times entirely inadequate to take care of the occurring losses. In a schedule in the file of W. R. Green, comptroller, captioned "Nonaccruing Loans and Investments, August 13, 1929", doubtful loans were indicated at $4,359,470.29. The reserve for depreciation on the same date, according to the general ledger account, was only $192,182.68. The general inadequacy of the reserve and the failure to provide for losses necessitated a transfer from the undivided profits at the end of the year of sufficient funds to cover the balance of the losses. This transfer from profits of prior years did not affect the operations of the current year.[12]

In other words, the report of current earnings of the bank included accrued interest receivable on loans. Subsequently, some of these loans became uncollectible and other losses were incurred; and the undivided-profits account had to be charged back with these losses. Had adequate reserves been created from current operations, this charge-back would not have been necessary.

> * * * As a result of this procedure, the earnings of the bank as shown in the auditing department reports did not reflect the actual results from operations. The minutes of the board of directors for the years 1931 and 1932 indi-

[10] Pt. 18, p. 8000.
[11] Pt. 18, p. 8000; pt. 19, p. 8398.
[12] Pt. 18, pp. 8001–8002.

cate that the earnings of the bank as shown by these auditing departments reports were submitted by the president to the board of directors and considered correct earnings by them in determining dividends and the financial condition of the bank.[13]

The "reserve for depreciation account" was obviously not a reserve but actually a portion of the "profit and loss account" through which to run losses, which, if reflected on the current statement of earnings of the bank, would have caused embarrassment to the bank management. To avoid showing the actual earnings of the bank when computed on a basis designed to include losses due to write-offs of bad loans, discounts, investments, etc., the bank management used the reserve for depreciation, reserve for taxes and undivided profits accounts, to make the net result from operations confused and ascertainable only by a detailed analysis of these accounts in connection with the reported earnings of the bank for each year. Had the bank created proper reserves, the operating statement would have reflected the losses.[14]

The failure to provide proper reserves and the practice of running the losses through these accounts made these accounts merely burial grounds for losses incurred by poor judgment of the banking officials.

The "Reserve for depreciation account", as heretofore stated, should cover losses due to the decline in value of securities and properties acquired lawfully. It is created by charging to current operations and crediting to the reserve an amount which, based on past experience and the nature of the securities, should be sufficient to take care of losses reasonably to be expected for the year.

The "Reserve for taxes account" is created by the same method for the purpose of setting up tax liability and charging the expense to the current year.

The "Undivided profits account" is a portion of the general surplus and is created by transferring the net earnings after all expenses. Under proper management this fund over a period of time would show a constant increase, unless deductions are made for the purpose of increasing surplus or for the payment of dividends in a nonprofitable year.

Had the purpose of these accounts been observed by the Guardian Trust Co., the statement of earnings made a part of the annual report would have reflected the losses constantly occurring, but the confusing methods the bank employed in running losses through these reserve accounts enabled it to show earnings of $7,573,470.51 in excess of the actual earnings, after deducting losses, for the 10-year period 1923 to 1932, inclusive. The earnings of the bank, as reported in the annual reports for these years, were $15,035,156.35, whereas the actual earnings on an accrual basis, after deducting losses, were $7,461,685.84. The difference between the yearly earning reported and the actual earning ranged from $200,000 to $2,000,000 each year, the $2,000,000 figure being reached in 1932.[15]

(iii) *Accrual and cash basis.*—The Guardian Trust Co. reported earnings to stockholders and directors on an "accrual basis", which

[13] Pt. 18, p. 8002; pt. 19, p. 8378.
[14] Pt. 18, p. 8002.
[15] A statement showing the year-by-year earnings as reported on the annual report of the bank, as compared with the actual earnings after deducting losses, is contained in the record, pt. 19, p. 8408.

included the accruing interest receivable on loans and securities and interest payable on deposits and other expenses, while for income-tax purposes the bank employed a "cash basis", which eliminated these items. The earnings reported to stockholders were $967,658.14 in excess of the earnings reported for tax purposes for the years 1923 to 1932, inclusive. Under the tax laws the fact that the earnings reported were on an accrual basis and not on a cash basis should have been disclosed to stockholders.[16]

(2) *Window dressing* (i) *Guardian Trust Co.*—An almost incredible situation existed as concerns reports to stockholders of the condition of the Guardian Trust Co., of Cleveland. Written reports showing the earnings for any period were never issued to stockholders. The stockholders were apprised of the company's earnings through the medium of reports read at the annual meeting of stockholders. These annual reports are most voluminous, consisting of over 100 printed pages.[17]

The Guardian Trust Co., of Cleveland, resorted to devices similar to those employed by the Guardian Detroit Union Group, Inc., and the Detroit Bankers Co., of Detroit, to superficially "dress up" the statements of its financial condition. The most common methods used to "window dress" the reports were repurchase agreements, "kiting" of checks, and solicitation of temporary deposits.

On September 28, 1931, the Guardian Trust Co. sold to the Bankers Trust Co. $5,006,163.52 and to the Chemical Bank & Trust Co. $2,000,000 of stocks and loans under repurchase agreements. These transactions, totaling $7,000,000, had the effect of bolstering the bank's liquid position by that amount. No mention was made in the statement of September 29, 1931, published the day after the consummation of these transactions, of the bank's contingent liability to repurchase these securities.[18]

On January 14, 1932, in a letter from W. R. Green, vice president of the Guardian Trust Co., addressed to F. Coates, Jr., clearing-house examiner, and Ira J. Fulton, superintendent of banks of Ohio, it was stated:

> We are enclosing herewith statement of condition of this company as of the close of business December 31, 1931, together with published statement with publisher's certificate attached.
>
> In addition to the figures shown on the report, we wish to advise you there was, as of the date of the statement, a contingent liability for the repurchase of United States bonds sold to the Federal Reserve bank in the amount of $5,734,000 and loans and securities sold to others in the amount of $4,954,770.40.[19]

The same information was contained in the regular call report to the Federal Reserve bank dated December 31, 1931.

The published statement of condition for December 31, 1931, did not include this information relative to the bank's inability to repurchase.

Cooperation among the banks in "window-dressing" activities is evident from the telegram sent on October 27, 1931, by W. R. Green to H. H. Helm, vice president of the Chemical Bank & Trust Co., requesting that certain substitutions be made in the repurchase agree-

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[16] Pt. 18, pp. 8004–8005.
[17] Pt. 18, p. 7999.
[18] Pt. 18, p. 8058.
[19] Pt. 18, pp. 8058–8059; pt. 19, p. 8458.

ment. Helm replied that the substitutions were undesirable and suggested that the advance be put on a collateral-loan basis. Helm further stated:

This could be changed temporarily to repurchase agreement to cover publication of statement if you so desire.[20]

In order to bolster the statement of June 30, 1932, particularly the deposits, the Guardian Trust Co. pledged $5,250,000 in United States bonds, held by the Discount Corporation of New York, for a "deposit" of $5,000,000 from the Irving Trust Co. The effect of this transaction was to increase the "cash and due from banks" from $9,000,000 to $14,000,000 on June 30 and to increase deposits by a like amount.[21]

The Guardian Trust Co. enlisted the aid of Henry L. Doherty & Co. in its "window-dressing" operations. On October 23, 1929, H. C. Robinson, senior vice president of the Guardian Trust Co., wrote to E. H. Johnston, of Henry L. Doherty & Co., stating:

As you know, we have to keep a 10-percent reserve in the Federal bank against money which we have on demand and a 3-percent reserve against money which is called "time money."

* * * * * * *

All I would ask you to do would be to write me a letter stating that the money held on deposit here by Henry L. Doherty & Co. or the Cities Service Co. would not be drawn except upon a 30-day notice to us.

That letter we would use only in the event the Federal Reserve bank asked us for evidence supporting our contention relative to time deposits. I want you to understand, however, that your money is subject to check whenever you require, the same as usual.[22]

Johnston refused this request, stating:

* * * This matter has been presented to us by one of our other very good friends, but we have so far not seen our way clear to handle the matter as you suggest. I wish that you would see me the next time you are in New York and we will discuss this matter a little further.[23]

However, Robinson, in a letter dated September 19, 1932, again solicited the aid of Henry L. Doherty & Co.:

We are looking for a call from the superintendent of banks some time between September 26 and October 1. I have called upon you heretofore on these occasions and you have responded loyally.

I am hopeful that you can help us out the last four days of this month with a substantial increase in your account. * * *[24]

On September 22, 1932, Henry L. Doherty & Co. answered:

* * * we shall be pleased to increase the balance in the Cities Service Securities Co. account the last week in September to about $500,000.[25]

On September 23, 1932, Robinson replied:

* * * This is very gratifying to us and we wish to thank you and your associates for your cooperation.[26]

In an effort to strengthen the September 30, 1932, statement, the Guardian Trust Co. borrowed $5,000,000 from the Bank of Manhat-

[20] Pt. 18, p. 8059; pt. 19, p. 8458.
[21] Pt. 18, p. 8059.
[22] Pt. 18, p. 8062; pt. 19, p. 8466.
[23] Pt. 18, p. 8062; pt. 19, p. 8466.
[24] Pt. 18, p. 8062; pt. 19, p. 8467.
[25] Pt. 18, p. 8062; pt. 19, p. 8467.
[26] Pt. 18, p. 8063; pt. 19, p. 8468.

tan Trust Co. on September 23, 1932. The loan was liquidated on October 4, 1932, immediately after the publication of the statement.[27]

On December 28, 1932, the executive committee of the Guardian Trust Co. concocted a plan which was tantamount to deception. On that date the Guardian Trust Co. had pledged with the Discount Corporation of New York about $7,000,000 in United States bonds. The Guardian Trust Co. issued an official check of $5,000,000 to the Irving Trust Co. and an official check of $2,000,000 to the Chemical Bank & Trust Co. for the purpose of securing the release of these pledged bonds. Letters were addressed to both banks on December 28, 1932, specifically requesting that the checks be not presented until after the end of the year.[27]

The Guardian Trust Co. avoided by this scheme the necessity of disclosing on the published statement of December 31, 1932, that bonds shown as resources were pledged to the extent of $7,000,000. Although the issuance of the checks was shown under "Checks outstanding", yet on January 4, 1933, when the checks were presented, "Bills payable and rediscounts" were increased $7,000,000, indicating that the liability for bills payable was at December 31, 1932, understated by $7,000,000.[28]

The assistance of others was solicited by the Guardian Trust Co. in its "window dressing," On December 28, 1932, H. C. Robinson, executive vice president of the Guardian Trust Co., addressed the following telegram to Ralph Morton, treasurer of the Empire Companies, Bartlesville, Okla.:

> Can you arrange to deposit some extra funds with us from December 30 to January 2?[29]

to which Morton replied:

> Mailing today deposit one hundred thousand. Sorry cannot do more, but cannot arrange it.[29]

(ii) *Union Trust Co.*—The Superintendent of Banks of Ohio issued on October 6, 1931, a "call" upon the Union Trust Co. for a statement of its condition as of September 29, 1931. A statement was submitted by the bank to the State department of banks, dated October 13, 1931, and a more condensed form published in the Cleveland News on October 15, 1931.[30]

In order to aid the Union Trust Co. to publish a report with a good liquid position, the Van Sweringens were prevailed upon to "lend" $10,000,000 of United States Government certificates to the Union Trust Co. through the Van Sweringen Corporation. This "window-dressing" transaction was arranged by letters between the Union Trust Co., Van Sweringen Corporation, and J. P. Morgan & Co. United States Government Treasury certificates and Treasury notes totaling at least $10,000,000 were held by J. P. Morgan & Co. in safekeeping for the account of Van Sweringen Corporation.[30]

On September 29, 1931, the Union Trust Co. "purchased" from the Van Sweringen Corporation $10,000,000 of United States Government certificates and notes for $10,030,000, plus accrued interest of $82,540.98, or a total purchase price of $10,112,540.98. Payment

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[27] Pt. 18, p. 8060.
[28] Pt. 18, p. 8061.
[29] Pt. 18, p. 8061; pt. 19, p. 8465.
[30] Pt. 18, pp. 8215–8216.

was made for the bonds by a journal entry on the books of the Trust Co. crediting the "Van Sweringen Corporation special account" in the amount of $10,112,540.98.[31]

The Union Trust Co. wrote to the Van Sweringen Corporation on September 29, 1931, confirming this "purchase" and pledging the United States Government bonds as security for the deposit. The letter stated:

* * * and we have today credited your checking account with the proceeds of such sale in the amount of $10,112,540.98.

This deposit is subject to demand withdrawal, and as security for such deposit we have simultaneously transferred to J. P. Morgan & Co. for your account the above mentioned $10,000,000 par value of United States Government Treasury certificates and Treasury notes, * * *[32]

The Van Sweringen Corporation, on September 29, 1931, wrote to J. P. Morgan & Co., as follows:

We have today sold to the Union Trust Co. of Cleveland $10,000,000 principal amount of United States Government Treasury certificates and Treasury notes now held by you for our account. Please hold these subject to the instructions of the Union Trust Co. of Cleveland.[32]

The Union Trust Co. also wrote to J. P. Morgan & Co. confirming the purchase and the pledge of the bonds, and stating:

* * * Kindly hold these Treasury certificates and Treasury notes for the account of the Van Sweringen Corporation as security for this demand deposits with us, all in accordance with the terms of the annexed letter.[33]

The Union Trust Co. published its statement of condition on September 29, 1931, declaring the Government bonds as assets of the bank. No mention was even made in the statement that these bonds had been specifically pledged. The effect of this transaction on the balance sheet of the Union Trust Co., as of September 29, 1931, was to increase the "assets" under "Government bonds owned" by $10,000,000 and a corresponding increase of demand deposits.[34]

Nine days after this "purchase" the Van Sweringen Corporation repurchased these bonds from the Union Trust Co. by an exchange of letters and a reversal of book entries. The Van Sweringen Corporation wrote on October 7, 1931, to J. P. Morgan & Co. stating that the bonds had been "purchased" from the Union Trust Co, and stating:

* * * Payment of the purchase price therefor is to be (has been) made by withdrawal of said deposit.[35]

J. P. Morgan & Co. was instructed—

Upon receipt of appropriate instructions from the Union Trust Co., please hold these United States Government obligations for our account.[35]

The Union Trust Co. then addressed a letter to J. P. Morgan & Co., dated October 7, 1931 (changed by hand to Oct. 8, 1931), as follows:

We have today sold to Van Sweringen Corporation the $10,000,000 principal amount of United States Government Treasury certificates and Treasury notes now held by you as security for demand deposits made by the Van Sweringen Corporation with this company in accordance with advice to you contained in

[31] Pt. 18, p. 8216.
[32] Pt. 18, p. 8216; pt. 19, p. 8990.
[33] Pt. 18, p. 8217; pt. 19, p. 8991.
[34] Pt. 18, p. 8217.
[35] Pt. 18, p. 8217; pt. 19, p. 8991.

our letter dated September 29, 1931, signed by J. R. Nutt, chairman of this company.

We have received from the Van Sweringen Corporation payment in full for the above-mentioned United States Government obligations, and wish you would, therefore, kindly hold them for the account of the Van Sweringen Corporation.[36]

It is perfectly obvious that this whole transaction, consummated without any change of possession of the bonds or exchange of cash, but merely by book entries and letters, was arranged for no other purpose than to "window dress" the statement of the Union Trust Co. The Union Trust Co. published its statement:

United States Government bonds owned	$10,030,000.00
Accrued interest receivable	82,540.98
Demand deposits	10,112,540.98

and these entries were reversed 9 days later. No interest was charged by the Union Trust Co. to the Van Sweringen Corporation for the period between September 29 and October 8, 1931, during which time the Union Trust Co. claimed ownership of these Government securities.[37]

(a) "*Repurchase agreements.*"—The Union Trust Co. employed the "repurchase agreement" device to increase its liquidity.

On September 22 and September 25, 1931, the Union Trust Co. sold to certain New York banks, by repurchase agreements, various loan instruments for a total of $12,296,422.44 and recorded on its books $3,555,141.19 from the Guaranty Trust Co., $6,741,281.25 from the National City Bank, and $2,000,000 from the Bankers Trust Co. The effect of this transaction appeared under "resources" on the records of the Union Trust Co. on September 22 and 25, 1931, as a reduction of "Total loans and discounts", principally "time collateral loans" and "notes and bills", and an increase of amounts "due from domestic correspondent New York City banks."[38]

Employing a post-dating policy on transactions for "window-dressing" purposes, the Trust Co. dated the repurchase agreements as of October 6, 8, and 9, 1931—a period of about 14 days after the actual sale of the instruments and about 10 days after the issuance of the call statement of September 29, 1931.[38]

These repurchase agreements were a costly convenience, and were resorted to merely to present a financial statement of sound appearance on September 29, 1931. An approximation of this cost is shown by the letter dated October 7, 1931, from the National City Bank to the Union Trust Co., as follows:

Upon receipt of your telegram this afternoon with reference to the Cleveland Cliffs Iron Corporation notes for $3,500,000 payable on March 23, 1932, we charged your account with $3,434,666.09 under advice. The notes are returned to you herewith, along with a memorandum covering the debit to your account.[39]

The difference between the larger and smaller amounts, $65,333.91, is the discount charged by the National City Bank for the period between the original sale and later repurchase.[40]

These purchase agreements were entered into in complete disregard of section 710–126 of the Ohio banking act. The Union Trust Co.,

[36] Pt. 18, p. 8217; pt. 19, p. 8992.
[37] Pt. 18, p. 8218.
[38] Pt. 18, p. 8218.
[39] Pt. 18, p. 8219; pt. 19, p. 9008.

at the time of making these sales to the New York banks, failed to record the contingent liability of $12,296,422.44 on its books and on its published statement of September 29, 1931. This omission was no mere oversight due to ignorance of this banking section, for in the published statement of December 31, 1931, the Union Trust Co., complying with this section, showed among its liabilities "loans with repurchase agreement, $5,772,320.63."[41]

(b) *Nondisclosure of hypothecation of Government bonds.*—The Union Trust Co., as of September 29, 1931, held on deposit United States Government and other public funds shown on the call statement in the amount of $15,124,218.11. These Government deposits and public funds were 100 percent secured by a pledge of bonds by the bank.[42]

In the statement of September 29, 1931, the Union Trust Co. did not disclose that out of the total of $50,603,752.42 United States Government and other bonds and securities any portion had been pledged to secure deposits of public and Government funds. Depositors were lulled into the belief that the entire $50,603,752.43 was behind their deposits, whereas in reality $15,124,218.11 of these securities were pledged.[42]

A comparison of the statement issued by the Union Trust Co. on September 29, 1931, and a true statement which included the transactions on the Government securities and repurchase agreement, would indicate that the true deposit liabilities were $256,723,286.50, with $12,431,903.12 bills payable and not deposit liabilities of $266,835,827.48, with no bills payable, as published by the bank. The published statement showed a liquidity of 30.45 percent, as compared to a true liquidity of 22.90 percent, or a distortion of 7.55 percent.[43]

(c) *Nondisclosure of mortgage liability on bank building and real estate.*—The Union Trust Co. carried on its books the bank building and other properties which it acquired by foreclosure. The financial statement of September 29, 1931, did not disclose the existence of a mortgage on the main bank building. The cost of the property was thereby understated and the mortgage liability was not disclosed. Only the equity in the property was shown. The building values were not shown less depreciation, which had the effect of inflating the values by the amount of depreciation accrued to September 29, 1931. For income-tax purposes, where depreciation is an allowable deduction, the bank kept a subsidiary record of its depreciation, so that it could obtain the maximum deduction.[44]

A true statement would include in the bank-building item the total cost of the property (not simply the equity) less the deduction of the accrued depreciation to September 29, 1931, and as a liability the unpaid balance due on the mortgage, as an encumbrance under the caption "mortgage payable on the real estate."[45]

The mortgage on the main bank building of the Union Trust Co. was held by the Northwestern Mutual Life Insurance Co. in an original amount of $6,300,000. On September 29, 1931, the balance

[41] Pt. 18, pp. 8219–8220.
[42] Pt. 18, p. 8220.
[43] Pt. 18, p. 8222, contains a schedule showing this distortion.
[44] Pt. 18, p. 8221.
[45] Pt. 18, p. 8221.

due on this mortgage was $4,200,000, which should have appeared as a mortgage-payable item under liabilities.[44]

The depreciation on the building to September 29, 1931, was approximately $553,764.55. This amount was deducted on the income-tax report as an allowable deduction but not deducted on its statement of condition. The resource item, bank buildings, and real estate owned, was, therefore, overstated by approximately $553,-764.55, as was the income reported to the depositors and stockholders on the published statement of condition under the caption of " surplus and undivided profits ", $17,222,943.60.[44]

(*b*) *Loans to officers and directors*

(1) *Guardian Trust Co.*—The total loans and discounts of the Guardian Trust Co. as of February 29, 1932, 1 year prior to its closing, aggregated $93,087,111.73. Loans to officers and directors of the Guardian Trust Co. as of that date totaled $5,926,071.90—over 6 percent of the total loans and discounts of the bank. Many of these loans were made without credit justification and disclose a flagrant laxity of maintenance of sufficient collateral.[46]

Referring to the general loan policy of the Guardian Trust Co., the State bank examiner, in the report of February 1932, stated:

> To begin with, a great many of the loans were past due, both collateral and unsecured. A number of collateral loans represent speculation, and apparently were made on that basis. By that I mean, the bank loaned entirely too much to the borrower and did not sell him out when they should have. They now have a greatly undercollateraled loan which the market cannot pay. A great many of the loans are dependent on market conditions, and will not be paid until prices are considerably higher than at present. This situation is strikingly true of certain officers' and some directors' loans. As you will note, officers and directors have borrowed $5,335,131.44 in their own names. This amount represents 33.3 percent of the present capital and surplus. It is needless to say their present borrowings are entirely too high and not along the lines of conservative banking. Irrespective of security, certain officers are owing entirely too much to the bank. This item is, of course, subject to severe criticism and is a reflection against the present management.[47]

J. A. House, president and a director of the Guardian Trust Co., was indebted to the bank on February 29, 1932, in the sum of $281,-638, and on April 8, 1933, in the sum of $245,933.48, allocated as follows:

	Feb. 29, 1932	Apr. 8, 1933
Loans to trust funds	$179,635.00	$166,599.96
Personal loans	11,000.00	5,157.88
Real-estate loans	91,000.00	74,175.64

(Pt. 18, p. 8041.)

Mr. House, like several of the other senior officers, used the device of obtaining loans to his trust estate and not in his own name. The records of these loans did not, therefore, disclose the true borrower but merely a trust-fund number.

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[44] Pt. 18, p. 8221.
[46] Pt. 18, p. 8040.
[47] Pt. 18, p. 8041.

The real-estate loans on first and second mortgages carried an interest rate of 5 percent until increased by the liquidator to 6 percent, which was the usual bank rate.[47]

In addition, loans were made to the Mills Co., a Cleveland concern manufacturing metal partitions. The president and vice president of this company are relatives by marriage of House, who is a director of the company. As of February 10, 1934, the Mills Co. and the members of the Mills family were indebted to the bank in the aggregate sum of $388,650.48.[48]

H. P. McIntosh, Jr., vice president of the Guardian Trust Co., was indebted to the bank at the time of closing in the aggregate sum of $110,200, against which credit balances have been offset, reducing the amount to $94,236.30 with collateral of $62,210.40.[49]

H. C. Robinson, senior vice president, borrowed through the medium of his trust account. There was an unpaid balance of $41,352.09 as of January 30, 1934, with interest in the amount of $2,605.46 unpaid and delinquent from December 15, 1932.[50]

In addition to the loans made directly to Robinson, loans were made to the Interstate Foundries, Inc., of which company Robinson, House, Green, McIntosh, and Fraser, all officers of the bank, were stockholders. The indicated unpaid balance due the Guardian Trust Co. as of February 26, 1930, was $438,531.89, which was secured by the company's first-mortgage bonds. At the time of the introduction of this report into evidence, after write-offs and credits, there was still due $225,400, secured by doubtful collateral.[51]

Thomas E. Monks, vice president, as of April 8, 1933, owed $42,090 to the Guardian Trust Co. Monks' personal real-estate corporation, the Allen Holding Co., owes a mortgage balance of $164,500.[52]

L. J. Kauffman, vice president, as of March 14, 1934, owed $77,984.18, with $8,083.98 delinquent interest and collateral valued at $30,196.60.[7] Kauffman was a director of a number of companies indebted to the Guardian Trust Co., among which was L. H. Heister, Inc., which owed on mortgages on vacant property $296,000. These mortgages are now in foreclosure.[53]

H. B. Stewart, a director and president of the A. C. & Y. R.R., owed, as of February 10, 1934, an unpaid balance of principal of $621,846.14, and interest accrued and delinquent of $24,980.05. The liquidator's appraisal of the collateral is $1,350. No value has been fixed for the principal security, A. C. & Y. R.R. stock. The liquidity of this loan is entirely dependent on the financial condition of this railroad. This substantial concentration of collateral in one company cannot be justified.[54]

(2) *Union Trust Co.*—Officers and directors of the Union Trust Co. were indebted to the bank on February 25, 1933, the day the bank closed, in the aggregate amount of $8,148,788.36, as follows:

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[47] Pt. 18, p. 8041.
[48] Pt. 18, p. 8043.
[49] Pt. 18, pp. 8043–8044.
[50] Pt. 18, p. 8044.
[51] Pt. 18, pp. 8044–8046.
[52] Pt. 18, p. 8046.
[53] Pt. 18, p. 8047.
[54] Pt. 18, pp. 8047–8048.

Direct liability	$7,393,805.63
Contingent liability	859,460.12
Total	8,253,265.75
Less duplications account of joint liability	104,477.39
Total	8,148,788.36

(Pt. 18, p. 8162; pt. 19, pp. 8747–8748.)

On February 17, 1934, the liability of directors to the bank was $6,128,491.36, as follows:

Direct liability	$5,549,384.41
Contingent liability	589,940.67
Total	6,139,325.08
Less duplications account of joint liability	10,833.72
Total	6,128,491.36

(Pt. 18, p. 8162; pt. 19, pp. 8747–8748.)

In the "Lenihan report", dated February 3, 1933, made as of December 20, 1932, for the edification of the directors of the bank, directors' liability was indicated to be $8,470,478.05 direct liability and $782,108.75 contingent liability, or a total of $9,252,586.80. The unsecured portion of these loans was $1,937,099.98, in addition to $4,718,200 on a nonaccrual basis.[55]

Among the loans on a nonaccrual basis was the $2,930,000 loan to K. V. Painter, the $808,800 loan to Parmely W. Herrick, the $919,000 loan to Otto Miller (only $520,000 was on a nonaccrual basis), and the $61,400 loan to W. J. Crawford, Jr.[56]

Out of the total loans to directors of $9,252,586.80 as of February 3, 1933, the undersecured loans aggregated $6,655,299.98, or over 71 percent of the total loans to directors.[57]

The total of collateral loans on December 20, 1932, was $64,876,214.05. The direct loans to directors of $8,470,478.05 were collateral loans—approximately 12 percent of the total collateral loans.[58]

(c) *Loans to officers and directors of other banks*

(1) *Guardian Trust Co.*—When the Guardian Trust Co. closed in February 1933, there was outstanding approximately a half million dollars in loans to officers and directors of other banks. Among these borrowers were E. R. Fancher, Governor of the Federal Reserve bank, who owed $11,388.47, unsecured, and $16,500, secured; W. M. Baldwin, president of the Union Trust Co., who owed $15,476.25 with collateral of $4,350; and A. W. Dean, a director of Guardian Trust Co., and treasurer of Enos Coal Mining Co.[59] On December 31, 1932, the Enos Coal Mining Co. and its officers, among whom was E. R. Fancher, owed the Guardian Trust Co. the following:

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[55] For an itemized tabulation of these loans, see pt. 18, p. 8163.
[56] Pt. 18, p. 8163.
[57] Pt. 18, p. 8164.
[58] Pt. 18, p. 8164. A detailed analysis of individual loans is contained in the record pt. 18, pp. 8162–8168, and 8181–8188.
[59] Pt. 18, pp. 8048–8051.

Enos Coal Mining Co. (direct)	$35,000
Enos Coal Mining Co. (indirect)	3,400
Enos Coal Mining Co. (bonds)	651,000
A. W. Dean (collateral)	133,300
A. W. Dean and E. R. Fancher	44,200
Fred S. McConnell	7,500
Algiers, Winslow & Western R.R. (bonds)	200,000
George A. Enos (collateral)	226,800
Total	1,301,200

(Pt. 18, p. 8050; pt. 19, p. 8505.)

The company suffered losses exceeding $100,000 in 1929, at the peak of prosperity. The bank officials should have known that the business was unlikely to be profitable unless some radical changes in expenditures and management policies were made. The conclusion is inevitable that the loans were made because of the position of Dean and Fancher.[60]

The loans made by the Guardian Trust Co. to the so-called "Eaton interests", represented by six loans, aggregated, as of April 8, 1933, $5,343,055.19, composed of the items indicated in the following schedule:

Eaton interests	Apr. 8, 1933		General average deposit balances 1931 and 1932
	Loans	Deposit balance (approximate)	
A. Cleveland Cliffs Co.	$2,010,338.61	$344,000	$300,000-$700,000
B. Continental Shares	1,145,281.62	15,000	11,000- 300,000
C. George T. Bishop, syndicate manager	440,796.59	None	None
D. Foreign Utilities, Ltd.	350,000.00	None	None
E. Otis & Co.	417,853.37	3,000	1,000- 50,000
F. R. H. Bishop, Jr., & Samuel Mather	978,785.00		
	5,343,055.19		

(Pt. 18, p. 8054)

Loans to this group are collateralized by securities involving the Mather & Otis-Continental operations.[61]

The loans and participations carried on the books of the Guardian Trust Co. in connection with the Van Sweringen interests are indicated in the following schedule:

Van Sweringen interests	Apr. 8, 1933		General average deposit balances, 1931-32
	Balance on loans	Balance on deposit	
O. P. and M. J. Van Sweringen	$2,841,000.00	[1] $25,000	$35,000-$45,000
Metropolitan Utilities, Inc.	1,465,324.60	None	None
	4,306,324.60		

[1] Includes balance of the Van Sweringen Co. and Vaness Co.

(Pt. 18, p. 8057.)

[60] For a detailed discussion of the Enos Loans, see pp. 8050-8053 of pt. 18.
[61] A detailed discussion of these loans is contained in the record, pp. 8054-8057 of pt. 18.

The borrowings of the Van Sweringens from the Guardian Trust Co. commenced in 1916, when they purchased the Nickel Plate Railroad and entered the railroad business.

(2) *Union Trust Co.*—The Union Trust Co., as of January 20, 1933, had outstanding loans to officers, directors, and employees of other Cleveland banks aggregating $5,193,615.44, as compared to total loans of every nature of $95,825,231.22 or 5.4 percent. In addition, there were outstanding loans to officers, directors, and employees of out-of-town banks in the sum of $1,318,499.54, or 1.3 percent of total loans.[62]

A comprehensive schedule showing the loans to officers, directors, and employees of the Union Trust Co. and other banks, and loans to corporations in which the officers and directors were interested, follows:

Schedule of loans to officers, directors, and employees of the Union Trust Co. and other banks of Jan. 20, 1933

Total loans of every nature		$95,825,231.22
Loans to officers, directors, and employees of the Union Trust Co.	$8,266,940.49	
Liability as endorser Union Trust Co.	898,736.62	
Total Union Trust Co.		9,165,677.11
Percent to total loans		.096
Loans to companies in which officers or directors are interested in Union Trust Co.:		
Secured loans	15,467,431.03	
Unsecured loans	5,043,189.40	
Total Union Trust Co.		20,510,620.43
Percent to total loans		.214
Loans to officers, directors, and employees of Other Cleveland banks:		
Guardian Trust Co.	1,845,725.26	
Cleveland Trust Co.	2,374,495.18	
Federal Reserve bank	154,395.00	
Society for Savings	239,200.00	
National City Bank	200,000.00	
Morris Plan Bank	49,000.00	
Central United National Bank	287,650.00	
Lorain Street Savings & Trust Co.	43,150.00	
Total other Cleveland banks		5,193,615.44
Percent to total loans		.054
Loans to officers, directors, and employees of out-of-town banks		1,318,499.54
Percent to total loans		.013
Total all loans to officers, directors, and employees of banks or to companies in which they are interested		36,188,412.52
Percent to total loans		.377
Total all other loans		59,636,818.70
Percent to total loans		.623
Grand total loans		95,825,231.22
Percent to total loans		100.0

Among the officers of other banks who borrowed heavily from the Union Trust Co. were J. Arthur House, president of the Guardian Trust Co., who at the time the Union Trust Co. closed was indebted

[62] Pt. 19. p. 8770.

to the bank in the amount of $67,900; Thomas E. Monks, vice president of the Guardian Trust Co., who owed $18,000; Belden Seymour, a director of the Cleveland Trust Co., who owed $37,215; M. J. Mandelbaum, a director of the Cleveland Trust Co., who owed $109,812.68; and F. H. Hobson, vice president of the Cleveland Trust Co., who owed $54,193.07.[63]

(*d*) *Excessive dividends*

(1) *Guardian Trust Co.*—The practice of the Guardian Trust Co. of eliminating from its combined statement the losses of subsidiaries, concealing losses in various accounts, enabled the Trust Co. to show earnings from which dividends could be declared.

The following is a tabulated comparison of the earnings shown in the Guardian Trust Co.'s annual report and the true earnings of the Trust Co., together with the amount of dividends paid from 1923 to 1932, inclusive:

Year	Earnings as reported	Actual earnings	Dividends paid
1923	$1,287,549.98	$451,030.68	$480,000
1924	1,048,646.16	521,137.26	480,000
1925	1,103,615.50	711,666.46	480,000
1926	1,192,616.95	725,141.64	560,000
1927	1,502,450.44	1,229,116.23	600,000
1928	1,482,758.00	1,069,250.75	600,000
1929	1,031,061.44	1,981,894.46	930,000
1930	2,079,722.27	1,290,280.30	1,050,000
1931	2,064,542.82	387,311.02	840,000
1932	1,342,192.79	1,110,438.22	350,000
	15,035,156.35	6,354,329.88	6,370,000

(Pt. 18, p. 8005; pt. 19, pp. 8360, 8370.)

The bank's dividends exceeded its actual earnings during this 10-year period by $15,670.12.

The payment of these dividends prevented the creation of "undivided profits", which would have enabled the bank to weather a period of financial stress.

The bank, without its subsidiaries, for the years 1923 to 1932, inclusive, despite reported earnings of $15,035,156.35, showed a shrinkage in its undivided profits account of $1,085,742.38—the difference between the balance of $1,690,572.09 on January 1, 1923, and the balance of $604,829.71 on December 31, 1932. Losses which were being sustained and dividends which were being paid were preventing the bank from attaining a position of security.[64]

The undivided profits of the bank and subsidiaries for the period from 1923 to 1932, and the decline from a credit balance of $2,194,518.88 as of January 1, 1923 to a debit balance of $52,254.84 as of December 31, 1932, with the concealment by the bank, succinctly tells the story of the bank's failure.[64]

This suppression of the true condition of the bank was deliberate. The management of the bank recognized the proper accounting principle by filing Federal income-tax returns on a consolidated basis.

[63] Pt. 18, pp. 8169–8171. Exhibit no. U–11–2 to U–11–2F; pt. 19, pp. 8771–8776, contains an itemized tabulation of all loans to officers and directors of other banks.
[64] Pt. 18, p. 8006.

As a result of filing on this basis, no income-tax liability was incurred, with the exception of $13,424 for the year 1929.

(2) *Union Trust Co.*—The Union Trust Co. paid cash dividends, from the time of its origin in 1921 to 1932 inclusive, in the aggregate sum of $27,904,750. Dividends from 1921 to 1927 were paid at the rate of 10 percent, then increased until 1932 to 12 percent, when dividends were reduced to 8 percent. Although the earnings of the Union Trust Co. were substantial in the period from January 1, 1928, to December 31, 1932, the undivided-profits account decreased $606,160.07 through payment of dividends and amounts appropriated to a reserve for losses.[65]

(e) *Excessive real-estate loans*

The State bank examiner's report as of January 20, 1933, of the Union Trust Co., regarding real-estate mortgage loans, disclosed that half the delinquent loans were over a year past due in interest and nearly all such loans were delinquent in taxes, with an alarming increase in such delinquency. The bank had 103 suits in foreclosure and expected to be forced to bid in at least 81 of these properties. As the delinquent interest and taxes increased, the property owner was certain to turn the property over to the bank. This report stated:

> In most cases the properties have been reappraised since the loan was granted. Some startling facts are revealed in the reappraisal. From the appraisals of 1927 to 1929 the 1931 and 1932 appraisals show a reduction in value from 20 to 50 percent. And the balance due on the bank's loan in a great many cases equals the 1932 appraisal. Unless some relief is granted or business conditions change I believe the bank will be forced to take over at least 300 of these delinquent loans.
>
> Another bad feature is the fact that the bank has over $2,000,000 loaned on vacant property. No attempt is now made to foreclose on such loans. All are delinquent in taxes. The bank will suffer most on allotment loans. The delinquent taxes are increasing and eating away the values back of the bank's mortgage.[66]

An analysis of the relation of real-estate loans to total loans discloses:

Date	Total loans	Real-estate loans	Percent of total
Jan. 25, 1929	$220,346,080.63	$76,846,359.10	34.9
Mar. 27, 1931	222,808,076.90	74,168,249.06	33.3
Dec. 20, 1932	152,404,226.63	66,429,477.43	43.6
Jan. 24, 1933	151,821,516.39	66,157,760.91	43.5

(Pt. 18, p. 8153; pt. 19, p. 8714.)

(f) *Violation of trust duty*

The Guardian Trust Co., as trustee of various trusts, violated its fiduciary relationship by burdening trust estates, when it had discretionary investment powers, with securities on which the bank realized a profit.

[65] Pt. 18, p. 8139.
[66] Pt. 18, p. 8153.

In the case of K. L. Grennan Realty Trust Co. bonds, the bank relieved one of its directors of a hugh block of these bonds at a 5-point profit to the director. These bonds were subsequently sold to the trusts, although the bank held a large block of the bonds which it could have sold to the trusts at cost, without the 5-point profit to the director.[67]

Some of the securities on which profits were made through the medium of passing the securities through the bond department to trust estates were:

The H. A. Stahl Properties Co. first-mortgage gold bonds, which were stepped up 8 points;

The Erie Prospect Co. first-mortgage gold bonds, stepped up 2 to 4 points;

The H. F. Neighbors Realty Co. 5½-percent land-trusts certificates, stepped up 3 points;

The Fairmount Development Co. 1926 first-mortgage bonds, stepped up 6 to 7 points;

The Fairmount Development Co. 1927 first-mortgage bonds, stepped up 5 to 6 points; and

K. L. Grennan Realty Trust Co. first-mortgage bonds, stepped up 5 points.[68]

(*g*) *Loans to Van Sweringens and controlled companies*

One of the proximate causes of the failure of the Union Trust Co. was the concentration of loans to and investments in the Van Sweringen enterprises. The policies and business management of the Union Trust Co. were dictated by Joseph R. Nutt, its president, who was influenced and dictated to by the Van Sweringens. As head of this banking institution, Nutt permitted the Van Sweringens to borrow in excess of the legal limits and to subsitute worthless collateral for valuable securities. When a loan to the Van Sweringens was refused at the main office of the Union Trust Co., it was granted at a branch of the Trust Co. upon the oral approval of Nutt.[69]

The Van Sweringens' and their controlled companies' borrowings from the Union Trust Co. may be summarized as follows:

Commercial and collateral loans	$11,412,908.54
Mortgage loans	772,064.57
Land contracts	1,000,000.00
Total	13,184,973.11
Interest delinquent to May 1, 1933	1,089,045.83
Total	14,274,018.94

When loans to the companies or to the Van Sweringens exceeded the legal limits of the bank's loaning powers and were questioned by the State examiner, the Union Trust Co. simply arranged to transfer part of the loans from one Van Sweringen company to another Van Sweringen company.[70]

Some directors and senior officers of the Union Trust Co., particularly D. L. Johnson, a director, realizing the unsoundness of so great a concentration of loans with the Van Sweringens, futilely dissented to a loan to the Higbee Co. (a Van Sweringen corporation) on De-

[67] Pt. 18, p. 8063.
[68] Pt. 18, pp. 8063–8068.
[69] Pt. 18, p. 8189.
[70] Pt. 18, p. 8127.

cember 8, 1931, and to the Van Sweringens on December 10, 1931. Johnson was not re-elected to the board of directors of the Union Trust Co. in 1932.[71]

Resistance to further loans to the Van Sweringens became so potent that an unsecured loan to the Daisy Hill Co. (a Van Sweringen company) was refused at the main office. An unsecured loan in the sum of $51,000 was, however, effected to this company at a terminal office on the oral approval of Nutt.[71]

In 1930, the Van Sweringens had completely exhausted their borrowing power with the Cleveland banks. In October 1930, arrangements were made to borrow from J. P. Morgan & Co. $39,500,000. Substantial collateral was needed to effect this loan. The collateral securing the loans made from the Cleveland banks had to be obtained by the Van Sweringens to consummate the loan from J. P. Morgan & Co. The Union Trust Co., as trustee for the other Cleveland banks participating in these loans, was custodian of this collateral. The Van Sweringens needed help, and the Union Trust Co. did not fail them. Substantially all of the collateral having any market value which was pledged with the Union Trust Co. was released from the Cleveland loans and turned over to the Van Sweringens to hypothecate against the loans from J. P. Morgan & Co. This "switching" of collateral was evidently effected by the Union Trust Co. without the knowledge or consent of the other loan participants.[72]

8. Banking Reform

The functions of commercial banking are unequivocal and definitive—flexible extensions of credit to indutsry without undue risk to the deposited funds of the public.

The recent banking experience of the nation and the inquiry into the collapse of our banking structure convinces that the existing banking organization is outmoded and archaic and incapable of adequately performing these functions so essential to the economic safety and welfare of the nation. In lieu of a comprehensive, coordinated, and cohesive system adapted to meet the changing needs of the country, there exists an incoherent, disjointed, and diversified banking labyrinth.

The banking system of this country has not been the result of a directed and guided evolutionary plan, but rather the consequence of a fortuitous and mutational development. The result has been a permutation and combination of banking institutions subject to a diversification of jurisdictions, with consequent overlapping and conflict of authority and supervision. A banking system which permits of circumvention of its legal safeguards merely by organization of a corporation under the favorable and amenable corporate laws of another State, is fatally deficient. A banking system which permits persons, without any particular aptitude, training, or background to legally assume the performance of the vital duties of a banker possesses dangerous potentialities.

Prescient and basic banking reforms are necessary. Correction of comparative trivialities will not suffice.

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[71] Pt. 18, p. 8127.

[72] Pt. 18, pp. 8127–8128. A complete, detailed history and analysis of the loans to the Van Sweringens and controlled companies is contained in the record, pt. 18, pp. 8189–8215.

CHAPTER V.—INCOME-TAX AVOIDANCES

The evidence developed by us in open hearings brought to light a variety of methods whereby the payment of income taxes was avoided or deferred until profits were more or less offset by losses. These disclosures laid the basis for legislative action designed to prevent tax avoidances and to simplify the revenue laws. Many changes have since been made in the income-tax laws directly aimed at the practices described in this chapter.

The need for reform, either in the law or its method of enforcement, or both, was made abundantly clear when the income-tax returns of some of the leaders of American finance for the years since 1929 were examined by the subcommittee. For the year 1929 the partners of J. P. Morgan & Co. collectively paid about $11,000,000 in taxes to the Federal Government. For the year 1930, 17 Morgan partners, including J. P. Morgan, paid no tax and 5 paid aggregate taxes of about $56,000. For the year 1931 not a single Morgan partner paid any tax. For the year 1932 not a single Morgan partner paid any tax.

For the year 1929 the partners of Kuhn, Loeb & Co. collectively paid about $1,900,000 in taxes. For the year 1930, 4 Kuhn, Loeb partners, including Otto H. Kahn, paid no tax, and 4 paid aggregate taxes of about $100,000. For the year 1931 six Kuhn, Loeb partners paid no tax, and the others paid taxes totaling less than $2,000. A similar situation prevailed in 1932.

The limitations of time prevented the subcommittee from determining how wide-spread this immunity from income-tax liability actually was among persons prominent in industry, commerce, and finance. It appears certain, however, that the methods of avoiding or minimizing the amount of tax payable were generally familiar to such persons as could afford to pay for expert advice. When confronted with these devices, the governmental bureaus charged with the duty of collecting taxes and enforcing the law appear to have been helpless to cope with them.

The necessity for changes in the law to curb these methods of avoidance existed for some time, and, had the inability to cope with such practices on the part of those governmental bureaus been revealed sooner, the revenues of the Federal Government would have increased by many millions of dollars. Not until the subject was brought sharply to public attention by the revelations before the subcommittee were serious steps taken to close the loopholes.

1. Tax Avoidance by Transfer of Securities to Relatives

Many cases were presented to the Senate subcommittee where securities were transferred to relatives in order to establish tax losses. The method employed was simple, consisting of a pro forma transfer of title to a relative toward the close of the tax year, and a retransfer of the same securities following the lapse of the 60-day period prescribed by law. The divestment of title was usually effective only for the minimum period during which a repurchase of the identical securities would have prevented the establishment of tax losses.

This device was exceedingly favored by leaders of American finance, whose relatives were generally possessed of considerable wealth in their own right. Thus, Thomas S. Lamont, a partner of J. P. Morgan & Co. established losses amounting to $114,807.35 in the sale of securities to his wife on December 31, 1930.[1] The tax on the amount of loss thus established would have been $20,365. In April 1931 he repurchased the securities from his wife. Both sides of the transaction were effected without the intervention of any intermediary. The payments were evidenced by entries on the books of J. P. Morgan & Co.

Mr. PECORA. Now, in what form did she make payment to you for these securities on December 31, 1930?

Mr. LAMONT. Her account in the office of J. P. Morgan & Co. was debited, was charged with the cost of these securities, and my account was credited.

* * * * * * *

Mr. PECORA. * * * How was that sale of those securities by your wife to you effected in April 1931?

Mr. LAMONT. I bought it back direct from her. Didn't occur to me to do it in any other manner.

Mr. PECORA. That is, there was no broker?

Mr. LAMONT. There was no broker.

Mr. PECORA. Or other agent or intermediary involved in the purchase of these securities by you from your wife?

Mr. LAMONT. That is right.[2]

Otto H. Kahn, of Kuhn, Loeb & Co., testified that on December 30, 1930, he sold five blocks of securities to his daughter, Maude E. Marriot, which he later reacquired by assignment in writing. Although the assignment was dated December 31, 1930, he stated that the document was actually executed in March 1931 thereby placing the retransfer just beyond the 60-day limitation period. Through this method, a loss of $117,584 was established whereby Kahn was enabled to deduct upward of $16,000 from his income tax for 1930.[3]

Charles E. Mitchell, chairman of the National City Bank, sold to his wife in 1929, 18,300 shares of National City Bank stock at a loss of $2,872,305.50. This transaction, Mr. Mitchell admitted, was entered into for the express purpose of establishing the loss for income-tax purposes. He later repurchased the stock from his wife.

Senator BROOKHART. What price did you pay for those last purchases?

Mr. MITCHELL. I sold this stock, frankly, for tax purposes.

Senator BROOKHART. That was to avoid income tax?

Mr. MITCHELL. Throwing my fortune into the breach as I did for the benefit of this institution, Senator Brookhart, in 1929, I had a definite loss in that stock which I was forced to take.

Senator BROOKHART. In other words, by making a sale of it that showed a loss in your income?

Mr. MITCHELL. That certainly did.

Senator BROOKHART. And then you bought it back afterwards?

Mr. MITCHELL. Yes, sir.

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[1] Thomas S. Lamont, June 9, 1933, J. P. Morgan & Co., pt. 2, p. 783.
[2] Thomas S. Lamont, supra, pp. 794, 796.
[3] Otto H. Kahn, June 28 and 29, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1150–1154; 1197–1206, 1219–1230.

Senator BROOKHART. That sale was just really a sale of convenience, to reduce your income tax?

Mr. MITCHELL. You can call it that if you will.

Senator BROOKHART. Well, is that right?

Mr. MITCHELL. Yes; it was a sale, frankly, for that purpose * * *.[4]

As a result of this transaction, Mitchell paid no income tax in 1929.[4a]

2. TAX AVOIDANCE BY SALE OF SECURITIES THROUGH FOREIGN CORPORATIONS

In 1924 U. S. & Foreign Securities Corporation transferred 500,000 shares of its common stock to Dillon, Read & Co. for $100,000. Dillon, Read & Co. distributed these shares to its members at 20 cents a share. James V. Forrestal, a member of the firm, received 750 shares as his portion. Subsequently, Forrestal increased his holdings by the purchase of 17,000 shares of U. S. & Foreign Securities Corporation at 75 cents a share and 12,500 shares at $10 a share.[5]

Forrestal caused to be organized the Beekman Co., Ltd., a Canadian corporation, with its principal place of business in Toronto, Canada, and the Beekman Corporation of Delaware, which owned all the stock of Beekman Co., Ltd.[6] Forrestal owned 70 percent and his wife 30 percent of the stock of Beekman Corporation of Delaware.

On July 3, 1929, Forrestal transferred 15,000 shares of U. S. & Foreign Securities Corporation to Beekman Co., Ltd. On August 10, 1929, he transferred an additional 5,000 shares to Beekman Co., Ltd.[7] Of the shares thus transferred, 15,000 were set up on the books of Beekman Co., Ltd., at $60 a share and the remaining 5,000 at $63.50 a share. The total figure was set up as paid-in surplus to the Canadian corporation.[8]

The purpose underlying the formation of both these corporations was to postpone and avoid the payment of income and inheritance taxes.[9] To understand the rationale for the procedure adopted an examination of the tax law then effective is necessary.

Under section 112 (b) (5) of the Revenue Act of 1928 as it existed at the time of these transactions, no gain or loss was recognized where securities were transferred by an individual to a corporation solely in exchange for stock in such corporation and where, immediately after the transfer, the transferor was in control of the corporation (control being defined as ownership of 80 percent or more of the common stock). In such case, even though the stock received from the corporation in exchange for the securities transferred to it exceeded in value the price paid for the securities by the transferor, the transaction was not subject to Federal income-tax liability at that time. Where, however, the transferor sold or liquidated the shares of the corporation which he received in exchange

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[4] Charles E. Mitchell, Feb. 21, 1933, National City, pt. 6, p. 1812.

[4a] Charles E. Mitchell, supra, p. 1814.

[5] James V. Forrestal, Oct. 18, 1933, Dillon, Read & Co., pt. 4, p. 2061.

[6] James V. Forrestal, supra, p. 2054.

[7] James V. Forrestal, supra, p. 2060.

[8] James V. Forrestal, supra, p. 2062.

[9] James V. Forrestal, supra, p. 2059. Bernhard Knollenberg, Oct. 18, 1933, Dillon, Read & Co., pt. 4, pp. 2077, 2079.

for the securities transferred by him, he would be subject to a tax on the difference between the original cost price of the securities transferred by him and the price realized for the securities received by him in the exchange. The legislative intent was that there should be no tax imposed until there was a realized profit.

Under section 113 (a) 6 of the Revenue Act of 1928, a corporation receiving securities was required to take as their cost basis not the value when the corporation acquired such securities but the amount paid for them by the prior owner, who had transferred them to the corporation.

Under the Canadian income-tax law, however, a different rule prevailed. A Canadian corporation which acquired property was entitled to take as its cost basis, in computing Canadian income tax, the value of the property at the time it was acquired by the corporation and not the cost to the prior owner. Thus in the case of the transfer by Forrestall of U. S. & Foreign Securities Corporation stock to the Canadian corporation, if that stock were sold by Beekman Co., Ltd., in Canada, the Canadian income-tax authorities would compute the taxable profit on the sale, not at the price which Forrestal paid for the securities but at their value when the Canadian corporation acquired them. On the other hand, under the law of the United States, if the stock were transferred by Forrestal to a domestic corporation and sold by it, whether in Canada or in the United States, or if the securities were sold by Beekman Co., Ltd., in the United States, an income tax measured by the difference between the cost to Forrestal and the price realized on the sale of the stock would be payable.

Bernhard Knollenberg, Forrestal's tax counsel, concluded that the rule in the case of a transfer by Forrestal of U. S. & Foreign Securities Corp. stock to the Canadian corporation as paid-in surplus would be the same as the rule in the case of an exchange of Forrestal's securities for the Canadian corporation's stock.[14]

The formation of the Delaware corporation was a refinement of the plan, the purpose of which was to avoid potential inheritance taxes under the Canadian law. If Forrestal were to own the stock of the Canadian corporation at the time of his death, a large Canadian inheritance tax, as well as the United States inheritance tax would be payable on the stock. However, if the stock of the Canadian corporation were owned by a domestic corporation, the latter would continue to exist even though the individual who owned its shares might die. By vesting in Forrestal and his wife the shares of the Delaware rather than the Canadian corporation, and by vesting in the Delaware company the shares of the Canadian corporation, a method was established of avoiding payment of the Canadian inheritance tax in the event of Forrestal's death. The United States inheritance tax would still be payable since the value of the Canadian corporation's stock would be reflected in the value of the Delaware corporation's shares held by Forrestal, but double inheritance tax liability would be avoided.[15]

The ultimate success of this attempt to avoid the payment of income tax on the tremendous profit on the U.S. & Foreign Securities

[14] Bernhard Knollenberg, supra, p. 2083.
[15] Bernhard Knollenberg, supra, p. 2077.

Corporation stock owned by Forrestal was dependent upon the sale of these securities by the Canadian corporation in Canada. Upon such a sale, the taxable profit would be not the difference between the cost to Forrestal of the shares transferred by him to the Canadian corporation and the selling price of the securities, but rather the difference between the market price of the securities at the time they were transferred to the Canadian corporation, which was far in excess of their cost to Forrestal, and the selling price. If the sale of the securities were effected in the United States instead of Canada, the profit would be measured by the difference between the cost to Forrestal and the selling price realized in this country.

It was part of the original plan of Forrestal to effect the sale of the securities transferred to Beekman Co., Ltd., in Canada, but this part of the plan went askew. The shares transferred by Forrestal to the Canadian corporation were not sold in Canada but were delivered, through the agency of Dillon, Read & Co., to the brokerage firm of Dominick & Dominick, who were operating a pool in U.S. & Foreign Securities Corporation stock on the New York Stock Exchange. The shares owned by the Canadian company were taken into the pool account, and sold in the open market on the New York Stock Exchange.[16]

In July and August 1929, through Dominick & Dominick, 16,783 shares of stock, which originally cost Forrestal $28,539.60, were sold by Beekman Co., Ltd., for the net aggregate sum of $892,-936.01. The difference of $864,396.41 represents the profit upon which, under the United States rule, the income tax is computed. Had Forrestal been the owner of the stock when it was sold through Dominick & Dominick, the tax upon his profit of $864,396.41 would have been $95,000. On the assumption that the sale of these securities was actually effected in the United States, a like sum would be payable by Beekman Co., Ltd., to the Federal Government.[17]

* * * * * * *

Albert H. Wiggin, of the Chase National Bank, organized in 1925, three Canadian corporations, Medfield Corporation, Ltd., Selcott Corporation, Ltd., and Greenwich Corporation, Ltd., for the avowed purpose of minimizing the payment of income taxes in the United States.

Mr. PECORA. What was the purpose for the creation of the Medfield Corporation, Ltd., which was one of those Canadian companies you have mentioned?

Mr. WIGGIN. I think the purpose of the Medfield Corporation, Ltd., the same as the other two Canadian companies, was for the purpose of minimizing the tax on other corporations.[18]

To accomplish this purpose, when one of Wiggin's domestic corporations desired to sell securities which might realize a taxable profit, the domestic corporation would exchange the securities it proposed to sell for the stock or debentures of one of the Canadian companies, which in turn would dispose of the securities in Canada. The ultimate sale of the securities and their delivery were effected in Canada and, hence, were not reported in the United States.

Mr. PECORA. How was it sought to accomplish that purpose, through what processes?

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[16] James V. Forrestal, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2062; Bernhard Knollenberg, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2087; and Paul M. Strieffler, Oct. 13, 1933, Dillon, Read & Co., pt. 4, pp. 2095, 2097

[17] James V. Forrestal, Oct. 13, 1933, Dillon, Read & Co., pt. 4, pp. 2066, 2071.

[18] Albert H. Wiggin, Oct. 31, 1933, Chase Securities Corporation, pt. 6, p. 2879.

Mr. WIGGIN. Well, say they sold securities, that the Shermar Corporation, or whatever company it was, sold securities to the Canadian companies, and took in exchange for those securities the stock and debentures of the Canadian companies.

Mr. PECORA. Well, by that means how was it hoped to save anything in the matter of income taxes?

Mr. WIGGIN. The investment of the Canadian companies—well, as I understand it, there was no tax on two of those Canadian companies on their earnings.

Senator COUZENS. Were the earnings of those companies all made in Canada? Was that the reason?

Mr. WIGGIN. Yes, sir.

Senator COUZENS. Then you did not make any income-tax return on those corporations whose earnings were made in Canada; is that correct?

Mr. WIGGIN. I will have to get the details on that. I cannot say "no" or "yes" to that question offhand. [After consulting an associate.] I am advised that no income tax was reported in Canada because counsel for the Canadian companies located in Canada said there was no tax to pay.

Mr. PECORA. How did those Canadian companies transact business?

Mr. WIGGIN. When they sold securities the securities were sold in Canada, delivered in Canada, and the money put in bank in Canada.

Mr. PECORA. And in that way it was claimed that the transactions all took place in Canada and hence were not liable to taxation by the United States Government; was that the contention?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. That was the scheme and purpose?

Mr. WIGGIN. That was the plan.[19]

* * * * * * *

Mr. PECORA. Your domestic companies were trading in securities continuously, were they not?

Mr. WIGGIN. Yes, sir.

Mr. PECORA. And whenever they bought securities and wanted to resell them at prices that would enable them to derive profits from the transaction, the resale was by means of an exchange of those securities with the Canadian companies, not for cash but for capital stock of the Canadian companies, and then the Canadian companies effected a resale of them in Canada—was that the process?

Mr. WIGGIN. The initial transaction; yes.

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Mr. PECORA. The only reason then for having these transactions take this circuitous route was to enable the Canadian companies to claim that the transactions were had entirely in Canada and hence did not become liable to taxation in favor of the United States Government if any profits were derived therefrom? Is that right, Mr. Wiggin?

* * * * * * *

Mr. WIGGIN. That is true as to the securities that were sold.[20]

The Canadian companies were dissolved in 1931 and their holdings were distributed to one of Wiggin's family-owned domestic corporations. This final step was likewise taken in such manner as to be exempt from taxation.

Mr. PECORA. And upon the dissolution of these three Canadian companies in 1931 what disposition was made of their assets?

Mr. WIGGIN. All of the securities of the Canadian companies were transferred to the Murlyn Corporation in 1931 in consideration of the issuance of capital stock. These were nontaxable transactions and all done under the reorganization section of the Income Tax Act.

Mr. PECORA. That is, the Canadian companies sometime prior to their dissolution turned over all of their securities they held in portfolio to the Murlyn Corporation?

Mr. WIGGIN. At the time of the dissolution.

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[19] Albert H. Wiggin, supra, p. 2879.
[20] Albert H. Wiggin, supra, pp. 2883–2884.

Mr. PECORA. And the Murlyn Corporation issued its own stock?
Mr. WIGGIN. Issued its own stock.
Mr. PECORA. To whom?
Mr. WIGGIN. To its stockholders.
Mr. PECORA. To the stockholders of the Canadian corporations?
Mr. WIGGIN. Yes; to the stockholders of the Canadian corporations, and they were, as you know, the same interests as the domestic corporations.
The CHAIRMAN. Then under this reorganization section that you mentioned they escaped income taxes?
Mr. WIGGIN. Yes, sir. There was no tax involved.
Mr. PECORA. No tax involved in the last stage of those transactions because they involved exchanges of securities?
Mr. WIGGIN. That is my understanding.[21]

3. TAX AVOIDANCES IN CONNECTION WITH SHORT SALES

From September 23, 1929, to November 4, 1929, Shermar Corporation, one of the private corporate vehicles of Albert H. Wiggin and his family, sold short 42,506 shares of Chase National Bank stock for $10,596,968.[22] To cover these short sales, the Shermar Corporation borrowed 49,020 shares from three family trusts theretofore created by Wiggin for his wife and each of his two daughters.[23] During the period when the stock of the three family trusts was loaned to Shermar Corporation, the trusts received and had the use of the $10,596,968 realized from the short sales.[24]

On October 25 and 30, 1929, Shermar Corporation returned to the trusts the shares of stock borrowed. This was made possible by Wiggin loaning 48,822 shares and Mrs. Wiggin loaning 10,000 shares to Shermar Corporation for that purpose. Neither Wiggin nor his wife received any consideration from Shermar Corporation for the loan of their shares.[25]

On December 11, 1929, Murlyn Corporation, another of Wiggin's family owned corporations, purchased 42,506 shares of Chase National Bank stock from Metpotan Securities Corporation, a wholly owned subsidiary of the Chase National Bank, for the total purchase price of $6,588,430. To finance the purchase, Murlyn Corporation borrowed the money from Chase National Bank and Shermar Corporation.[26]

The 42,506 shares purchased by Murlyn Corporation corresponded in number to the net short position of Shermar Corporation. Had Shermar Corporation purchased these shares for $6,588,430 on December 11, 1929, it would have realized a taxable profit of $4,008,538 on the short sales. In order to avoid this result, Wiggin caused Murlyn Corporation to purchase the shares. At this juncture, one Wiggin family corporation was "short" and another was "long" the same number of shares of Chase National Bank stock.

On February 4, 1931, a merger was effected by Wiggin between Murlyn Corporation and Shermar Corporation. Shermar Corporation delivered its capital stock to the shareholders of Murlyn Corporation in exchange for the securities then in the portfolio of Murlyn Corporation, which included the 42,506 shares of Chase

[21] Albert H. Wiggin, supra, p. 2884.
[22] Albert H. Wiggin, Nov. 1, 1933, Chase Securities Corp., pt. 6, pp. 2951, 2954.
[23] Albert H. Wiggin, supra, p. 2952.
[24] Albert H. Wiggin, supra, p. 2959.
[25] Albert H. Wiggan, supra, pp. 2958–2959.
[26] Albert H. Wiggin, supra, p. 2966.

National Bank stock. The exchange was not taxable.[28] By means of the merger, Shermar Corporation acquired the 42,506 shares of Chase National Bank stock which enabled it to close out its short account.[29]

The effect of these transactions was to postpone to 1931 the realization of the profits which would have been taxable in 1929 had Shermar Corporation covered its short position in that year.[30] But Shermar Corporation had no taxable income for the year 1931. Although its tax return reported the profit derived from the short sales of Chase National Bank stock, its losses for 1931 were more than sufficient to offset this profit.

The profit on these short sales was for all practical purposes earned in December 1929 when Murlyn Corporation acquired sufficient shares to cover the short position of Shermar Corporation. Nevertheless, because of the legal fiction of distinct corporate entities, the acquisition of the stock by Murlyn Corporation was not an acquisition by Shermar Corporation, even though the ownership of the two companies was substantially the same. Hence, Shermar Corporation did not technically acquire the 42,506 shares until its merger with Murlyn Corporation on February 4, 1931, and the profit was treated as having been earned at that time, with the result that no tax was ever paid on it.[31]

* * * * * * *

The investigation disclosed that trusts, like private corporations, were sometimes employed to postpone payment of taxes on profits realized from short sales.

In 1925 and 1926 William Ewing, a partner of J. P. Morgan & Co., and his wife, Maria T. Ewing, created separate, irrevocable trusts, of which Ewing was trustee, in favor of each of their four children.[32] In 1928 Ewing, as trustee, sold short 4,350 shares of the stock of Johns-Manville Corporation, dividing the sales equally among the four trusts.[33] The aggregate selling price was $654,476.[34] In order to make delivery of the stock sold, Ewing, as trustee, borrowed 1,800 shares from his wife and 2,550 shares from himself, individually. The aggregate cost to Ewing and his wife of the shares so borrowed had been $206,625. The difference between the amount realized on the short sales and the cost of the stock to Ewing and his wife was $447,851. This difference was not treated as a profit, of course, since Ewing and his wife did not sell their securities but merely loaned them to Ewing, as trustee. Ewing admitted that the reason which prompted him as trustee to borrow the stock from his wife and himself instead of purchasing it to cover the short sales, was to avoid realizing a taxable profit. The money received by Ewing, as trustee, from the short sales was immediately placed to the credit of his own and his wife's account with J. P. Morgan & Co., as security for the loan of stock made by them to Ewing, as trustee.[34] Thus the funds were as effectively made available for their use as if they had sold their stock and realized the profit. At the time of the

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[28] Albert H. Wiggin, supra, p. 2063.
[29] Albert H. Wiggin, supra, pp. 2061, 2964.
[30] Albert H. Wiggin, supra, p. 2064.
[31] Albert H. Wiggin, supra, pp. 2962–2963, 2965.
[32] William Ewing, June 9, 1933, J. P. Morgan & Co., pt. 2, p. 801.
[33] William Ewing, supra, p. 804.
[34] William Ewing, supra, pp. 807–809.

hearings in June 1933, 5 years after the original short sales, the short position of the trusts had not been entirely covered.[36a]

* * * * * * *

Frank E. Taplin, former president of the Pennroad Corporation, also utilized family trusts to avoid the payment of taxes. In 1918 Taplin was about to sell a considerable block of North American Coal Co. stock at a substantial profit, when he was advised that if he were to make an irrevocable gift of the stock first the cost of the stock to the donee on a subsequent sale would be regarded for income-tax purposes as its market value at the time of the gift. Acting upon this advice Taplin created three irrevocable trusts in favor of his three children, respectively, and transferred the stock to these trusts. By this means he avoided the payment of any tax. Since that time, however, the law has been amended, and now fixes the cost of the stock to the donor as the basis of cost to the donee.[37]

In 1918 Taplin created an irrevocable trust for the benefit of his son. Subsequently, Taplin, as trustee, acquired 25,166 shares of Pittsburgh & West Virginia Railway Co., which he sold in 1929 to the Pennroad Corporation at a profit of $2,559,132.72.[38]

Taplin, as trustee, filed an income-tax return for the year 1929 on behalf of the trust estate as an investor and not as a dealer in securities. In 1926, however, Taplin, as trustee, had filed an income-tax return for the same trust as a dealer and, as such, had been permitted to carry forward a loss sustained in a previous year.[39] As an investor, Taplin was required to pay 12½ percent on capital gains. As a dealer in securities he was not entitled to the benefits of capital loss or capital gain. Finding it more advantageous to change his position, he filed the 1929 return as an investor. Had the return made on behalf of the estate for 1929 been filed by Taplin as a dealer in securities rather than as an investor, as had been done in 1926, the tax would have been assessed at $684,676.52 instead of $309,755.43, a difference of $374,921.09.[40]

4. Tax Avoidance by Dissolution of Partnerships at Propitious Intervals

In legal contemplation a partner's retirement from or entrance into a partnership constitutes a dissolution of such partnership. Upon such dissolution, under the income-tax law, the partnership is entitled to revalue its securities at the market value on the date of such "dissolution" and to carry forward for a period of 2 years any loss on such revaluation.

At the end of 1927 and 1929, changes occurred in the partnership of J. P. Morgan & Co. which resulted in the dissolution of the partnership and revaluation of its securities at the market value on the respective dates of such dissolution.[41]

On June 30, 1930, Thomas S. Gates retired from J. P. Morgan & Co., and the securities of the partnership were revaluated as of that date. For the period from July 1 to December 31, 1930, losses

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[36a] William Ewing, supra, p. 800.
[37] Frank E. Taplin, July 6, 1933, Kuhn, Loeb & Co., pt. 3, p. 1489.
[38] Frank E. Taplin, supra, pp. 1480–1481.
[39] Otto C. Larsen, July 6, 1933, Kuhn, Loeb & Co., pt. 3, p. 1484. Frank E. Taplin, July 6, 1933, Kuhn, Loeb & Co., pt. 3, p. 1482.
[40] Frank E. Taplin, supra, p. 1486.
[41] L. A. Keyes, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 73.

amounting to $817,558.89 were reported by J. P. Morgan & Co. as ascertained, realized losses upon closed transactions for assets sold. There was no revaluation of the securities as of December 31, 1930.[42]

At the close of business on January 2, 1931, S. Parker Gilbert was formally admitted to the firm of J. P. Morgan & Co., although it had been determined prior to December 31, 1930, that he was to join the firm.[43] The assets of the old partnership were revalued at the close of business on January 2, 1931, and by virtue of such revaluation, a loss of $21,071,862.94 was established for the 2-day period, January 1 and 2, 1931.[44] Had S. Parker Gilbert been admitted into the firm at the end of the calendar year 1930 in conformity with the practice of the firm in former years of retiring or admitting partners on June 30 or December 31, the assets would have been revalued as of December 31, 1930, and the same loss of $21,000,000 would have been established. That loss, however, would have been available as a deduction only during the succeeding two calendar years of 1931 and 1932.[45] By admitting S. Parker Gilbert to the firm on January 2, 1931, instead of December 31, 1930, J. P. Morgan & Co. acquired the right to carry forward this loss of over $21,000,000 against its taxable income for the years 1932 and 1933, receiving thereby an extension of 1 year during which the loss was available.[46]

The firm availed itself of approximately $4,000,000 of this loss for the year 1932 under the carry-forward provisions, and still had available for the year 1933 approximately $17,000,000. The year's extension was made possible simply by the expedient of admitting S. Parker Gilbert as a partner on January 2, 1931, instead of December 31, 1930.[47]

5. Miscellaneous Practices

(a) *Assistance rendered by financial institutions to customers in avoiding taxes*

The Chase Harris Forbes Corporation, in an effort to cultivate and maintain the goodwill of its customers, voluntarily and gratuitously offered to assist them in establishing losses which could be deducted from their income-tax payments.

In a letter dated August 17, 1932, from Chase Harris Forbes Corporation to William Mitchell Kendall, one of its customers, it was stated:

> Enclosed is a memorandum telling the story of what we are trying to do to help our customers establish certain losses which can be deducted from their income-tax payments. The law passed by the last Congress has made it very difficult to establish losses this year because losses through the sale of so-called "taxable securities" can be established only as an offset against gains, and, of course, very few people made any profits which can be used against losses on taxable securities.
>
> Provision has been made, however, which makes it permissible to establish losses through the sale of municipal and government bonds, both domestic and foreign. Just why Congress should have allowed losses on foreign political divisions I do not know, but such is the case.
>
> Where we can we are trying to exchange over into practically the same security so that the question of safety is not involved, and if it saves a few

[42] L. A. Keyes, supra, p. 72.
[43] L. A. Keyes, supra, pp. 77–78.
[44] L. A. Keyes, supra, pp. 73, 77. J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 42.
[45] L. A. Keyes, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 79.
[46] George Whitney, May 25, 1933, J. P. Morgan & Co., pt. 1, p. 80.
[47] L. A. Keyes, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 83.

dollars to the holder it seems to be worth while. The only thing you need to do is to let me know if it is all right to go ahead and work out, as we can, what savings are possible on your next income-tax return.

If you want more details not contained in the memorandum, please do not hesitate to call upon me.[48]

In a letter dated July 5, 1932, addressed to a customer, Chase Harris Forbes Corporation advised him that through an exchange of securities which could be effected by Chase Harris Forbes Corporation, he could establish a substantial loss for income-tax purposes without sacrificing the security of his investments.[49]

In a memorandum from G. A. Kinney, an officer of the Chase National Bank, to another official, dated December 18, 1931, it was stated:

Please sell the attached 1,000 shares of Chase stock in the name of Charles E. Keaton at the market, check to his order to be mailed to him at Hempstead, Long Island. Mr. Keaton is a member of the advisory board of the Hamilton Trust branch and is taking a loss for tax purposes with the intention of repurchasing after 30 days.[50]

The Chase National Bank was lending the facilities and personnel of the bank and its securities affiliates to assist customers in avoiding the payment of income taxes. At the same time the bank was holding out the temptation of avoiding taxation as a means of inducing customers to "switch" securities.

A rule has recently been promulgated by the Internal Revenue Bureau requiring each taxpayer to file a statement disclosing what assistance he has received in the preparation of his income-tax return.

(b) *Laxity in enforcement*

Internal-revenue agents accepted without examination income-tax returns prepared by J. P. Morgan & Co. on the assumption that preparation by that firm ipso facto established the correctness of the returns. For example, the tax return of Mrs. Margaret Y. Newbold for the year 1928, prepared by J. P. Morgan & Co., bore the following legend:

Returned without examination for the reason that the return was prepared in the office of J. P. Morgan & Co., and it has been our experience that any schedule made by that office is correct. The books of the taxpayer are located in Philadelphia, and if necessary schedule C may be verified in that city. This office, however, recommends that the return be accepted as filed.

C. M. SHEPPARD,
Internal Revenue Agent.[51]

Many other returns, particularly of partners in large banking houses, were likewise exempted from adequate scrutiny. When examinations were made, the time devoted to them was comparatively short, in view of the wealth of the taxpayers and the complex nature of their transactions. Thus, in 1930, according to the Bureau's own records, 1 day was spent in checking the partnership return of J. P. Morgan & Co. and Drexel & Co.—the most powerful banking group in the world.[52] This return was not subjected to any field examination, and apparently the agent's explanation was sufficient to satisfy the Internal Revenue Bureau that none was necessary.

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[48] Committee Exhibit No. 82, Nov. 1, 1933, Chase Securities Corporation, pt. 6, p. 2941.
[49] Committee Exhibit No. 83, Nov. 1, 1933, Chase Securities Corporation, pt. 6, p. 2944.
[50] Committee Exhibit No. 84, Nov. 1, 1933, Chase Securities Corporation, pt. 6, p. 2946.
[51] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 48.
[52] J. P. Morgan, supra, p. 48.

CHAPTER VI. INVESTMENT TRUSTS AND HOLDING COMPANIES AND CONCENTRATION OF CONTROL OF WEALTH

1. Investment Trusts

In the past decade, investment trusts have assumed such proportions and magnitude as to become a vital factor in the financial structure of the Nation. Although bearing an essential similarity to banking, the organization, operation, and management of investment trusts have not been subjected to comparable legal control, and apart from the application of the Securities Act of 1933 and the State blue sky laws to the sale of new issues, there has been no legal safeguard provided for the investing public.

This laissez faire policy nurtured a mushroom propagation of investment trusts of incalculable economic significance. The investment company became the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country. The investment trust was the vehicle employed by individuals to enhance their personal fortunes in violation of their trusteeship, to the financial detriment of the public. Conflicts of duty and interest existing between the managers of the investment trusts and the investing public were resolved against the investor. The consequences of the operations of these management trusts have been calamitous to the Nation. As was stated by Otto H. Kahn, when interrogated upon the activities of investment trusts:

> A great many sins have been committed there, Senator Fletcher. Many things have been done which ought not to have been permitted. * * *[1]

The exposure of the abuses and evils of investment trusts must be expeditiously translated into legislative action to prevent recurrence of these practices.

Proper Federal regulation of investment trusts, according to Clarence Dillon, was desirable and would be helpful.[2] In the opinion of the subcommittee, Federal regulation is indispensable.

(a) DEFINITION OF INVESTMENT TRUSTS

An investment trust is a company, incorporated or unincorporated, organized to acquire and hold securities in other companies for investment purposes.

A holding company is a company, incorporated or unincorporated, organized to acquire and hold securities in other companies with the purpose to control or materially influence the management of these companies. The distinguishing features of an investment trust

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[1] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1317.
[2] Clarence Dillon, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2113.

from a holding company are the extent of diversification of security holdings and the intent of their acquisition. The underlying motive of investment trusts is investment. The basic motivation of holding companies is influence or control of management.

(b) HISTORY OF INVESTMENT TRUSTS IN THE UNITED STATES

The investment trusts in the United States purported to be patterned after the English and Scottish finance trusts, which were organized in England as early as 1865. The British trusts, designed to afford the investor an opportunity of diversified investment, have had a satisfactory financial history and record. The estimated total invested capital of these British investment trusts in 1933 was approximately a billion dollars. In the United States the estimated total resources of investment trusts in 1924 was less than $15,000,000. Both the number and resources of the American investment trusts have greatly increased since that time.

The underlying principles of investment trusts were the combination of funds of many small investors to lessen investment risks by diversification of investment, and the maintenance of specialized management at a moderate cost. The British trusts, dominated by a tradition and experience of diversification of investment, of disinterested management, and of nonspeculative activity, successfully accomplished these purposes for many years.

The capitalization of the English and Scottish trusts almost invariably consisted of two classes of stock: " Preference stock ", with a priority as to fixed dividends, usually 4¼ to 5 percent, and as to assets upon liquidation; and " ordinary or deferred stock ", with rights to the additional earnings of the trust after the payment of dividends to the " preference stock." Two types of investment were thereby created: One which emphasized greater security with a limited yield, while the other emphasized greater yield with increased risk.[3]

The American investment trust merely superficially resembled the British trust, for the very factors which accounted for the success of the British trusts (diversification of investment, disinterested management, conservative investments, and standardized management charges) were disregarded by the organizers of the American investment trusts.

(1) *United States & Foreign Securities Corporation*—(*i*) *Organization and history*.—The United States & Foreign Securities Corporation, an investment trust and an investment holding company, was organized by Dillon, Reed & Co. under the laws of the State of Maryland in October 1924.[4] This corporation was formed to buy, sell, underwrite, offer, and generally to deal in corporation, governmental, and other securities, both American and foreign, and to take part, when desirable, in the organization and operation of corporations.[5]

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[3] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1554. A detailed statement by Clarence Dillon of the history of investment trusts in Great Britain and the United States, particularly the United States & Foreign Securities Corporation and United States & International Securities Corporation, is contained in Committee exhibit no. 1-A, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1606–1610.

[4] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1555.

[5] Committee exhibit no. 8, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1587–1588.

The authorized and issued capitalization of the United States & Foreign Securities Corporation was 250,000 shares of first preferred 6 percent cumulative dividend stock of no par value; 50,000 shares of second preferred 6-percent cumulative dividend stock of no par value; and 1,000,000 shares of common stock.[6] The first preferred stock was entitled to $100 per share and accrued dividends in the event of liquidation. The second preferred stock was entitled to 6 percent dividend after the 6 percent dividend had been paid on the first preferred stock, and was entitled to $100 per share in the event of liquidation, after payment of $100 per share on the first preferred stock. The common stock was entitled to 6 percent dividends only after the payment of the 6 percent dividends on both the first and second preferred stock.

The first preferred stock originally had no voting power, which was confined exclusively to the common stock; but subsequently, voting power was given to the first preferred in the event of default in the payment of dividends.

Allotment certificates for one share of first preferred stock and one share of common stock were offered at $100 per certificate to the public, and the entire issue of 250,000 shares of first preferred and 250,000 shares of common stock were subscribed for by the public for the aggregate sum of $25,000,000.[7]

Substantially, Dillon, Read & Co. purchased the 50,000 shares of second preferred stock for $5,000,000 and received, in addition to the second preferred stock, 250,000 shares of common stock. The remaining 500,000 shares of common stock were sold to Dillon, Read & Co. for the sum of $100,000, or 20 cents a share. Dillon, Read & Co., in consideration of $5,100,000, acquired all the second preferred stock, 50,000 shares, and 750,000 shares of the 1,000,000 shares of common stock.[7]

The market quotations of the United States & Foreign Securities Corporation common stock reached a high of $72 per share during 1929.[8]

After the division of the allotment certificates purchased by the public into first preferred stock and common stock, voting power was granted to the first preferred stock, but only in the event of default in the payment of dividends. Dillon, Read & Co., in consideration of $5,100,000, obtained 50,000 shares of the second preferred stock and 750,000 shares of the common stock, which had the exclusive voting power, except in the event of default in the payment of premiums, thereby acquiring absolute control of this investment company in which the public had invested $25,000,000.

The most circuitous mechanics were employed in the issuance and sale of the securities of the United States & Foreign Securities Corporation. After the capital structure had been determined by Dillon, Read & Co. and the corporation organized under the laws of Maryland, J. Perry Olcott, a bookkeeper in the employ of Dillon, Read & Co., in a letter dated October 10, 1924, addressed to the United States & Foreign Securities Corporation, offered to cause Dillon, Read & Co. to pay to the corporation on or before October

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[6] Committee exhibit no. 8, supra, pp. 1587–1588. Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1555.
[7] Clarence Dillon, supra, pp. 1557–1558.
[8] Clarence Dillon, supra, p. 1591.

21, 1924, the sum of $5,000,000 in cash, $100 per share for every share of the 50,000 shares of second preferred stock, on condition that $50,000, or $1 per share, be fixed as the full consideration for the issuance of said stock and be credited to the capital stock of the corporation, and the remaining $4,950,000 be set aside as a general reserve. Olcott undertook to cause persons to make an initial payment on or before November 3, 1924, of 25 percent of the allotment price for 250,000 shares of preferred stock, the sum of $1,000,000 to be retained by Dillon, Read & Co. from this initial payment as compensation for the sale and distribution of the allotment certificates; to distribute one share of common stock with every share of preferred stock sold; and to pay $100,000 in cash to the corporation. The corporation undertook to issue to Dillon, Read & Co. allotment certificates of 250,000 shares of first preferred and 250,000 shares of common stock, 50,000 shares of second preferred stock, and 250,000 shares of common stock, and the balance of 750,000 shares of common stock.[9]

This offer was accepted by the United States & Foreign Securities Corporation by Robert O. Hayward, vice president, who was a partner of Dillon, Read & Co.[10]

Simultaneously, a letter dated October 10, 1924, was sent by J. Perry Olcott to Dillon, Read & Co., transmitting the terms of the offer of United States & Foreign Securities Corporation relating to the sale of the corporate securities,[11] and a letter from United States & Foreign Securities Corporation to Dillon, Read & Co. embodying the terms of the agreement with Olcott, among which was the issuance by the corporation of 50,000 shares of second preferred and 250,000 shares of common for $5,000,000.[12]

On October 20, 1924, Olcott wrote to Clarence Dillon confirming the agreement that Clarence Dillon and his associates, as distinguished from Dillon, Read & Co. as an entity, would purchase the 500,000 shares of common for $100,000.[13]

It is perfectly manifest from these letters of agreement that, whether considered as part of a single transaction, as insisted by Clarence Dillon, or as a distinct transaction, an allocated consideration of 20 cents a share was paid by Clarence Dillon and his associates for the 500,000 shares of common stock of the corporation.[14]

The 50,000 shares of second preferred stock were issued to Dillon, Read & Co., who, in turn, sold 500 shares of second preferred, together with 500 shares of common, at $100 per unit, to F. H. Ecker, John Sherwin, Robert S. Schaffner, Herbert Fleischhacker, and Anson W. Burchard, respectively, and 100 shares of second preferred and 100 shares of common to George W. Wickersham. These individuals subsequently were designated by Dillon, Read & Co. members of the board of directors of United States & Foreign Securities Corporation with a salary to each of $5,000 per annum.[15]

The 500,000 shares of common stock, with an allocated consideration of $100,000, were issued to John W. Hornor, of Dillion, Read & Co., who, in turn, distributed these shares to the partners of Dillon,

[9] Committee exhibit no. 2, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1560–1561.
[10] Committee exhibit no. 2, supra, p. 1561.
[11] Committee exhibit no. 3, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1568–1569.
[12] Committee exhibit no. 4, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1569–1570.
[13] Committee exhibit no. 5, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1571–1572.
[14] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1563–1574, 1580–1581.
[15] Clarence Dillon, supra, pp. 1576–1577, 1579.

Read & Co. in proportion to their partnership interest, who individually paid for the stock.[16]

The 750,000 allotment certificates of one share of first preferred and one share of common were sold to the public at $100 per unit by the usual syndication methods, through a selling agency of 300 dealers throughout the country, who received in the aggregate the $1,000,000 retained by Dillon, Read & Co. from the initial payment to the United States & Foreign Securities Corporation, or 4 points per share selling commission. Dillon, Read & Co. retained $339,000 as its share of the selling commission.[17]

In connection with the sale of these securities to the public, circulars were issued and advertisements published purporting to disclose all the essential details of the corporate structure and financing.[18] These circulars and advertisements did not disclose the retention of $1,000,000 out of the $5,000,000 paid by the public for the securities.[19]

The corporation received $29,100,000, in lieu of $30,100,000, for all the securities issued.

A reserve of $4,950,000 out of the $5,000,000 payment by Dillon, Read & Co. for the second preferred stock was set up by the corporation, which fund was available under the Maryland law, although not under the New York law, for payment of dividends to the first preferred, and to charge off losses.[20]

The United States & Foreign Securities Corporation purchased all securities, bought for the account of the investment trust, through Dillon, Read & Co., who charged a commission for executing the transaction on the stock exchange. For the period from October 15, 1924, to December 31, 1925, an aggregate of $46,436,233.96 of securities were bought and sold by the company through Dillon, Read & Co.[21]

The common stock of United States & Foreign Securities Corporation never paid any dividends, and at the time of the hearings October 3, 1933, was quoted at $10 a share.[22]

(2) *United States & International Securities Corporation*—(i) *Organization and history.*—In 1928 the United States & Foreign Securities Corporation, which was controlled by Dillon, Read & Co., caused to be organized the United States & International Securities Corporation, a Maryland corporation with a capital structure of 3,000,000 shares of no-par-value common stock, 500,000 shares of first preferred 5-percent cumulative stock, and 100,000 shares of second preferred 5-percent dividend stock.[23]

Allotment certificates for 1 share of first preferred, 1 share of common stock, and an option warrant to subscribe to 1 share of common stock at $25 per share were offered to the public at $100 per unit for an aggregate of $50,000,000. The United States & Foreign Securities Corporation purchased for $10,000,000 all the 100,000 shares of second-preferred stock of the United States & International Secu-

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[16] Clarence Dillon, supra, p. 1583.
[17] Clarence Dillon, supra, pp. 1566, 1585. Committee exhibit no. 7, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1611–1616, contains a complete list of dealers and their participations.
[18] Committee exhibit no. 8, Oct. 3, 1933, Dillon, Read & Co., pt. 4, pp. 1587–1588.
[19] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1589.
[20] Clarence Dillon, supra, pp. 1590–1591, 1593.
[21] Clarence Dillon, supra, p. 1593.
[22] Clarence Dillon, supra, p. 1591.
[23] Clarence Dillon, supra, p. 1594.

rities Corporation and receive in addition 2,000,000 shares of the common stock, or two-thirds of all the authorized common stock.[24]

Clarence Dillon could offer no explanation for the necessity of organizing this new investment corporation.

Senator COUZENS. I asked you why you organized the second investment trust? You controlled the first one?

Mr. DILLON. Yes.

Senator COUZENS. And then you organized the second one. I wondered why.

Mr. DILLON. Simply because, in our judgment, it was a desirable thing to do. I do not know why.

Mr. PECORA. Why was it more desirable to go through all the burden and expense of organizing a second investment trust with a total capitalization of $60,000,000 when you already had an investment trust qualified and equipped to transact the same kind of business that the second investment trust conducted and operated?

Mr. DILLON. It was simply to expand the operations, to put them on a little larger scale.

Mr. PECORA. Well, could you not expand, as Senator Couzens has suggested, by the issuance and sale to the public of additional stock by the original investment trust in the amount of $60,000,000?

Mr. DILLON. I do not think you could have sold it. What sort of stock would you have sold? What sort of security would you have offered?

Senator COUZENS. Just simply increased the authorized capital stock.

Mr. PECORA. Simply increased the authorized capital stock; certainly.

Mr. DILLON. I do not think you could have sold it.

Mr. PECORA. Why not?

Mr. DILLON. Because this second investment trust was set up with $10,000,000 junior to the public's money. Now, you could not do that again in the first one because you did not have such a ratio, probably.

Mr. PECORA. The ratio was identical to the ratio that was used in the first investment trust, was it not?

Mr. DILLON. Yes; but if you would have sold $60,000,000 more, what would you have sold? I do not quite follow what you mean. I do not see how you could have expanded United States & Foreign to that extent. I do not think the structure would carry it.

Mr. PECORA. Well, was the second investment trust organized to conduct the same kind of business as the first investment trust was organized to conduct and did conduct?

Mr. DILLON. Yes; that is correct.

Mr. PECORA. Well, why could not an additional sum of $60,000,000 have been added to the capital structure of the first investment trust through the issuance and sale of additional stock by an appropriate amendment to its bylaws that would have authorized it to issue such additional stock?

Mr. DILLON. Well, you might have worked out such a set-up. I do not know.[25]

The sale of the $50,000,000 of first preferred stock of the United States & International Securities Corporation to the public was effected by the same general method employed in the disposal of the United States & Foreign Securities Corporation stock.

Dillon, Read & Co. received an originating fee of 1 point, or $500,000, and 3 points were allowed to the distributing syndicate, or $1,500,000; and of the $2,000,000 paid by United States & International Securities Corporation for the flotation of this issue, Dillon, Read & Co. received an aggregate of $1,065,000, which included its originating fee and participations in the various syndicating groups.[26]

[24] Clarence Dillon, supra, p. 1595.
[25] Clarence Dillon, supra, pp. 1596–1597.
[26] Clarence Dillon, supra, p. 1602.

2. Abuses

The investment trust has become an important component of the investment system of our Nation. Availing themselves of the successful record of English and Scottish investment trusts as a potent sales argument to inveigle the participation of the public, American financiers, devoid of the tradition, training, viewpoint, and competency of the British investment trustees, employed the investment trust to indulge in venturesome transactions in securities with the "public's money", and as vehicles for personal profit.

A veritable epidemic of investment trusts afflicted the Nation. The conception of function of these professed skillful investing managers of the function of an investment trust was diametrically opposed to the British viewpoint. Our investment trusts, lacking the essential characteristics of the British companies, were founded in speculative desire and dedicated to capital appreciation rather than investment return. The investment trusts of this country, from their inception, degenerated into a convenient medium of the dominant persons to consummate transactions permeated with ulterior motives; served to facilitate the concentration of control of the public's money; enabled the organizers to realize incredible profits; camouflaged their real purpose to acquire control of equities in other companies; and became the receptacles into which the executive heads unloaded securities which they, or corporations in which they were interested, owned.

The deplorable consequences to the American investing public, with their misplaced reliance upon and confidence in the competency and integrity of purpose of the investment trustees, is woefully exemplified by the Goldman-Sachs Trading Corporation. During the period from its incorporation in December 1928, with a capital of $100,000,000, of which the public furnished $90,000,000, or 90 percent, by purchasing the stock at 104, to December 31, 1931, the Goldman-Sachs Trading Corporation lost $60,000,000 in capital and surplus. The stock of this investment trust was quoted at 1¾ at the time of the hearing, May 19, 1932.[27]

(a) Concentration of control of public's money

Through the medium of the investment trust, the organizers were enabled to acquire control of an amount of the public's money grossly out of proportion to their own original investment.

In the instance of United States & Foreign Securities Corporation, Dillon, Read & Co. and its associates, in consideration of the investment of $5,100,000, procured 50,000 shares of the second-preferred stock and obtained absolute control of that corporation through the ownership of 750,000 shares of common stock, which had the exclusive voting power, of the $25,000,000 invested by the American public. Not content with this acquisition of concentration of control, Dillon, Read & Co. employed $10,000,000 of the funds of United States & Foreign Securities Corporation to purchase 100,000 shares of second-preferred stock and 2,000,000 shares, or 80 percent, of the common stock of the United States & International Securities Corporation,

[27] Walter E. Sachs, May 20, 1932, pt. 2, pp. 566–567.

thereby acquiring control of an additional $50,000,000 of the public's money.

Dillon, Read & Co. and its associates, by the investment of $5,100,-000, minus the commission received by them for the sale of the securities of United States & Foreign Securities Corporation and United States & International Securities Corporation, controlled, by this device of pyramiding trusts, $90,000,000 of wealth, a net $75,000,000 of which had been furnished by the public, ten of the remaining fifteen millions having been paid out of the earned surplus of the first corporation.

Mr. PECORA. Now, by this method is it not a fact that Dillon, Read & Co., through an original investment of $5,000,000 which it paid for the second-preferred stock of the first investment trust—the United States & Foreign Securities Corporation—plus the $100,000 that was paid for the block of 500,000 shares of the common stock of the first investment trust, acquired a control measured by the ownership of a large majority of the common stock of the first investment trust, and through the medium of the first investment trust buying for $10,000,000 all of the authorized second-preferred stock of the second investment trust, plus 2,000,000 shares of its 2,500,000 shares of common stock actually issued and outstanding, were enabled to acquire control of both of these investment trusts having a total capitalization of $90,000,000?

Mr. DILLON. Was it $90,000,000?

Mr. PECORA. $30,000,000 of first; $60,000,000 of second.

Mr. DILLON. That is correct, but you are duplicating, because the first trust took $10,000,000 of its own assets to put in junior to the public's money in the second trust.

Mr. PECORA. All right. It made that contribution to the capital of the second investment?

Mr. DILLON. That is correct.

Mr. PECORA. And that $10,000,000 which was paid by the first investment trust for the second-preferred shares of the second investment trust was paid out of an earned surplus?

Mr. DILLON. That is correct. It was paid out of the equity money—money belonging to the common stock.

Mr. PECORA. So that there was not necessarily this duplication of $10,-000,000 in the capitalization of both companies, was there?

Mr. DILLON. No; you are correct.

Mr. PECORA. The $10,000,000 was paid out of earned surplus?

Mr. DILLON. You are correct.

Mr. PECORA. And paid into the treasury of the second investment trust?

Mr. DILLON. That is correct.[38]

The purchase of the stock of United States & International Securities Corporation by United States & Foreign Securities Corporation for $10,000,000, out of earned surplus, was derogative and prejudicial to the public holders of the common stock of United States & Foreign Securities Corporation, who were deprived of the fund from which dividends might be declared.

The CHAIRMAN. You would have had money for dividends on the common stock if you had not put that money into another investment in the second investment trust?

Mr. DILLON. We might have, but we never paid dividends on the common stock.

The CHAIRMAN. I know; but you had it there. You had the $10,000,000 there.

Mr. DILLON. We had the $10,000,000 there and we invested it in the second company and lost that in protecting the public's money that went into the second company. The public's money is still practically intact. There is about ninety dollars odd a share, I am told by my associates, still there for the public, although our $10,000,000 that was junior has been lost.

[38] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1598.

Mr. PECORA. You do not mean "our $10,000,000", do you?
Mr. DILLON. Yes; I thought you said $10,000,000 from the investment trust.
Mr. PECORA. That had been earned by the first investment trust?
Mr. DILLON. Yes.
Mr. PECORA. When you say "our $10,000,000" you do not mean $10,000,000 that came out of the pockets of Dillon, Read & Co. or its individual members?
Mr. DILLON. Oh, no; I mean the earnings available for common stock.
Senator COUZENS. So, as a matter of fact, the 250,000 shares that went as bonus stock for the 250,000 shares of preferred was sacrificed for the purpose of creating the second investment trust?
Mr. DILLON. No, sir.
Senator COUZENS. Why, certainly. In other words, if you had not taken the $10,000,000 out of the first investment trust you could perhaps have paid dividends on the common stock of the first trust; but you did not do that, although you had distributed 250,000 shares as bonus stock——
Mr. DILLON. That is right; but we have never paid dividends on the common stock.
Mr. PECORA. But you had earned enough to justify the payment of dividends on the common stock.
Mr. DILLON. If you would pay your dividends out of capital appreciation. We did not, because we were working on the theory that dividends on the common stock would be paid out of income; that is, interest and dividends received. As the capital grew we did not use that. We left that to protect the first preferred, and as the income from that capital would have become large enough to take care of the first preferred and the second, and if there had been anything left over, we would have paid dividends on the common.
Senator COUZENS. What constituted this $10,000,000 you took out of the first trust to buy stock in the second trust?
Mr. DILLON. Cash.
Mr. PECORA. Representing earned surplus?
Mr. DILLON. That is correct.
Senator COUZENS. Well, then, that was not appreciation of capital. That was cash that you could have disbursed to the common-stock holders of the first trust. It was a realization; it was earnings.
Mr. DILLON. Yes, sir.
Mr. PECORA. A surplus made up of earnings.
Mr. DILLON. That is correct.
Senator COUZENS. So you sacrificed the common stock holders of the first trust to create a second trust by taking $10,000,000 of cash out of the first trust to buy common stock in the second trust?
Mr. DILLON. We could have taken that $10,000,000 and invested it in something else, but we invested it in this company, rather than investing it in Steel common or anything else.
Senator COUZENS. I know you did not buy Steel common. You bought something which you yourself controlled. So I do not think it is quite comparable.
The CHAIRMAN. It enabled them to get control of $60,000,000 more.
Senator COUZENS. Certainly.[29]

The propriety of this investment by the United States & Foreign Securities Corporation in the second preferred and common stock of the United States & International Securities Corporation was seriously questioned.

Mr. DILLON. * * * Senator Couzens spoke of the $10,000,000 that was paid in the second preferred and that should have gone as dividends to the common-stock holders. Had that been done, you realize that Dillon, Read & Co. would have received $7,500,000.
Senator COUZENS. You would have made much more off that $60,000,000 than on this $5,000,000, even if you had done that. But the question is not how much you made. The point, I think, is that it is rotten ethics to take $10,000,000 out of an investment trust you own, or which you control, rather, its ownership being in the public hands, and put it in another investment trust to further augment your own profits. I think that is reprehensible.
Mr. DILLON. Oh, that was not the fact.

[29] Clarence Dillon, supra, pp. 1599–1600.

Senator COUZENS. Certainly it augmented it, because you controlled this and the other $60,000,000 you sold to the public, and you also had common stock from which you might have earned dividends.

Mr. DILLON. From which we might have. The public has been taken care of.

Senator COUZENS. Yes; but, Mr. Dillon, you understand, of course, that I am not attacking your good faith. I still insist that you were speculating and using the stockholders' money in another corporation, which you had no right to do.

Mr. DILLON. But we were stockholders.

Senator COUZENS. You controlled them.

Mr. DILLON. Of this $10,000,000, $7,500,000 would have come to us.

Mr. PECORA. Seventy-five percent of the capital stock of the first investment trust?

Mr. DILLON. That is right.[80]

The fact is, however, that dividends were paid on the second preferred stock until 1931 by the United States & Foreign Securities Corporation, purchased by Dillon, Read & Co. for $5,000,000. The 750,000 shares of common stock had been purchased for an allocated consideration of $100,000, or 20 cents a share. Dillon, Read & Co. was merely sacrificing dividends on this $100,000 investment to obtain control of an additional $50,000,000 in capital.

Senator COUZENS. Did they pay dividends on the second preferred up to that time?

Mr. DILLON. Yes, sir.

Senator COUZENS. So you got dividends for the $5,000,000 you put in?

Mr. DILLON. That is right; up until—well, now, let me see when.

Mr. PECORA. Until 1931, wasn't it?

Mr. DILLON. Yes; I think so.

Senator COUZENS. So when you were organizing your second investment trust, you were just sacrificing dividends on a $100,000 investment for the other common shares?

Mr. DILLON. You can put it that way if you like.[81]

Although the United States & Foreign Securities Corporation was organized to invest in standard stocks, $10,000,000 of its earnings were substantially diverted in the investment in second preferred stock of the United States & International Securities Corporation.

Senator ADAMS. The theory of your first investment trust was the investment in standard stocks; that is, you were taking those standard stocks?

Mr. DILLON. Yes.

Senator ADAMS. This was a diversion of earnings of the first trust into an investment that was not in that classification, was it?

Mr. DILLON. Except that it was a new trust. It was to buy the same standard stocks as the first one did. It was engaged in the same sort of business.

Senator ADAMS. You did not invest it in first preferred; you invested it in the second?

Mr. DILLON. Yes.

Senator ADAMS. You did not invest in the same grade of securities?

Mr. DILLON. We invested it in the same grade of securities in this way. That was money that belonged to the common stock of the first trust.

Senator ADAMS. Are you sure it belonged to that? In other words, you had first preferred stock out to whom you owed a first obligation, didn't you?

Mr. DILLON. That is correct.

Senator ADAMS. So it did not belong to the common-stock holder unless you were perfectly sure that your first preferred dividend was secure, did it?

Mr. DILLON. Yes, sir; that is true.

Senator ADAMS. Then you had second preferred ahead of the common stock?

Mr. DILLON. Yes, sir.

Senator ADAMS. So you cannot say that this all belonged to common stock?

Mr. DILLON. Well, it could have been declared as dividends on the stock. It was available for that.

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[80] Clarence Dillon, supra, pp. 1602–1603.
[81] Clarence Dillon, supra, p. 1605.

Senator ADAMS. It could have been done, do you say?

Mr. DILLON. Yes, sir.

Senator ADAMS. But, as wise managers you would not have cleaned down the accumulations. You would not have cleaned them right down, but you paid the first dividend, and then what was left you would have paid out in that way?

Mr. DILLON. Yes; that was why we did not pay that.[32]

The $10,000,000 invested by the United States & Foreign Securities Corporation in the second preferred and common stock of the United States & International Securities Corporation was carried, as of December 1, 1932, and as of October 3, 1933, the date of the hearing, at a nominal value of $1, for the second preferred had no asset value at those times.[33] By this investment the stockholders of the United States & Foreign Securities Corporation were deprived of a fund available for the payment of dividends.

Mr. PECORA. The $10,000,000 that the United States & Foreign paid to the United States & International for the second preferred stock, and which second preferred stock you admit has no asset value today, represented earnings of the United States & Foreign, did it not?

Mr. DILLON. That is correct.

Mr. PECORA. Those earnings were available for distribution by the United States & Foreign to its common stockholders?

Mr. DILLON. That is correct.

Mr. PECORA. No such distribution was ever made to the common stockholders because no dividend was ever paid on the common stock by the United States & Foreign?

Mr. DILLON. That is correct.

Mr. PECORA. Earnings were available to pay dividends on the common stock of the United States & Foreign, were they not?

Mr. DILLON. Yes.

Mr. PECORA. And could have been declared?

Mr. DILLON. Yes.

Mr. PECORA. And had they been so declared, the public, which purchased for $25,000,000 the first preferred stock of the United States & Foreign, would have participated in the distribution of those dividends because with the purchase of the $25,000,000 worth of first preferred stock they acquired as a bonus, share for share, 250,000 shares of the common stock?

Mr. DILLON. Correct. They would have received one-fourth of the dividends and we would have received three-fourths.

Mr. PECORA. The public, which paid $25,000,000 into the first investment trust, never received a penny by way of dividends on the common stock?

Mr. DILLON. We thought the investment of the first investment trust in the second investment trust would be a very good investment, or we would not have made it.

Mr. PECORA. And that $10,000,000 so invested in the second preferred stock of the second investment trust is now marked down to $1 on the books of the United States & Foreign?

Mr. DILLON. That is correct. However, it has a potential value.

Mr. PECORA. So that sum of $10,000,000 which was available for distribution in the form of dividends on common stock, instead of going to the stockholders, went to the United States & International?

Mr. DILLON. It was invested in United States & International for the benefit of the stockholders of United States & Foreign Securities Corporation.

Mr. PECORA. And to that extent the stockholders of the first preferred stock who subscribed $25,000,000 to the first investment trust were deprived of one-fourth of the $10,000,000 which was available for distribution as dividends on common stock?

Mr. DILLON. No; they were not deprived of that.

Mr. PECORA. They did not receive it.

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[32] Clarence Dillon, supra, pp. 1603–1604.
[33] Clarence Dillon, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2120. Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, p. 1850.

Mr. DILLON. No; but they had their interest in the investment that was made.

Mr. PECORA. But the investment that was made has since been marked down to $1.

Mr. DILLON. That is correct.[84]

(b) EXCESSIVE PROFITS TO ORGANIZERS

The organizers of investment trusts always succeeded in devising a financial set-up which allocated to them a most substantial equity in the company with a minimum of cash investment.

Dillon, Read & Co. invested $5,000,000 in the second preferred stock of United States & Foreign Securities Corporation, as compared to $25,000,000 invested by the public in the first-preferred stock. Adopting the theory of Clarence Dillon that the purchase of the 50,000 shares of second-preferred and the 750,000 shares of common stock for $5,100,000 was one transaction and that 750,000 shares were allotted to the second preferred, as compared to 250,000 shares allotted to the first preferred, the associates of Dillon, Read & Co. were receiving 15 times as much per dollar as the investing public. Placed upon the basis, as indicated by the documentary proof, that the purchase of the 500,000 shares of common stock for $100,000 was a distinct transaction, the associates of Dillon, Read & Co. received 500 times as much in common-stock value as the public, who invested $100 per share in the first preferred. Clarence Dillon could discern no unfairness in this proportionate allocation of equity in the corporation between the organizers and the investing public, asserting that Dillon, Read & Co., had it so desired, could have acquired all the common stock for its $5,000,000 investment.

Senator ADAMS. I am not questioning that situation, that you put your own money in, $5,000,000, as security behind the first preferred, but I was merely reducing it to mathematics for my own information. You would also have 15 times as much in prospective profits for that money as compared with what the investor was getting.

Mr. DILLON. We could have taken 100 percent. We could have taken all that profit. We could have bought all the common stock for $5,000,000.

Senator ADAMS. Do you remember what Lord Clive said? "When I consider my opportunities I marvel at my moderation."[85]

The common stock of United States & Foreign Securities Corporation in August 1929 had a book value of $48 per share, and 750,000 shares of the common stock purchased by Dillon, Read & Co. for an allocated consideration of $100,000 had a book or asset value of $36,000,000. The market value of this common stock was considerably in excess of $36,000,000, the stock having reached a quotation of $72 per share, with a potential market value to these associates of $54,000,000.[86]

Nor was the potential profit nebulous or evanescent, for many of the associates of Dillon, Read & Co. disposed of their United States & Foreign Securities Corporation holdings at prices greatly in excess of the original cost to them. A substantial portion of this common stock was sold by these individuals by means of options granted to Dominick & Dominick, members of the New York Stock Exchange, who organized pool or trading accounts under these options.

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[84] Clarence Dillon, Oct 13, 1933, Dillon, Read & Co., pt. 4, pp. 2120-2121.
[85] Clarence Dillon, Oct. 5, 1933, Dillon, Read & Co., pt. 4, p. 1707.
[86] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1606.

The first option, granted December 20, 1928, to Dominick & Dominick by Dillon, Read & Co., purporting to act for its associates, covered 30,000 shares of United States & Foreign Securities Corporation common stock, 10,000 shares at $47.50, 10,000 shares at $50, and 10,000 shares at $55, over a period of 6 months. The option was subsequently enlarged to 40,000 shares, but only 25,000 shares were taken down by Dominick & Dominick at an average price of $49.[37] The option was the orthodox type, contemplating the formation of a pool or trading account, in which Dillon, Read & Co. had no participation, and granting Dominick & Dominick, as managers, the right to call for delivery of 20,000 shares from the optionors to cover short sales and prohibiting the optionors from effecting any public sales of any additional common stock. The pool or trading account, operating from December 20, 1928, to June 22, 1929, purchased and sold 129,650 shares as compared to 145,800 shares, the total volume of trading on the New York Curb Exchange, where the stock was listed. Approximately 48 percent of the entire volume of trading in the United States & Foreign Securities Corporation common stock was effected by Dominick & Dominick.[38]

Further options were granted on June 22, 1929, to Dominick & Dominick by Dillon, Read & Co. for the same associates, for 19,198 shares of United States & Foreign Securities Corporation common stock at $52 per share for a period of 60 days. A pool or trading account under this option was also organized, in which a 25-percent participation in the profits was allocated to Dillon, Read & Co.[39]

The associates of Dillon, Read & Co. delivered to Dominick & Dominick under both these options 74,198 shares for an aggregate amount of approximately $4,000,000, of which sum $1,225,000 was received by these associates for the 25,000 shares delivered under the first option.[40] All these shares formed part of the original block of 500,000 shares of common stock acquired by these associates from the United States & Foreign Securities Corporation for $100,000, or 20 cents a share.

Mr. Pecora. And those 74,108 which were sold by you and your associates through these two accounts for an aggregate of about $4,000,000 were out of a block of 500,000 shares originally acquired by individual members of Dillon, Read & Co. for 20 cents a share, or for a total of less than $15,000 in 1924?

Mr. Christie. Some of them had changed hands in between 1924 and 1929.

Mr. Pecora. But they had only changed hands among the associates of Dillon, Read & Co.?

Mr. Christie. Yes; that is right.[41]

These associates of Dillon, Read & Co., during the approximate period of these two accounts, disposed of an additional 46,354 shares of common stock of the United States & Foreign Securities Corporation to Dillon, Read & Co., who in turn sold them direct to customers and not through the exchange. The total number of

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[37] Robert E. Christie, Jr., Oct. 4, 1933, Dillon, Read & Co., pt. 4, p. 1671. Committee exhibit no. 9, Oct. 4, 1933, Dillon, Read & Co., pt. 4, pp. 1646–1647 and 1688–1689.

[38] Robert E. Christie, Jr., Oct. 4, 1933, Dillon, Read & Co., pt. 4, p. 1667.

[39] Robert E. Christie, Jr., supra, p. 1670. Committee exhibits nos. 10 and 11, Oct. 4, 1933, Dillon, Read & Co., pt. 4, pp. 1675–1676 and 1677.

[40] Robert E. Christie, Jr., Oct. 4, 1933, Dillon, Read & Co., pt. 4, pp. 1671, 1685.

[41] Robert E. Christie, Jr., supra, p. 1685.

shares sold during this period by these associates was 120,552, for an aggregate consideration of $6,843,380.66.[42]

Mr. PECORA. If my calculations are correct, the 120,552 shares, which you and your associates individually sold in this manner during this period of time, were sold for an aggregate of $6,843,380.66, and the corporation—this investment trust—received only $24,110.40 for the stock when it issued it in 1924. That is at the rate of 20 cents a share.

Mr. CHRISTIE. May I confer?

Mr. PECORA. Yes; are my figures correct, Mr. Christie?

Mr. CHRISTIE. Yes; the figures, I think, are right, Mr. Pecora, but, as you have said, I would like to be clear that this group of individuals did not all have a cost of 20 cents a share. Some of them had changed and had a higher cost.

Mr. PECORA. I said it was stock that originally was issued by the investment trust for 20 cents a share, and the persons to whom it was originally issued were all associates of Dillon, Read & Co. That is correct, is it not?

Mr. CHRISTIE. Yes; at the time that was issued the stock was worth less than 20 cents a share. That was the nominal price for it.

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Mr. CHRISTIE. I wanted to convey that that stock was bought with the second preferred for the $5,100,000, and actually the 20 cents is a mere nominal assigned valuation. Say it cost nothing, if you will, but in August 1929, which is nearly 5 years later, the company had a book value back of that stock of around $48 a share, so that the picture had changed, and this stock that was sold at an average of 56 was quite a different stock in value than it was 5 years earlier.

Mr. PECORA. We know that; but the figures which I embodied in my previous question are correct, to the following effect: That the 120,552 shares which you and some of your associates in Dillon, Read & Co. sold to the public through the medium of these two accounts conducted by Dominick & Dominick, as well as through the medium of individual sales made in the open market for a total consideration of $6,843,380, was stock which cost those associates, or those of them who got the stock upon its original issue in October 1924, the sum of $24,110.40, at the rate of 20 cents a share.

Mr. CHRISTIE. Up until just the very end—where you said that some of those associates paid 20 cents a share—that was correct. Just at the very end of your statement, I think, where you say it cost those associates that total amount of 20 cents times that, that is not technically correct, but I gather that what you mean is that that stock goes back to the original stock that had this nominal valuation placed upon it.

The CHAIRMAN. He means an original cost of 20 cents.

Mr. PECORA. Exactly. That is what I said.

Mr. CHRISTIE. Quite right.[43]

The granting of the options, which formed the basis of pool or trading accounts which contemplated short selling, and in which Dillon, Read & Co. participated, was repugnant to the trust owed to the stockholders of the United States & Foreign Securities Corporation and the investing public.

When interrogated on the ethics and propriety of the trading account managed by Dominick & Dominick, Robert E. Christie, Jr., testified:

Mr. CHRISTIE. But the one that confirms our participation in the account.

Mr. PECORA. And establishes and fixes the rights, duties, and privileges of Dominick & Dominick as managers of the account and the powers that they may exercise thereunder as such managers.

Mr. CHRISTIE. And gives the managers the power to make any kind of a transaction that they want to.

Mr. PECORA. Yes; whether to buy or to sell or to sell short.

Mr. CHRISTIE. Yes, sir; broad trading——

[42] Robert E. Christie, Jr., supra, p. 1686.
[43] Robert E. Christie, Jr., supra, pp. 1686–1688.

Mr. PECORA. Broad trading privileges, were they not, including the conduct of transactions that might be characterized as gambling transactions, as distinguished from investments?

Mr. CHRISTIE. I suppose so.

Mr. PECORA. Is that a fair inference?

Mr. CHRISTIE. I suppose so.

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Senator COUZENS. Well, is that a constructive operation for a concern that is engaged in the investment trust business to diversify the investments of small investors and protect their interests? Would you call that a constructive job for a trustee such as you were, under the circumstances?

Mr. CHRISTIE. Well, the trust was not involved in this. These sales——

Senator COUZENS. Oh, no. I do not like that quibbling about the trust.

Mr. CHRISTIE. I do not mean to quibble with you, sir. But I thought you were out when this started. These were sales that were made by a group of 10 or 11 individuals of a part of their stock, some of whom had acquired it in 1927, and it was their own stock that they were selling this way. It was not stock offered or new stock offered by the trust, nor was it the firm stock of Dillon, Read & Co.

Senator COUZENS. No; but the same group of men was charged with the very great responsibility of handling millions and millions of the public's money and to invite small investors who were not able to make their own investments or diversify their securities. You were engaged in a speculative short-selling operation, which hardly seems the ethical thing for trustees to do.

Mr. CHRISTIE. Well, we were participants in this account and had the power to do all these things that you say.

Senator COUZENS. And yet you were trustees for millions and millions of the public's money.[44]

Although the United States & Foreign Securities Corporation had been committed at that time to a policy of nonpayment of dividends on the common stock, the dominant organizers of the company were particeps to stock-market activities designed to create a wider distribution of the common stock among the investing public.

Senator COUZENS. Yes; and yet you went on and did not pay any dividends on this stock at any time. You did not pay any dividends then and have not paid any dividends since, as I understand it?

Mr. CHRISTIE. On the common stock?

Senator COUZENS. Yes.

Mr. CHRISTIE. No; it was the policy of the company only to pay dividends on the common stock if the earnings from the capital invested was sufficient to pay the dividends on the first and second preferred, and if anything was left over, and that had not been true.

Senator COUZENS. Well, you had that inside information. You knew that you had accumulated $10,000,000 out of this undertaking and then went and invested it in a second-class security in another investment trust, and all this time you were posing to the public as good trustees for some $90,000,000 of their money. What I am trying to bring out is whether that was what you men from Wall Street think is good ethics.

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Senator COUZENS. You admitted a while ago that it was not the policy of the company to pay dividends on the common stock, and yet you are unloading on the public the common stock at prices which you hope eventually to still raise, knowing all of the time from the inside as operators of this trust that it was not the policy to pay any dividends. I do not care much about those legal ethics that you lawyers keep talking about. I am talking about the general public, which has a right, it seems to me, to rely upon men of integrity to protect their trust and not to engage in these operations.

Mr. CHRISTIE. Well, this company had a policy of making available to its stockholders very complete information. That was available to the stockholders. There was no attempt to conceal it.

Senator COUZENS. When you created this pool and this short-selling arrangement, and all other tricks of the trade, you did not tell the public, as I recall

[44] Robert E. Christie, Jr., supra, pp. 1678-1679.

the testimony, that you had adopted a policy of not paying any dividend on this common stock.

Mr. CHRISTIE. No; this operation was conducted by another firm in which, it is true, we participated at this time, and it was in 1929, and the trust was formed in 1924. A part of this common stock had been distributed to some of the individuals as distinct from Dillon, Read & Co. Some of those individuals had that stock. If they withdrew, they either still had that stock or they could sell it. But the obligation of the management of that fund was not affected, whether I have it or some other person has some of that common stock, as far as I see it.

Senator COUZENS. That is where you and I see differently, because you had inside information as to the policy when you were selling this stock.

Mr. CHRISTIE. I do not believe so.

Senator COUZENS. Well, you said the company had adopted a policy of not paying any dividends on the common stock, and still you were creating a market for it, knowing well there were no contemplated dividends to be paid upon it. That is the kind of thing that I think the public ought to know about.

Mr. CHRISTIE. Most of these people, as far as I know; I feel fairly sure that the people who sold the stock at that time only sold a part of their stock. It was a very limited number of our associates that did it. We did it as individuals and not as a firm.

Senator COUZENS. But still, individuals go to make up the firm. You cannot segregate your responsibility, it seems to me, as a member of the firm and as an individual. You are responsible for the firm's conduct and its reputation. At least, I think the public has a right to assume that, whether you do or not.[45]

(C) FAILURE TO DIVERSIFY HOLDINGS

The organizers of an investment trust justified the formation of the investment company primarily upon the ground that the small investor was afforded a means of diversifying his security holdings, thereby obviating or abating the risk attendant to investments in a limited number of securities. As was testified by Clarence Dillon in elucidating upon the purposes of the formation of the United States & Foreign Securities Corporation:

> So then we turned to consider an investment trust that would buy stocks. The thing that moved us most in this consideration was the fact that the small investor cannot get diversification. He can buy a few shares of this or that, but he takes the risk in that one company, whereas if he bought stock in an investment trust he would get a diversification. * * *
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> The function of it was to invest this large sum of money at the minimum of expense, because the expenses of administration would be spread over a large fund, and to give the investor the advantage of a management, if I may say so with due modesty, persons skilled in that particular line, and also to diversify his risk.[46]

The organizers of investment trusts in this country merely paid lip service to this expressed purpose. The record before the subcommittee demonstrates that the proclaimed intent of diversification was merely a cloak to conceal the real purpose—to acquire concentrated holdings in particular industries, thereby subjecting the investor to the very risk he was seeking to avoid.

The United States & International Securities Corporation as of December 31, 1932, had in its portfolio 45,000 shares of Chicago, Rock Island & Pacific Railway Co. common stock, acquired at a cost of $5,566,366.99, and St. Louis & San Francisco Railway Co. common stock, acquired at a cost of $5,820,983.39, or an aggregate cost of $11,387,350.38.[47] In addition, this investment trust had substantial

[45] Robert E. Christie, Jr., supra, pp. 1679–1681.
[46] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1554.
[47] Ernest B. Tracy, Oct. 6, 1933, Dillon, Read & Co., pt. 4, pp. 1720, 1931.

holdings of other railroad securities.[48] There was invested in the common stock of the Chicago, Rock Island & Pacific Railway Co. and the St. Louis & San Francisco Railway Co., $11,387,350.38 of the total capital of $60,000,000 of the United States & International Securities Corporation, or approximately 19 percent.

Senator ADAMS. Mr. Tracy, may I ask you the question, you were here the other day when Mr. Dillon was explaining the fundamentals of the investment trust, were you not?

Mr. TRACY. I have been here; yes.

Senator ADAMS. As I recollect it, he said it was to afford the opportunity to the small investor to secure the diversification which he could not secure in his own individual purchases. How do you reconcile that theory of the operation of an investment trust where you put 40 percent of the money contributed by the first-preferred-stock holders into two stocks?

Mr. TRACY. They were large investments, Senator; yes, but we exercised——

Senator ADAMS (interposing). They did not follow the principle of diversification, did they?

Mr. TRACY. We exercised great care, we thought, and investigated those two companies thoroughly.

Senator ADAMS. But didn't you use as the basis for the formation of the investment trust the very argument that any man might make mistakes in one or another, so that the thing to do was to distribute them? I think that was Mr. Dillon's argument; so that a man might make a mistake, but if you distributed it as widely as you could you avoided that great hazard. Now you ran right into the hazard that you organized the institution to avoid.

Mr. TRACY. We did run into that hazard, but it was not 40 percent, Senator.

Senator ADAMS. Well, there was nearly $11,000,000, wasn't there, in these two companies?

Mr. TRACY. Out of a $60,000,000 corporation.

Mr. PECORA. Over $11,000,000.

Senator ADAMS. This was not the Foreign Securities?

Mr. TRACY. International.

Senator ADAMS. International—then, I will have to reduce my figures to 20 percent.

The CHAIRMAN. This was the second one.

Mr. PECORA. Thirty-three and one-third would be more accurate, Senator.

Senator ADAMS. It is still very liberal.

Mr. TRACY. Eleven million out of sixty.

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Senator ADAMS. But you were saying to the general public, "You are apt to make mistakes, and the thing to do is to secure diversification. Don't put too many of your eggs in one basket. We will take care of that, and see that they are properly distributed."

Mr. TRACY. We had a lot of cash on hand, Senator. We had a lot more money coming that was due on the allotment certificates. I do not know whether you remember the yield that you could get on investments in that period.

Senator ADAMS. Yes; I know.

Mr. TRACY. All the directors felt that railroads offered the best yield, the best return commensurate with safety, which one could put his money into at that time. We made a very intensive study of the railroads. We had a number of reports on other railroads that we did not go into.

Senator ADAMS. You yielded to the same temptation that Mr. Dillon was speaking of the other day. I think he almost pictured himself as a "mossback" in investment circles. He said that they would not yield to the temptation to get high yields, and yet, instead of avoiding that, you did yield to the temptation of high yields.

Mr. TRACY. We had to invest our money to yield better than 5 percent, because that is what we had to pay our stockholders.

Senator ADAMS. But you were advising purchasers to avoid that very thing.

Mr. TRACY. Our object was to look for safety first, Senator.

Senator NORBECK. They did not prove safe.

Mr. TRACY. No.[49]

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[48] Ernest B. Tracy, supra, p. 1745.
[49] Ernest B. Tracy, supra, pp. 1732–1733.

The consequences to the investing public who participated in this investment trust were precisely similar to the investing public who did not avail themselves of the "persons skilled in that particular line."

Both these railroad lines went into receivership, and as of December 31, 1932, the market value of the common stock of both these railroads acquired by the United States & International Securities Corporation for the aggregate amount of $11,387,350.38 was $194,837.50.[50]

The total shrinkage in value of the securities in the portfolio of the United States & International Securities Corporation, as of December 31, 1932, was $26,562,400, and of that total, a shrinkage of $11,192,512, or approximately 42 percent, occurred in the common stock of the Chicago, Rock Island & Pacific Railway Co. and the St. Louis & San Francisco Railway Co.[51]

Goldman-Sachs Trading Corporation, as already stated, as of December 31, 1931, sustained a capital shrinkage of $60,000,000 in its original capital of $100,000,000.[52]

A striking instance of either the incompetency or deficiency of integrity of purpose of the investment managers and their failure to observe the basic requisite of diversification, was the financing of the Frosted Foods Co. by the Goldman-Sachs Trading Corporation. The Goldman-Sachs Trading Corporation and the Postum Co. (subsequently known as the General Foods Corporation) in June 1929 formed the Frosted Foods Co. to acquire the stock of the General Foods Co., which represented an investment of $1,750,000, and the only other claimed substantial asset of which company was a patent right to a process for the freezing of foods. Postum Co. had an agreement with the committee of stockholders of the General Foods Co. to purchase all its stock for $23,500,000. Postum Co. then sold 150,000 shares of additionally issued stock of Postum Co. to Goldman-Sachs Trading Corporation for $10,750,000. This money, together with an additional $12,750,000 contributed by Goldman-Sachs Trading Corporation, was employed to acquire, through the newly formed Frosted Foods Corporation, for the benefit of the Postum Co. and Goldman-Sachs Trading Corporation, the stock of General Foods Co. The entire sum of $23,500,000 used to consummate the purchase of the stock of General Foods Co. was, therefore, furnished by Goldman-Sachs Trading Corporation.

Goldman-Sachs Trading Corporation received for its $23,500,000, 150,000 shares of Postum Co. and 49 percent of the stock of General Foods Co., which represented an allocated consideration of $12,750,000, whereas Postum Co. received for its $10,750,000 (obtained from Goldman-Sachs Trading Corporation for the 150,000 shares of Postum Co. stock) 51 percent of the stock of General Foods Co. and certain preference rights to dividends and upon liquidation. Goldman-Sachs Trading Corporation furnished, in addition, $1,500,000 (the working capital) to the Frosted Foods Corporation.

The total investment in the Frosted Foods deal, consummated in June 1929 by the Goldman-Sachs Trading Corporation, 90 percent

[50] Ernest B. Tracy, supra, pp. 1720, 1734.
[51] Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, p. 1805.
[52] Walter E. Sachs, May 20, 1932, pt. 2, p. 566.

of the capital of which company was the public's money, was $25,000,000.

The stock of the Postum Co. acquired by Goldman-Sachs Trading Corporation for $10,750,000 was sold at a loss of $230,000. The stock of the Frosted Foods Co., acquired by Goldman-Sachs Trading Corporation for $12,750,000, was charged off at the end of 1930 on the books at $1, and at the end of 1931 was transferred to General Foods Corporation (successor to Postum Co.) for 30,000 shares of Postum Co. stock, which was then quoted at $30 per share, or an aggregate of $900,000.

The Goldman-Sachs Trading Corporation, in a period of approximately 2 years, sustained a loss in excess of 50 percent of its $25,000,000 investment in this Frosted Foods Co. deal.[53]

(*d*) "UNLOADING" OF SECURITIES ON INVESTMENT TRUSTS

Investment trusts possess the functional indicia and connotations of banks. These investment companies are intrusted with funds by the public with intent to effectuate investments which assure the investor of a fair return upon his money without subjection to undue risk. As was stated by Clarence Dillon, referring to the United States & Foreign Securities Corporation, "I am a large holder of what you call the 'public's money.'"[54]

This guardianship is burdened with the elemental fiduciary duty of fair dealing at arm's length with the public. The realization of secret profits of pecuniary advantage by the dominant personalities of these investment trusts, from the transactions consummated through the medium of these trusts, is repellent to the concept of true function of these investment companies.

The limited inquiry which this Committee has been able to make into investment trusts exposed a predominance of conflict of interest and duty of investment managers and their cestui qui trust, the investing public. The record indicates that the losses sustained are attributable to the fact that these investment managers resolved these conflicts in their own favor to the pecuniary disadvantage of the investor. Executive authorities employed the investment trusts as convenient receptacles into which to unload securities which they personally, or corporations or copartnerships in which they were interested, owned.

The directors of the United States & International Securities Corporation, as of October 5, 1933, were Matthew C. Brush, a large stock-market operator; Charles Hayden, member of the firm of Hayden, Stone & Co., members of the New York Stock Exchange and substantial dealers in investment securities; Clarence Dillon; J. H. Hillman, Jr.; Dean Mathey, a partner of Dillon, Read & Co.; Ernest B. Tracy, president of United States & Foreign Securities Corporation and United States & International Securities Corporation; and Edward G. Wilmer, who had been associated with Dillon, Read & Co. The board of directors of the United States & International Securities Corporation was the body that exercised the ultimate

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[53] For detailed testimony on this transaction and on the devious, circuitous method of payments employed by Goldman-Sachs Trading Corporation, for some unexplained reason, see Walter E. Sachs, supra, pp. 566–580. Committee exhibit no. 9, May 20, 1932, pt. 2, pp. 580–583, and letter of William A. Gray to the Committee on Banking and Currency, pp. 13–15.

[54] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1601.

judgment on investments to be made by the investment trust for its portfolio.[55]

The conflict of interests existing where the directors of the investment trust were also engaged in the investment-banking business, could not be fairly resolved by any "dissociation of personality." Robert E. Christie, Jr., when interrogated upon this conflict of interest and duty, testified:

Mr. PECORA. Let us see, Mr. Christie, just what the atmosphere was that surrounded Mr. Hayden. As a director in this investment trust he was charged with the duties and responsibilities of a trustee toward the stockholders of the investment trust, to see that wise and sound investments were made in securities with the moneys of the stockholders poured into the investments.

Mr. CHRISTIE. That is right.

Mr. PECORA. As a member of the firm of Hayden, Stone & Co., which had a large securities department, and which included the business of issuing and selling securities, he was interested in furthering and facilitating the profitable conduct of the business of that firm of Hayden, Stone & Co., was he not?

Mr. CHRISTIE. That is right; yes.

Mr. PECORA. Don't you think that that placed him at times, under a temptation—I am not suggesting that he yielded to it, but don't you think at times that placed him under a temptation whereby his judgment, as a trustee or director of the investment trust, might unconsciously become warped, and he might be induced to favor the purchase of securities sponsored by his private firm?

Mr. CHRISTIE. I think that that is a question of Mr. Hayden's character.

Mr. PECORA. Apart from his character, apart from the personality involved, I am looking at the elements in the situation.

Mr. CHRISTIE. I really do not see any conflict there, when you consider the man's experience and his ability to consider the problem that he has before him in the light of his obligation and his duty. I appreciate and grant that he has two interests, that of the investment trust and that of his own company.

Senator ADAMS. You would not see any impropriety in Mr. Hayden sitting on the board and recommending the purchase of securities which his firm was issuing?

Mr. CHRISTIE. Not at all.

Senator ADAMS. The courts do not agree with you on that.

Mr. PECORA. I do not think the courts generally agree with a man filling such a dual role.

The CHAIRMAN. Your position is that the board of directors of the investment trust would have to pass upon it; but suppose that the board of directors of that trust were composed of men in a like situation to that of Mr. Hayden. Then they could trade among themselves as to what would be suitable, and what not, to the sacrifice of the interests of the investment trust.

Mr. CHRISTIE. You might very well, I suppose, have a set-up within a board that would work as you suggest, Senator Fletcher. The other point, that Senator Adams brought out, was that I think very often that a man in that position might really know all about some situation, some company, some industry, because of some other position that he might have.

Senator ADAMS. That is one of the objections to it.

Mr. CHRISTIE. It might work either way; but it also has possibilities for good. That is what I meant to say in answer to your question. I do not deny that it might work the other way.[56]

With a full consciousness that this conflict of interest existed and might affect the validity of transactions consummated, the organizers of the United States & International Securities Corporation included in the certificate of incorporation of that corporation a provision affirming the validity of such transactions and relieving the directors of liability for participating in such transactions. The charter of the company, subsequently amended, originally provided:

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[55] Robert E. Christie, Jr., Oct. 5, 1933, Dillon, Read & Co., pt. 4, p. 1701.
[56] Robert E. Christie, Jr., supra, p. 1703.

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 wise affected by the fact that such director or directors doing it may have interests therein which are or might be adverse to the interests of this corporation, even though the vote of the director or directors having such adverse interest shall have been necessary to obligate the corporation upon such contract or transaction. No such director or directors shall be liable to the corporation, or to any stockholder or creditor thereof, or to any other person, for any loss incurred by it under or by reason of such contract or transaction, nor shall such director or directors be accountable for any gain or profits realized thereon.[57]

Ernest B. Tracy approved of this provision in principle.

Mr. PECORA. Then you say you approve of that sort of provision?

Mr. TRACY. I do.

Mr. PECORA. You think it is proper and essential to the best interests of the investment trust to have its directors and officers protected from liability in case of any dishonest exercise of judgment by such a clause as this? I mean in event that they should be guilty of such action.

Mr. TRACY. So many of our directors are directors of other companies that I suppose the lawyers put that in. I think it is all right. And our company has always been run honestly, as the results show.

Senator ADAMS. Mr. Tracy, aside from the question of honesty, it is a question of good judgment. You recognize that almost all human minds are influenced in their decisions by their personal interest. It may be an honest influence. This permits a man to participate in a transaction in which he has conflicting interests and in which his honest judgment may be influenced by those interests. Do you not think that that is an objectionable thing?

Mr. TRACY. I think it is, in a way, Senator, but with all the directorships that a great many of our directors have we would have had to eliminate some of the best securities that there were available for investment.

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Senator ADAMS. So you have seen fit in that to incorporate a provision setting aside the law that has been established as a result of a good deal of experience. That is, the courts in the absence of this could say to you that a director might not participate in passing upon a transaction in which he has an interest. The courts have said that that is necessary, in their judgment, to protect against these errors of judgment as well as against perhaps a violation of the fiduciary relation. It is a question of whether or not a corporation acting as an investment trust rather than as a fiduciary should set itself up in conflict with the rule which equity courts have seen fit to establish.

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Mr. PECORA. You approved of it in principle?

Mr. TRACY. I approved of it.[58]

Clarence Dillon, however, stated:

I think this clause is too broad, myself.[59]

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Mr. PECORA. What was the reason for including or inserting that provision in this charter?

Mr. DILLON. I assume that that was done by the lawyers as a general practice. Provisions similar to that are, I think, not unusual. It is done in order to give protection to directors against, well, we will say, unfair claims that might be made against them. It is to protect them against that.

Mr. PECORA. It also goes further than that, and gives those directors protection against claims that might be fair because based upon the exercise of

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[57] Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, p. 1816. Clarence Dillon, Oct. 11, 1933, Dillon, Read & Co., pt. 4, p. 1884. (The subsequent amendment is contained in the record: See Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, pp. 1816–1817.)

[58] Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, pp. 1818–19.

[59] Clarence Dillon, Oct. 11, 1933, Dillon, Read & Co., pt. 4, p. 1884.

judgment by directors where that judgment was not exercised by them in good faith.

Mr. DILLON. If that were true, I think a clause like that should not be placed in any certificate of incorporation, because I think a director should be fully responsible, fully liable for the exercise of good faith in all things.

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Mr. DILLON. If that is put in, or any other provision is put in a charter, which would excuse a director for the exercise of bad faith, then I certainly think it is their fault. I do not think any company should do that.

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Mr. PECORA. Mr. Dillon, would you today approve in principle the inclusion of any such provision in the charter of a company whose securities are to be sold to the public?

Mr. DILLON. We have got a real problem there to know how to handle it; not in this company, but I mean in general. I think directors should be responsible for their acts, for the exercise of care and diligence. They should be liable for any malfeasance or bad faith, of course. On the other hand, when you consider that directors receive as compensation anywhere from $200 to probably $600 a year, you have got to give some sort of protection to a man of character and standing if you want him to do a public service by serving on a public company, where he gets nothing out of it except acting in the interests of the stockholders.[60]

The fact is that the directors of United States & Foreign Securities Corporation received not the customary $200 to $600 per year, but $5,000 a year.[61]

Instances were uncovered where these directors and persons controlling investment trusts succeeded in unloading their own securities upon the investment companies.

The United States & Foreign Securities Corporation relieved Dillon, Read & Co. of a substantial block of railroad stock to the patent pecuniary advantage of Dillon, Read & Co.

On July 13, 1929, the United States & International Securities Corporation entered into a $30,000,000 railroad securities joint account with Dillon, Read & Co., to be conducted on a basis of equal participation.[62] Ernest B. Tracy, president of United States & Foreign Securities Corporation and United States & International Securities Corporation, testified that United States & International Securities Corporation and Dillon, Read & Co., favorably impressed with the prospects of railroad securities, concluded to acquire substantial holdings in railroad stocks by means of a purchasing account.[63] The account was terminated on November 9, 1929, and had acquired during its existence securities aggregating a total cost of $10,891,578.

The securities so acquired included 27,400 shares of Chicago, Rock Island & Pacific Railway Co. common stock acquired at an average price of $138.36, for a total of $3,791,593.99, and 32,000 shares of St. Louis & San Francisco Railway Co. common stock at $130.39, for a total of $4,172,480.

The account also purchased 10,000 shares of Southern Pacific Co. at $145.73, 10,000 shares of Pennsylvania Railroad Co. at $98.98, 15,300 shares of Southern Railway common at $159.76, and $2,487,000 par value Seaboard Air Line Railway Co. bonds.[64]

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[60] Clarence Dillon, supra, pp. 1883–85.

[61] Clarence Dillon, supra, p. 1884. Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1579.

[62] Committee exhibit no. 15, Oct. 6, 1933, Dillon, Read & Co., pt. 4, p. 1747.

[63] Ernest B. Tracy, Oct. 6, 1933, Dillon, Read & Co., pt. 4, p. 1734.

[64] Ernest B. Tracy, supra, pp. 1735–1736. Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, p. 1782.

The trading account sustained a nonrealized loss of $2,300,000—the difference between the market quotations on November 9, 1929, and the cost to this account. These securities in the trading account were distributed equally between Dillon, Read & Co. and the United States & International Securities Corporation. The United States & International Securities Corporation advanced $14,262,369.20 to this joint trading account, and Dillon, Read & Co. on its books credited the United States & International Securities Corporation with $7.131,184.62—one-half of the cost of the securities.[65] Among the securities so delivered by the joint account to Dillon, Read & Co. were 13,700 shares of Chicago, Rock Island & Pacific Railway Co. and 16,050 shares of St. Louis & San Francisco Railway Co., which represented one-half of the securities of both these railroads purchased by the joint account.[66]

On November 11, 1929, 2 days after the termination of the joint trading account, the United States & Foreign Securities Corporation, dominated by its executive head, Ernest B. Tracy, who was also executive head of the United States & International Securities Corporation, and by Dillon, Read & Co., purchased from Dillon, Read & Co. these 13,700 shares of Chicago, Rock Island & Pacific Railway Co. common stock at $114.25, for a total of $1,565,225, and the 16,050 shares of St. Louis & San Francisco Railway Co. common at $111.25, for a total of $1,793,587.50, the then prevailing market prices of these securities.[67]

At the time of the hearings, October 3, 1933, both the Chicago, Rock Island & Pacific Railway Co. and the St. Louis & San Francisco Railway Co. were in receivership, and the stock which had been previously purchased from Dillon, Read & Co. for $2,359,812 had only a nominal value.

These purchases from Dillon, Read & Co. were not formally approved in the minutes of the investment trust prior to their consummation, but were ratified and confirmed subsequently at the December 11, 1929, meeting of directors.[68]

Ernest B. Tracy stated that the joint account had been formed to acquire railroad stock, in which both Dillon, Read & Co. and the investment trust had great confidence; yet Dillon, Read & Co., immediately upon the termination of this account, sold all the shares of Chicago, Rock Island & Pacific Railway Co. common and St. Louis & San Francisco Railway Co. common which had been acquired by Dillon, Read & Co. as participants in this account. It is significant that although Tracy professed great faith in railroad securities and diversification of securities, he limited the purchases from Dillon, Read & Co. to Chicago, Rock Island & Pacific Railway Co. and St. Louis & San Francisco Railway Co. common stocks.

Mr. Pecora. In your conferences with representatives of Dillon, Read & Co. did they indicate that they had an opinion similar to yours about the wisdom of acquiring railroad shares at that time?

Mr. Tracy. I know that they believed in railroad shares at that time.

Mr. Pecora. If they believed in railroad shares at that time, will you explain why they parted with their railroad shares at that time to your investment trust?

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[65] Ernest B. Tracy, Oct. 6, 1933, Dillon, Read & Co., pt. 4, pp. 1730-1741. Ernest R. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, pp. 1782, 1806.

[66] Ernest B. Tracy, supra, p. 1785.

[67] Ernest B. Tracy, supra, p. 1801.

[68] Ernest B. Tracy, supra, pp. 1787, 1804.

Mr. TRACY. That I don't know.

Mr. PECORA. You thought they were gentlemen whose judgment was worth something with regard to securities values, did you not?

Mr. TRACY. Their judgment was worth a good deal, which the record shows.

Mr. PECORA. Did it strike you at any time during those transactions back in November 1929 that it might be unwise for your investment trust to take on these railroad shares, in view of the fact that Dillon, Read & Co., a company whose judgment you thought a great deal of, held an opinion apparently to the effect that they ought to sell their railroad shares?

Mr. TRACY. I do not know anything about their reasons at that time. I know we had a lot of money that we wanted to invest, and we thought those securities were good investments, and that is why we purchased them.

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Mr. PECORA. You did not want the other railroad securities in the account?

Mr. TRACY. No.

Mr. PECORA. Why not?

Mr. TRACY. The directors did not want them; that is all.

Mr. PECORA. Did they give any reason?

Mr. TRACY. I cannot give you the reason.

Mr. PECORA. Apparently up to this time the directors of your trust were keen about acquiring railroad shares?

Mr. TRACY. We had been, but we thought it was best to have those two.

Mr. PECORA. You did acquire a variety of shares of railroad stock for the purposes of this joint account between July and November 1929, did you not?

Mr. TRACY. Correct.

Mr. PECORA. Two days after the termination of the joint account with the **distribution of the acquired shares to the participants** we see that your investment trust, the first one, United States & Foreign, bought back from Dillon, Read & Co. not all of the railroad shares that had been the subject of the joint trading account, but only two issues, the Chicago, Rock Island & Pacific and the St. Louis & San Francisco?

Mr. TRACY. That is right.

Mr. PECORA. Why were not any of the other railroad shares purchased from Dillon, Read & Co. that had been acquired for the joint account?

Mr. TRACY. I believe we already owned a substantial amount of securities.

Mr. PECORA. You already owned substantial blocks of these two railroad securities, did you not?

Mr. TRACY. I would have to look up and see how much we had in the United States & Foreign Securities Corporation.[69]

The fact is that the United States & Foreign Securities Corporation owned, at the time it acquired the additional shares from Dillon, Read & Co., 4,000 shares of Chicago, Rock Island & Pacific Railway Co. common stock.[70] This substantial block of stock was purchased at the market price from Dillon, Read & Co. soon after the stockmarket crash in October 1929.

Mr. PECORA. All right. You regarded the funds of these two investment trusts of which you were president at that time as trust funds?

Mr. TRACY. We were responsible to the stockholders for the investment of their money.

Mr. PECORA. And you regarded them in that sense as trust funds committed to your care and custody for investment and reinvestment?

Mr. TRACY. Correct.

Mr. PECORA. And you regarded yourself as a trustee for the stockholders of these two investment trusts, did you not?

Mr. TRACY. Certainly. I was responsible to the stockholders.

Mr. PECORA. And do you think that it was sound judgment to discharge that kind of responsibility by buying railroad shares during a panic week in the stock market?

Mr. TRACY. I do.

Mr. PECORA. With prices fluctuating as much as 14 points in 1 week?

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[69] Ernest B. Tracy, supra, pp. 1791-1793.
[70] Ernest B. Tracy, supra, p. 1795.

Mr. TRACY. I certainly do. We thought those securities were very cheap, and that is why we purchased them.

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Mr. PECORA. Did Dillon, Read & Co. give you any reason at that time why they were willing to sell these railroad shares that you thought were a mighty good purchase for the investment trust?

Mr. TRACY. No; Dillon, Read & Co. gave me no reason.[71]

On December 31, 1929, the United States & Foreign Securities Corporation sold, at the then prevailing market price, to the United States & International Securities Corporation the 13,700 shares of Chicago, Rock Island & Pacific Railway Co. common stock at $111.75 per share, purchased from Dillon, Read & Co. at $114.75, and the 16,050 shares of St. Louis & San Francisco Railway Co. common stock at $105.22, purchased from Dillon, Read & Co. at $111.75, for a total consideration of $2,157,079.[72]

This sale was allegedly effected to sustain a loss by United States & Foreign Securities Corporation for income-tax purposes, although the stockholders of the United States & Foreign Securities Corporation were different from the stockholders of the United States & International Securities Corporation, and the securities were never repurchased by the United States & Foreign Securities Corporation after the expiration of the 60-day period prescribed by the income tax law.[73]

Similarly, there were, as of December 31, 1932, in the portfolio of the United States & International Securities Corporation, 131,908 shares of common stock and 9,930 warrants for common stock of the Seaboard Air Line Railway Co., aggregating a total cost of $1,476,675.79, with bonds of that railway which cost the investment trust $506,847.15, for a total gross investment in this railroad company of approximately $2,000,000.

On October 11, 1929, the United States & International Securities Corporation contracted to participate in an underwriting syndicate of Seaboard Air Line Railway Co. common stock, managed by Dillon, Read & Co. and Ladenburg, Thalmann & Co. at $12 per share, less $1 commission. Dillon, Read & Co. and Ladenburg, Thalmann & Co. were the bankers for the Seaboard Air Line Railway Co.[74]

This railroad had had a bad financial record, and stock was offered to stockholders to rebuild the condition of the road. After the market decline in October and November, 1929, with a substantial decline in the market price of Seaboard, few stockholders exercised the privilege to purchase the stock, and the United States & Foreign Securities Corporation was compelled to take up, in January 1930, a large proportion of the 131,000 shares originally contemplated. Two million shares were offered to stockholders, who subscribed for only 300,000 shares, or approximately 7 percent.[75]

The reorganization plans failed to materialize, and the Seaboard Air Line Railway Co. went into receivership in December 1930—11 months after the United States & Foreign Securities Corporation had acquired the common stock.[76]

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[71] Ernest B. Tracy, supra, p. 1700.
[72] Ernest B. Tracy, supra, pp. 1807, 1821.
[73] Ernest B. Tracy, supra, pp. 1806–1809.
[74] Ernest B. Tracy, supra, p. 1846.
[75] Ernest B. Tracy, supra, pp. 1840–1847. Clarence Dillon, Oct. 11, 1933, Dillon, Read & Co., pt. 4, pp. 1869–73.
[76] Clarence Dillon, supra, p. 1878. Ernest B. Tracy, Oct. 10, 1933, Dillon, Read & Co., pt. 4, p. 1841.

In addition, there were in the portfolio of the United States & International Securities Corporation 100,000 shares of common stock of the Louisiana Land & Exploration Co., of which Tracy was president, which cost the investment trust $278,125, with a market value, as of December 31, 1932, of $75,000, and of other corporations of which the directors of the United States & International Securities Corporation were officers and directors.[77]

The securities of numerous corporations of which the investment managers were directors found their way into the portfolios of the investment trusts.

Mr. TRACY. I don't remember, but don't think I would have done it because it is not my custom to recommend securities of any company of which I am on the board. I always give them information about it, though.

Mr. PECORA. Well, apparently it was not the custom of any member of the board to recommend to the board of directors of the investment trust the purchase of any securities that that particular director might have been interested in. Is that so?

Mr. TRACY. As a rule it was never done.

Mr. PECORA. In other words, that was the custom?

Mr. TRACY. Yes, sir.

Mr. PECORA. Nevertheless, we find in the portfolio of that investment trust large blocks of securities issued by corporations in which directors of the investment trust were interested.

Mr. TRACY. Oh, unquestionably. We would have to eliminate a great many good securities if we did not do that.

Mr. PECORA. You would have to eliminate, for instance, such good securities as Rock Island Railroad and San Francisco Railway, which brought a loss of over 11 million dollars to the portfolio.

Mr. TRACY. That is correct.

Mr. PECORA. You would have to eliminate those, too?

Mr. TRACY. We would have to eliminate those too; yes.

Mr. PECORA. And you would have to eliminate Louisville Land & Exploration Co., too?

Mr. TRACY. Well, that does not happen to be in receivership, but we would have to eliminate it; yes.

Mr. PECORA. Well, it is not in receivership, but according to your statement of December 31, 1932, those 100,000 shares of stock, although costing the investment trust $278,125, their market value as of December 31 last, was $75,000.

Mr. TRACY. Yes; that shows that.

Mr. PECORA. How about Seaboard Airline Railway Co. securities—and that railroad is in receivership, isn't it?

Mr. TRACY. It is.[78]

Another instance where the investment trust was employed for the pecuniary advantage and benefit of the controlling persons is the case of Continental Shares, Inc.

Continental Shares, Inc., an investment trust organized in 1926 with a public investment of approximately $150,000,000, was dominated by Cyrus S. Eaton, of Cleveland, Ohio, who was also the principal partner of Otis & Co., members of the New York Stock Exchange.

The common stock of this trust sold at a peak of $78 and was quoted at 25 cents at the time of the hearing, June 11, 1932.[79]

The record indicates that during the month of October 1929 in order to prevent the suspension of Otis & Co. from the exchange

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[77] Ernest B. Tracy, supra, pp. 1813–1814. For testimony relating to securities of these corporations in the portfolios of the United States & Foreign Securities Corporation and United States & International Securities Corporation, see pp. 1814–15, 1836–47.

[78] Ernest B. Tracy, supra, pp. 1813–1814.

[79] David Stock, June 10, 1932, pt. 3, pp. 900–901.

because of financial difficulties, it was arranged that Continental Shares, Inc., purchase from the Foreign Utilities Co., Eaton's private Canadian corporation, for $57,000,000, certain securities which were already pledged with various banks as collateral for loans, to be paid for by $35,000,000 in cash and the balance in Continental Shares stock at $21 per share. Loans of $30,000,000 and $5,000,000 were made by the Chase National Bank and the Union Trust Co. of Cleveland, respectively, to Continental Shares, Inc., to enable that investment trust to purchase the securities from Foreign Utilities Co. The mechanics were that the $35,000,000 was used to pay off the loans to Otis & Co., Foreign Utilities Co. and Eaton by various banks and thereby release the securities hypothecated for these loans by Otis & Co., Foreign Utilities and Eaton. These released securities were then collateralized with Chase National Bank and the Union Trust Co. as security for the $35,000,000 of loans to Continental Shares, Inc. Chase National Bank and the Union Trust Co. did not deem these securities ample collateral for the $35,000,000 loan, and Continental Shares, Inc., was compelled to pledge an additional $28,000,000 of its own stock as further collateral.

The result was that Otis & Co., Foreign Utilities, and Eaton were relieved of their bank loans; and Continental Shares, Inc., was obligated to Chase National Bank and the Union Trust Co. in the sum of $35,000,000, and, in addition to the securities that it had acquired for $57,000,000 from Foreign Utilities Co., had to pledge as collateral other securities that it owned.[80]

(e) FORMATION OF INVESTMENT COMPANIES FOR ULTERIOR PURPOSES

The popular conception of the formation of an investment trust was diversification of securities investment with emphasis upon investment return.

Types of investment companies were organized, however, with the concealed purpose of purchasing securities not primarily for the investment benefit of the trust or its stockholders, but to enhance the interests of some other company affiliated indirectly with the management of the trust, or to obtain control of companies in a single field or industry.

The evil consists in the fact that the public, because of the organizers' failure to adequately disclose the real purpose of the investment company, may be induced to participate in a trust which is really dedicated to a purpose with which the investor is not in accord. The public may be misled as to the true character of his investment.

(1) *Formation of investment trust in interest of other companies.*—A conspicuous example of the formation of an investment company to benefit primarily an affiliated company was the Pennroad Corporation, which was organized to protect the interest of the Pennsylvania Railroad against invasion by competing firms.

The circular issued in connection with the Pennroad Corporation stock offering stated:

Your directors have given earnest consideration to recent developments in the field of transportation, and have reached the conclusion that it will be of

[80] David Stock, supra, pp. 911–916. The activities of Continental Shares, Inc., are contained in the record: See pp. 900–975 and the letter of William A. Gray, p. 25.

material advantage to this company and its stockholders for the stockholders to unite in establishing a corporation so organized that it may make investments and take advantage of opportunities on a much broader basis than is possible under the limited powers of a railroad company. Your directors are of the opinion that such an independent instrumentality is needed to protect your interests and those of your company.[81]

This circular contained no adequate disclosure that the real purpose of the Pennroad Corporation was to protect the Pennsylvania Railroad against purchases by competing companies of strategic properties.[82]

As was stated by Henry H. Lee, president of the Pennroad Corporation:

Mr. PECORA. What I am trying to get at is a statement from you in your own language of the purposes for which the Pennroad Corporation was created.

Mr. LEE. It was created in the interest of the stockholders of the Pennsylvania Railroad Co. to make investments that the directors of Pennroad see fit to make.

Mr. PECORA. Well, were the investments to be made by the Pennroad Corporation of a character that would serve the interests of the Pennsylvania Railroad Co. and its stockholders?

Mr. LEE. I think so.

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Mr. PECORA. What protection was it contemplated to give to the interests of the Pennsylvania Railroad and its stockholders through the medium of the Pennroad Corporation?

Mr. LEE. By the acquisition of securities of railroad companies principally which might be valuable from a strategic standpoint in connection with the railroad question generally in the United States.

Senator BARKLEY. And which might be bought by other roads, and you formed this corporation for that purpose?

Mr. LEE. They might be, sir.[83]

(2) *Formation of investment companies to control single industries.*—Companies formed ostensibly as investment trusts have really functioned as holding companies.

The United Corporation, organized by J. P. Morgan & Co., ceased to act as an investment company to aid investors in pooling their funds to obtain a diversification of investment, and became a large holder of equities in many companies in a single field—public utilities. The companies in which the United Corporation owned large interests controlled 22 or 23 percent of the central station output in the electric field, and approximately 22 percent in the gas business.[84]

Companies masquerading as investment trusts have been set up by interests controlling a group of companies in order to facilitate the maintenance of that control.

The Insull Utility Investments, Inc., and Corporation Securities Co., of Chicago, both investment trusts, were organized and employed by the Insull interests to maintain a solidified control of the Insull operating companies. The Insull Utility Investments, Inc., an Illinois corporation, was organized in December 1928 with Samuel Insull as president; Samuel Insull, Jr., as vice president; Martin J. Insull as vice president; Philip J. McEnroe, the book-

[81] Committee exhibit no. 10, June 20, 1933, Kuhn, Loeb & Co., pt. 3, p. 1240.

[82] Otto H. Kahn, June 27, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1005–1006. Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1280.

[83] Henry H. Lee, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1328–29.

[84] George H. Howard, May 26, 1933, J. P. Morgan & Co., pt. 2, p. 319. Committee exhibit no. 24, May 26, 1933, J. P. Morgan & Co., pt. 2, p. 822, tabulates companies.

keeper of Insull, Sr., as treasurer; and John F. O'Keefe, the private secretary of Insull, Sr., as secretary, to buy, hold, and trade in securities generally. The announced purpose was to acquire and hold securities of the Commonwealth Edison Co., Peoples Gas Light & Coke Co., Public Service Co. of Northern Illinois, Middle-West Utilities Co., and their affiliated companies, but was not restricted to such investments.[85]

The authorized capital of the Insull Utility Investments, Inc., was 250,000 shares of prior preferred stock of no par value, 250,000 shares of preferred stock of no par value, and 3,000,000 shares of common stock of no par value. The Insull Utility Investments, Inc., issued to Samuel Insull, Martin J. Insull, Margaret A. Insull, and Samuel Insull, Jr., 750,000 shares of common stock at $7.54 per share, with warrants to purchase 1 share of common stock at $15 per share, and 40,000 shares of preferred stock at $100 per share. In consideration for the issuance of these securities, the Insull family transferred securities of the Commonwealth Edison Co., Peoples Gas Light & Coke Co., Public Service Co. of Northern Illinois, and Middle-West Utilities Co., for a total of $9,765,908, to the investment trust at their then market value, of a claimed aggregate of $8,752,468.20.[86]

Under an agreement dated January 17, 1929, the Insull Utility Investments, Inc., granted the members of the Insull family options on a total of 199,820 shares at $15 per share, exercisable at any time within 2 years, and agreed to sell Samuel Insull, who agreed to buy or cause to be purchased 250,000 additional shares of common stock at $12 per share during the year.[87]

The warrants to purchase the 250,000 shares of common stock at $15 were exercised by the Insulls, and Samuel Insull caused to be purchased the 250,000 shares of common stock at $15. The Insulls, therefore, owned 964,000 shares of common stock and caused to be sold to others 250,000 shares, or a total of 1,214,000 shares.

The common stock was listed on the Chicago Stock Exchange on January 17, 1929, the date the Insull Utility Investments, Inc., agreed to sell Samuel Insull 250,000 shares at $12 per share, with an opening price of $30 per share. The stock, on the second day, reached $40 a share. On August 2, 1929, the common stock attained a peak price of $149 a share.

The 764,000 shares of common stock issued to the Insull family in December 1928 at $7.50 per share, for an aggregate of $5,730,000, on January 17, 1929, had a total market value of approximately $22,920,000. The 250,000 shares of common stock contracted to be sold on January 17, 1929, at $12 per share, for a total of $3,000,000, had on that date a market value of $7,500,000.[88]

The Corporation Securities Co. of Chicago was organized in October 1929, with Samuel Insull, Samuel Insull, Jr., and Martin J. Insull as officers of this investment trust.

The Insull Utility Investments, Inc., and the Corporation Securities Co. of Chicago, during their existence, purchased large quantities of securities issued by the Insull operating companies.

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[85] Samuel Insull, Jr., Feb. 15, 1933, Insull, pt. 5, p. 1398.
[86] Samuel Insull, Jr., supra, pp. 1400–1401.
[87] Samuel Insull, Jr., supra, p. 1405.
[88] Samuel Insull, Jr., supra, p. 1408.

Samuel Insull, Jr., admitted that the purpose of both these investment trusts was to enable the Insull family to maintain control, through stock ownership, of these operating companies.

Mr. PECORA. Was not the primary purpose of the incorporation of the investment trust known as the Insull Utility Investments Co. to enable your father and his family group to have a control, through stock ownership, of the principal operating companies?

Mr. INSULL. Yes, sir.

Mr. PECORA. And was not the main purpose of the incorporation of the Corporation Securities Co. of Chicago likewise to enable your father and his family group to exercise control, through stock ownership of the holding companies' securities, of the main operating companies?

Mr. INSULL. Well, yes. In general, I would like to put it this way, that the general purpose of both corporations was to perpetuate, not necessarily control of the family, but the control of a group of operating people, including in the companies not a full control but sufficient control—I think it is expressed in some of these documents—that if the public generally were sympathetic with the operating management there should be, in these investment companies, a large enough block of stock, together with the general public, to offset any other interests that might want to come in and get control.

On the other hand, there was never a large enough block of stock, nor was there ever contemplated there should be—because it would be impossible—to hold control as against a united group of general outside stockholders, the public generally. The purpose was to hold control as against some compact financial interests, if you had the support of the public generally.[89]

(f) STOCK EXCHANGE MEMBERS AND INVESTMENT TRUSTS

The absence of legal impedimenta to the formation, or of governmental regulation of investment trusts encouraged the organization of these investment companies by members of organized securities exchanges.

Through the medium of these investment trusts, the members of exchanges and dealers in securities created a source of supply of securities to be sold by their selling organizations. A conflict of interest and duty was created, for the members of exchange who ostensibly acted as agents for their customers were in reality acting as principals selling securities of the investment trusts which these members dominated.

From 1929 to 1933, inclusive, 39 member firms and 115 partners of member firms of the New York Stock Exchange acted as promoters, organizers, and managers of 329 investment trusts of the management type. Six individual members of the New York Stock Exchange acted as promoters, organizers, officers, directors, or managers of six investment trusts during that same period.[90]

The New York Stock Exchange evidently recognized the necessity of regulating the participations of its members in investment trusts. Section 2 of chapter 14 of the Rules of the New York Stock Exchange provides that no member or firm registered on the exchange shall be associated in an investment trust of any character either by participating in its organization or management, or by offering or distributing its securities, unless the Committee on Stock List shall have previously determined that it has no objection to such association. The extent of the regulation, or the basis for granting permission, is not disclosed.

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[89] Samuel Insull, Jr., Feb. 16, 1933, Insull, pt. 5, pp. 1430–1440.
[90] Committee exhibits Nos. 8 and 12, May 1, 1934, pt. 17, pp. 7862, 7874.

3. Regulation of Investment Trusts

Some measure of protection is afforded the investing public in connection with investment trusts by the Securities Act of 1933, which requires fuller disclosure by organizers of investment trusts of the pertinent facts relating to the organization of these trusts. The effectiveness of this regulation is confined to the primary distribution of the capital stock of these investment trusts and in nowise covers the abuses and malpractices of the subsequent conduct and management of these investment trusts. The necessity for regulation was admitted by Clarence Dillon and Otto H. Kahn. Otto H. Kahn suggested compelling fair dealing and complete disclosure.

> * * * that investment trusts, first of all, must not be controlled by a small group of people who happen to own one particular issue to which the voting power has been confided. Investment trusts must be controlled by their own people.
>
> Secondly, investment trusts must deal at arm's length with every comer, including those who created it. They must not play favorites with those who are its originators. They are not children in the sense that I am my father's child. They are the public's child, and the public has provided the origination, and the public has provided the wherewithal that gave them their education. I think if you will make it the general rule that investment trusts must deal at arm's length with everybody, and must not be controlled by some small stock issue created for the purpose of providing control, but must deal under the direction of their stockholders, and if you subject them, as you will subject them, to the same rule of profit disclosure, facts disclosure, to which the private banker is subjected, I think you will have done about all that can now be done or that should now be done.[91]

In the opinion of the subcommittee, the quantum of regulation propounded by Otto H. Kahn is too inadequate and proscribed. Regulation of investment trusts, to be efficacious, must be comprehensive and commensurate with the vital purpose of protecting the public, whose funds have been intrusted to the investment managers.

4. Holding Companies

The line of demarcation between investment trusts, formed to own relatively small amounts of diversified securities, and holding companies, formed to control companies or industries, oftentimes is nebulous. The true holding company, as has already been stated, is formed with the definite purpose of managing or influencing the management of a particular company or a particular field of industry. The holding company is primarily a device by which a group of persons, through the use of the public's money, are enabled to amass control of industries and public utilities and the substantial wealth of the Nation.

The Alleghany Corporation is a typical instance. The Van Sweringens, through a ramified series of organizations and pyramiding of holding companies and investment trusts, were enabled to acquire, through the use of the investors' funds, control of a vast network of railroads with a "shoe-string" investment.

> Mr. Van Sweringen. Mr. Pecora, just as we adjourned on yesterday you asked the question as to how many dollars my brother and I and our associates had put into these railroad ventures, if you will, our own money to start with,

[91] Otto H. Kahn, June 30, 1933, Kuhn, Loeb & Co., pt. 3, p. 1317.

not borrowed, not obtained by the sale of securities. I read and we read your question last evening, and I am pleased that it is in a form that I can answer frankly. That amount of dollars, to come straight to the point, was $1,000,000.

* * * * * * *

Mr. PECORA. Do you mean by that, Mr. Van Sweringen, among other things, that the total amount of cash, constituting the personal means of you and your brother and your associates in these various railroad enterprises that have been described by you, was $1,000,000?

Mr. VAN SWERINGEN. At the start that was the amount of dollars that we put in, and others grew. You might say that that starting was a shoe string, and I think I would be inclined to agree with you that that is so. Nevertheless, we made of that shoe string what we have today.

Mr. PECORA. What I want to make sure of is whether or not this $1,000,000 represents the aggregate of the personal capital that you and your associates put in this whole scheme of formation of the railroad system that is known as the "Van Sweringen interests."

Mr. VAN SWERINGEN. At the outset that was the amount of dollars. Of course, as I have said, they grew into more dollars, or more value, as time went on.

Mr. PECORA. You persist in saying at the outset that that was the sum you put in?

Mr. VAN SWERINGEN. Yes.

Mr. PECORA. Does it represent the aggregate of the capital investment out of your own means that you and your associates have made in all those enterprises? That is what I want to find out.

Mr. VAN SWERINGEN. Yes; I think that would be a fair answer as made.[92]

(*a*) ALLEGHANY CORPORATION

(*1*) *Organization and history*—(*i*) *Nickel Plate road.*—Oris P. Van Sweringen and Mantis J. Van Sweringen, in association with Joseph R. Nutt and C. L. Bradley, in 1916 commenced their first substantial railroad activities with the decision to acquire the Nickel Plate road (New York, Chicago & St. Louis R.R. Co.), passing through Cleveland from east to west.[93] The stock control of the Nickel Plate was then held by the New York Central Railroad Co.

The negotiations for the purchase of majority stock ownership and stock control of the Nickel Plate road culminated on July 5, 1916, with an agreement whereby the Van Sweringens purchased 25,032 shares of first preferred stock, 62,750 shares of second preferred stock, and 62,400 shares of common stock for an aggregate of $8,500,000. An initial cash payment of $2,000,000 was made, and the balance of $6,500,000 was in the form of 10 notes of $650,000 each, the first note payable on or before five years and yearly thereafter for a total period of ten years.[94]

The Van Sweringens pledged, as collateral for the payment of the 10 notes aggregating $6,500,000 to the New York Central Railroad Co., with the Guaranty Trust Co. of New York as depository, all of the stock of the Nickel Plate road acquired by them from the New York Central Railroad Co. for the $8,500,000.[95]

On July 3, 1916, two days before the completion of the negotiations with the New York Central Railroad Co., the Van Sweringens borrowed $2,100,000 from the Guardian Savings & Trust Co. of Cleveland to enable them to make the required $2,000,000 initial

[92] O. P. Van Sweringen, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 657–659.
[93] O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, pp. 564, 571.
[94] O. P. Van Sweringen, supra, p. 572.
[95] O. P. Van Sweringen, supra, p. 575.

cash payment to the New York Central Railroad Co.[96] The Van Sweringens, therefore, had borrowed every dollar needed to acquire the controlling stock of the Nickel Plate road.

(ii) *Nickel Plate Securities Corporation.*—In December 1916 the Nickel Plate Securities Corporation, a holding company, was organized. On December 26, 1916, the board of directors accepted the following proposal of the Van Sweringens: In consideration of the transfer to the Nickel Plate Securities Corporation by the Van Sweringens of all the stock of the Cleveland Terminal Co. issued or to be issued by this terminal company in acquiring the common stock of the Cleveland & Youngstown Railroad Co., the Terminal Building Co., and the Terminal Hotels Co., and also the rights of the Terminal Properties Co. to acquire certain lands, and all the rights and interest of the Van Sweringens in the agreement of July 5, 1916, made with the New York Central Railroad Co., including the equity in the stock of the Nickel Plate road hypothecated as collateral for the notes aggregating $6,500,000, the Nickel Plate Securities Corporation would issue to the Van Sweringens all the common stock—250,000 shares, $50 par value, or $12,500,000 par value—and would assume the Van Sweringens' indebtedness of $2,100,000 to the Guardian Savings & Trust Co.; and assume all the obligations and liabilities of the Van Sweringens under the contract of July 5, 1916, with the New York Central Railroad Co., including the obligation to pay the 10 notes aggregating $6,500,000. The Van Sweringens undertook to obtain subscriptions for $2,075,000 of preferred stock of the Nickel Plate Securities Corporation, to be used to pay the $2,100,000 obligation of the Van Sweringens to the Guardian Savings & Trust Co. assumed by the holding company.[97]

Unqualified voting power was granted to the common stock of the Nickel Plate Securities Corporation, while voting power to elect a majority of the board was granted the preferred stock only in the event of default in the payment of dividends.[98]

The effect of these Van Sweringen transactions was that the Nickel Plate Securities Corporation assumed the entire indebtedness, aggregating $8,500,000, which enabled the Van Sweringens in the first instance to purchase the stock control of the Nickel Plate road from the New York Central Railroad Co., and the Van Sweringens owned all of the common stock of the holding company, thereby acquiring voting control. The only other assets contributed by the Van Sweringens to the holding company were the stocks issued by the Cleveland Terminal Co. hereinbefore referred to.[99]

The Van Sweringens subscribed to over half a million dollars of the $2,075,000 par value of preferred stock of the Nickel Plate Securities Corporation, and sold the balance to associates and private interests at $100 per unit (one share of preferred with one share of common stock). The funds were used to pay the $2,100,000 Guardian Savings & Trust Co. loan. The 10 notes, aggregating $6,500,000, held by the New York Central Railroad Co. were paid by October 1923 by the Nickel Plate Securities Corporation.[1]

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[96] O. P. Van Sweringen, supra, p. 575.
[97] O. P. Van Sweringen, supra, pp. 579–588.
[98] O. P. Van Sweringen, supra, p. 583.
[99] O. P. Van Sweringen, supra, pp. 577, 583.
[1] O. P. Van Sweringen, supra, pp. 585, 591.

On February 13, 1922, the Nickel Plate Securities Corporation, by a supplemental agreement, acquired all the rights and equities of the Van Sweringens in the Nickel Plate stock hypothecated to secure the $6,500,000 of notes.[2]

After acquiring stock control of the Nickel Plate Road, the Van Sweringens commenced to enlarge its geographical scope. Congress of the United States had directed that a study be made with a view to grouping, in the public interest, the railroads throughout the country into a limited number of systems. Dr. W. Z. Ripley had been named by the Interstate Commerce Commission to conduct this survey. The Government authorities tentatively recommended for the eastern region of the country general systems exceeding four in number. The Van Sweringens concluded that four systems for the eastern region would be sufficient and that one group should include the Nickel Plate Road, the Lake Erie & Western, the Toledo, St. Louis & Western, the Erie, the Pere Marquette, the Chesapeake & Ohio, the Hocking Valley, the Wheeling & Lake Erie, the Chicago & Eastern Illinois, the Virginian, the Bessemer & Lake Erie, or the Buffalo, Rochester & Pittsburgh, as well as either the Lackawanna or the Lehigh Valley, with smaller lines. A transcontinental system was not contemplated or favored at that time.[3]

The Van Sweringens, acting pursuant to their conclusion, acquired ultimately the majority interests in the Chesapeake & Ohio Railroad, which included the Hocking Valley, and built 60 miles of connecting link to the Great Lakes. The Lake Erie & Western and the Toledo, St. Louis & Western ("Clover Leaf") were subsequently consolidated with the Nickel Plate in 1922. The Interstate Commerce Commission permitted the issuance of stock to effect this consolidation. The Van Sweringens then acquired a majority of the outstanding stock of the Buffalo, Rochester & Pittsburgh.[4]

The Toledo, St. Louis & Western ("Clover Leaf") was acquired in generally the same manner as the Nickel Plate Road had been acquired—by an initial cash payment and substantial deferred payments.

At the time of its consolidation with the Lake Erie & Western and the Toledo, St. Louis & Western ("Clover Leaf"), the Nickel Plate changed its capital structure, and the Nickel Plate Securities Corporation, as owner of shares of stock of the Nickel Plate Road, acquired preferred and common stock under this reformed capital structure. The holding company sold some of its new preferred Nickel Plate Road shares to the public, and from these funds paid $4,450,000, the balance due on the $6,500,000 notes held by the New York Central Railroad Co.[5]

The Van Sweringens also contemplated purchasing the Huntington interest in the Chesapeake & Ohio—73,000 shares, or 15 percent of the outstanding capital stock—which was for sale. This 15-percent interest was sufficient to give the Huntington interests domination of the Chesapeake & Ohio in the sense that they had been seating the directors of the railroad. J. P. Morgan & Co. advised

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[2] O. P. Van Sweringen, supra, p. 585.
[3] O. P. Van Sweringen, supra, pp. 586–587.
[4] O. P. Van Sweringen, supra, pp. 565, 588–589.
[5] O. P. Van Sweringen, supra, p. 592.

the Van Sweringens against this expenditure at that time.[6] In 1923, however, the Van Sweringens and J. P. Morgan & Co. felt that the time was propitious for the acquisition of the Huntington interest in the Chesapeake & Ohio. The Nickel Plate road purchased 70,000 shares at $80 per share, and the Nickel Plate Securities Corporation 3,000 shares at $565 per share, for a total of $7,300,000. The market value of the Chesapeake & Ohio common stock at that time was about $70 per share.[7] The Nickel Plate Road obtained the $5,600,000 to effect this purchase from the sale of $7,274,000 par value second improvement mortgage bonds. The Nickel Plate Securities Corporation secured the $1,700,000 to purchase the stock from the Vaness Co. in reduction of an open account between the companies.[8] The Vaness Co. had borrowed approximately $3,000,000 from the Guaranty Trust Co. of New York to effect this payment.[9] Oris P. Van Sweringen testified that the discrepancy in price of the Chesapeake & Ohio stock to the Nickel Plate road at $80 and to the Nickel Plate Securities Corporation at $565, was to avoid criticism that the railroad paid $100 per share when the market was only $70 per share. The Van Sweringens decided to pay $565 per share to make up the difference in the total purchase price.[10]

(iii) *Vaness Co.*—The Vaness Co. was organized January 9, 1922, by the Van Sweringens and their associates, Joseph R. Nutt and C. L. Bradley, who owned all of its capital stock, as a personal corporate vehicle. The authorized capital of the Vaness Co. was 162,500 shares of no par value common stock and 50,000 shares of $100 par value preferred stock. All of the common stock and approximately $4,000,000, or 80 percent, of the authorized preferred stock were issued to the Van Sweringens and their associates.[11]

The Van Sweringens and their associates, by virtue of their control of the Nickel Plate Road, through ownership of the common stock of the Nickel Plate Securities Corporation, were able to acquire with the moneys, principally obtained from the investing public, a dominating interest in the Chesapeake & Ohio Railroad.[12]

The Van Sweringens assumed management of the Chesapeake & Ohio Railroad on January 30, 1923. By means of the sale of $7,875,000 par amount of equipment bonds at 96.46 on March 20, 1923, and $18,000,000 par amount of equipment bonds at 98 net on June 17, 1924, to J. P. Morgan & Co. the Van Sweringens obtained over $25,875,000 used for the purchase of equipment of the Chesapeake & Ohio Railroad.[13]

Having completed their acquisition of control of the Chesapeake & Ohio Railroad, the Van Sweringens, in the latter part of 1923 and early part of 1924, turned their attention to the acquisition of control of the Erie Railroad as a necessary part of the system the Van Sweringens were attempting to build.[14]

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[6] O. P. Van Sweringen, supra, pp. 565, 594.
[7] O. P. Van Sweringen, supra, p. 599.
[8] O. P. Van Sweringen, June 6, 1933, J. P. Morgan & Co., pt. 2, p. 620.
[9] O. P. Van Sweringen, supra, pp. 622–623.
[10] O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, pp. 602, 605–607.
[11] O. P. Van Sweringen, supra, pp. 602–603.
[12] O. P. Van Sweringen, supra, p. 601.
[13] O. P. Van Sweringen, supra, pp. 610–611. O. P. Van Sweringen, June 6, 1933, J. P. Morgan & Co., pt. 2, p. 620.
[14] O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, pp. 565, 610.

After conferences with George F. Baker, who was allegedly a large stockholder of the Erie Railroad, the Van Sweringens, through the Vaness Co., commencing in November 1923, and until January 1925, purchased 387,000 shares of common, 24,700 shares of first preferred, and 52,600 shares of second preferred of the Erie Railroad for an aggregate consideration of approximately $11,-200,000.[15]

Oris P. Van Sweringen, when interrogated, could not disclose from what sources or in what manner the Vaness Co. had obtained the funds with which to purchase this Erie stock.[16] The minute books of the Vaness Co. disclosed that between October 31, 1923, and February 6, 1925, the board of directors of the Vaness Co. had authorized borrowings from various banks in the aggregate sum of $11,-206,406.10. Oris P. Van Sweringen could not disclose what portion, if any, of these loans had been used in the purchase of the Erie stock. He had no recollection how or from whom these loans had been made. He admitted that substantial loans had been made by the Guardian Savings & Trust Co. and the Union Trust Co., both of Cleveland, to the Vaness Co. Joseph R. Nutt, one of the associates of the Van Sweringens, was president of the Union Trust Co., and J. Arthur House, a director of the Nickel Plate Road, was president of the Guardian Savings & Trust Co.[17]

The Van Sweringens then acquired control of the Pere Marquette Railroad, commencing the purchase of stock in April 1924. The Van Sweringen interests, at the time of the hearings, owned 313,900 shares of common, a majority of the common stock, and 12,600 shares of preferred. The Chesapeake Corporation owned 27,500 shares of the common stock of the Pere Marquette.[18]

With the acquisition of the Pere Marquette Railroad, the Van Sweringen interests had large, and in some cases majority, interests in the Nickel Plate road, the Chesapeake & Ohio, and its subsidiary the Hocking Valley, the Erie, and the Pere Marquette. The Interstate Commerce Commission was petitioned early in 1925 in the "First Nickel Plate Unification Case" to consolidate into one system the Chesapeake & Ohio, the Pere Marquette, the Nickel Plate, the Erie, the Hocking Valley, and the contemplated 60 miles of connecting road that was subsequently built in Ohio. The Interstate Commerce Commission denied the petition in March 1926, stating in its opinion, among other things, that the plan had been arranged to keep control in the hands of its proponents, though their interest was a minority one.

> We cannot escape the conclusion that the plan was arranged with the intention of keeping the control in the hands of its proponents, even though their interest is a minority one in fact. Such an arrangement is not in accord with sound railroad practice. The Nickel Plate is the only railroad of importance in the country in which the preferred-stock holders do not have the right to vote, and now it is proposed to extend this feature to over $155,000,000 of new stock of a company comparable with the New York Central, Pennsylvania, and Baltimore & Ohio. The common stock of the new company will not greatly

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[15] O. P. Van Sweringen, supra, p. 615. O. P. Van Sweringen, June 6, 1933, J. P. Morgan & Co., pt. 2, p. 630.

[16] O. P. Van Sweringen, supra, p. 631.

[17] O. P. Van Sweringen, supra, p. 635. For a more detailed report of the Van Sweringen loans from the Union Trust Co. and the Guardian Savings & Trust Co., and their contributing effect to the closing of both these institutions, see ch. IV of this report; also pt. 18, pp. ----.

[18] O. P. Van Sweringen, supra, p. 651.

exceed $174,000,000 out of a total capitalization of over $950,000,000. We believe it to be self-evident that the public interest requires that the entire body of stockholders of a railroad which is bonded in excess of one-half of its investment, and not a powerful few, shall be responsible for its management. It can be done only by giving them the power to control the management. The lethargy of ordinary stockholders in exercising their power to control the management of these large corporations has often been commented upon, but, nevertheless, the power should be in their hands to use as they see fit. It is inimical to the public interest to strip stockholders of their voting power, thus rendering it so much easier to control a great transportation system by a comparatively limited amount of investment."[19]

The Interstate Commerce Commission also directed attention to an agreement dated January 11, 1924, pursuant to which the Van Sweringens, owners of 130,000 shares of common voting stock of the Vaness Co., and C. L. Bradley and Joseph R. Nutt, both directors of the Nickel Plate Road, holders of 16,250 shares, deposited such stock with a trustee, receiving in lieu thereof trustee certificates of the Vaness Co. in proportion to the number of shares deposited, the stock so deposited constituting the entire voting stock of the Vaness Co.

The voting certificates issued to Bradley and Nutt, and the rights represented thereby, were subject to purchase by the Van Sweringens under the terms of an option expressed in the agreement. The agreement constituted and appointed the Van Sweringens, C. L. Bradley, and Joseph R. Nutt managers of the trust, which was to continue for 21 years after the death of the last survivor, with the right on the part of the survivors to appoint successors to deceased managers. Under this trust agreement, the Van Sweringens were able to divest themselves of all beneficial interest in the Vaness stock and still retain voting control of the contemplated new Nickel Plate Railroad Co., without any direct or indirect ownership of a share of stock in the new company.[20]

The decision of the Interstate Commerce Commission indicated that the Chesapeake & Ohio, rather than the Nickel Plate Road, should be the backbone of the newly contemplated system. Since it was a condition precedent to any consolidation of roads that there be a physical connection of the various railroads contemplated in the consolidation, the Van Sweringens obtained the right to build the 60 miles of road to connect the Chesapeake & Ohio and the Hocking Valley between Waverly, Ohio, and Columbus, Ohio.[21] The permission of the Interstate Commerce Commission was then obtained to consolidate the Chesapeake & Ohio, the Hocking Valley, and the 60 miles of connecting link, so that the Chesapeake & Ohio had a continuous line from Tidewater at Newport News, Va., to Toledo, Ohio, on the Great Lakes.[22]

With this consolidation accomplished, the Van Sweringens concluded that if the Chesapeake & Ohio were to become the nucleus of a system of which the Nickel Plate should form a part, it was necessary that the Nickel Plate road should not own in part its prospective parent, the Chesapeake & Ohio. The Nickel Plate road had to be divested of the ownership of Chesapeake & Ohio shares.

[19] O. P. Van Sweringen, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 601–602.
[20] O. P. Van Sweringen, supra, pp. 603–604.
[21] O. P. Van Sweringen, supra, p. 605. O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, p. 566.
[22] O. P. Van Sweringen, supra, p. 566.

(iv) *Chesapeake Corporation.*—To accomplish this the Chesapeake Corporation, a holding company, was organized in May 1927, with an authorized capitalization of 900,000 shares of common stock, no par value, with voting rights.[23] By means of the Chesapeake Corporation, the Nickel Plate road was divested of ownership of the Chesapeake & Ohio shares and at the same time kept these two railroads compacted. An exchange of shares of the Chesapeake Corporation was effected for the shares of the Chesapeake & Ohio Railroad, owned by the Nickel Plate road. A complicated series of transactions was employed to effectuate this purpose.

(v) *Special Investment Corporation.*—The Van Sweringens caused to be organized the Special Investment Corporation, a subsidiary of the Nickel Plate road, in April 1926, with an authorized capital of 500,000 shares of common stock, no par value.[24] On April 16, 1926, the New York, Chicago & St. Louis Railway Co. (commonly known and referred to in this report and in the testimony as the "Nickel Plate") sold to the Special Investment Corporation 155,000 shares of common stock of the Chesapeake & Ohio Railway Co. and 120,000 shares of common stock of the Pere Marquette Railroad Co. for 304,065 shares of the Special Investment Corporation.[25]

Subsequently, and up to May 10, 1927, the holdings of the Special Investment Corporation of Chesapeake & Ohio stock were increased to 345,000 shares, either by exchange of its own capital stock or for a cash consideration, the Special Investment Corporation borrowing the moneys necessary to make the cash payments.[26]

(vi) *General Securities Corporation.*—In May 1927 the Van Sweringens caused to be organized the General Securities Corporation with an authorized capital of 382,500 shares of common stock. The Vaness Co. transferred 255,000 shares of Chesapeake & Ohio common stock that it owned to the General Securities Corporation, subject to a debt of $67.50, in exchange for the issuance of all of the General Securities common stock to the stockholders of the Vaness Co.[27] The General Securities Corporation then put into the Chesapeake Corporation these 255,000 shares of stock of the Chesapeake & Ohio at the rate of exchange of 1½ shares of Chesapeake Corporation stock for each share of Chesapeake & Ohio stock.

The General Securities Corporation was organized chiefly for the purpose of effecting the exchange of the 255,000 shares of common stock of the Chesapeake & Ohio owned by the Vaness Co. to the Chesapeake Corporation in return for the capital stock of the Chesapeake Corporation. Through the medium of the General Securities Corporation, the Van Sweringens were able to avail themselves of the income-tax exemption in connection with corporate reorganizations on any taxable profit realized on this exchange.

In addition, the 345,000 shares of Chesapeake & Ohio stock owned by the Special Investment Corporation were also transferred to the Chesapeake Corporation, subject to an indebtedness of $67.50 per share, for 1½ shares of Chesapeake Corporation for each share of

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[23] O. P. Van Sweringen, supra, p. 566. O. P. Van Sweringen, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 665–666.
[24] O. P. Van Sweringen, supra, p. 671.
[25] O. P. Van Sweringen, supra, pp. 671–672.
[26] O. P. Van Sweringen, supra, p. 672.
[27] O. P. Van Sweringen, supra, p. 675.

Chesapeake & Ohio stock so transferred. A total of 600,000 shares of the common capital stock of the Chesapeake & Ohio was thereby acquired by the Chesapeake Corporation and taken in on their books at $104,850,000, at the rate of $174.75 per share—the lowest quoted sales price on May 19, 1927.

The 255,000 shares turned in the Chesapeake Corporation by the Vaness Co., through the medium of the General Securities Corporation, had cost $31,128,235.33, and the 345,000 shares turned in by the Special Investment Corporation had cost $39,960,425, or a total of $71,088,660.33, as compared with $104,850,000, the market price on May 19, 1927, when turned over to the Chesapeake Corporation.[28]

On May 10, 1927, a letter was addressed to the stockholders of the New York, Chicago & St. Louis Railway Co. (Nickel Plate road) apprising them of this plan to transfer ownership of the stock of the Nickel Plate road to the Chesapeake Corporation, and also offering 1.7 shares of Chesapeake Corporation stock for each share of common stock of the Nickel Plate road held by the common-stock holders as of record at the close of business May 1, 1927.[29]

To fund the debt of approximately $40,000,000, or $67.50 per share on the 600,000 shares of Chesapeake & Ohio Railway stock transferred to the Chesapeake Corporation, and also to obtain approximately $3,000,000 working capital, an issue of $48,000,000, 20-year 5-percent convertible collateral trust bonds was sold by the Chesapeake Corporation to J. P. Morgan & Co. and the Guaranty Co. of New York at 90½ on May 10, 1927.[30]

On May 10, 1927, a contract was entered into between J. P. Morgan & Co., the Guaranty Co. of New York, and the Chesapeake Corporation providing for the sale of the $48,000,000 of Chesapeake Corporation 20-year 5-percent convertible collateral trust bonds, dated May 15, 1927, and due May 15, 1947, at 90½. As security for the payment of the principal and interest of such bonds and performance of all other covenants contained in the indenture, the 600,000 shares of common stock of the Chesapeake & Ohio, which were to be acquired by the Chesapeake Corporation from the General Securities Corporation and the Special Investment Corporation, were pledged as collateral.[31]

Simultaneously, on May 10, 1927, the Vaness Co. undertook to pay to J. P. Morgan & Co. and the Guaranty Co. the additional sum of $240,000 if the sale of the Chesapeake Corporation bonds was consummated as provided for in the aforesaid agreement, and the sum of $480,000 in the event that the sale of the bonds was not consummated.[32]

This additional payment of $240 000 reduced the price of the bonds from 90½ to 90. Oris P. Van Sweringen testified that these additional payments had been provided, in the event of the consummation, as a fair consideration for the services rendered by J. P. Morgan & Co. in marketing the securities, and, in the event of the nonconsummation, as a service charge in connection with the issue.[33] The contract

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[28] O. P. Van Swerlngen, June 8, 1933, J. P. Morgan & Co., pt. 2, pp. 713, 759.
[29] Committee's exhibit no. 45, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 667–668.
[30] O. P. Van Swerlngen, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 680–681.
[31] O. P. Van Sweringen, supra, pp. 685–687.
[32] O. P. Van Sweringen, supra, p. 688.
[33] O. P. Van Sweringen, supra, pp. 689–690.

was consummated, and the Vaness Co. paid $240,000 to J. P. Morgan & Co. and the Guaranty Co. of New York.[34] Oris P. Van Sweringen testified that the Vaness Co. had been motivated in assuming this obligation of alternative payments because of the parental interest which the Vaness Co. had in the Chesapeake Corporation.[35]

Mr. PECORA. In other words, the Vaness Co. was considered by you to be the father of the Chesapeake Corporation

Mr. VAN SWERINGEN. In a measure; yes.

Mr. PECORA. And as a loving and dutiful father, you took care of its child's interest?

Mr. VAN SWERINGEN. Yes, sir.[36]

On May 10, 1927, the Vaness Co. was indebted to J. P. Morgan & Co. in the sum of $35,000,000. Out of the proceeds of the issue of the $48,000,000 of Chesapeake Corporation bonds, $15,000,000 of this indebtedness which the Vaness Co. owed J. P. Morgan & Co. was paid on June 6, 1927.[37]

Mr. PECORA. All right. So that the parent, the Vaness Co., this mother and father of the Chesapeake Corporation, took care of its little child by transferring to it part of the indebtedness which the parent owed to J. P. Morgan & Co.; is that right?

Mr. VAN SWERINGEN. No.

Mr. PECORA. Doesn't it work out that way?

Mr. VAN SWERINGEN. Not in that way. Pardon me; you said does it work out?

Mr. PECORA. Yes.

Mr. VAN SWERINGEN. It does work out that way.

Mr. PECORA. Does it work out that way in practical effect?

Mr. VAN SWERINGEN. Yes.[38]

The Vaness Co. indebtedness of $35,000,000 to J. P. Morgan & Co. was secured by 90,000 shares of Nickel Plate common, 202,000 shares of Chesapeake & Ohio common, 200,000 shares of Erie common, and 30,000 shares of Pere Marquette common, with a total market value of $67,455,500.[39] This indebtedness had been created in part to enable the Vaness Co. to buy these shares. The 202,000 shares of Chesapeake & Ohio common stock, which were included in that collateral, were also included in the 255,000 shares of Chesapeake & Ohio common stock transferred by the Vaness Co. to the Chesapeake Corporation, and, therefore, were part of the 600,000 shares of Chesapeake & Ohio collateral to secure the $48,000,000 Chesapeake Corporation bond issue. The 600,000 shares of Chesapeake & Ohio common stock acquired by the Chesapeake Corporation subject to an indebtedness of $67.50 per share, were to be discharged, as already stated, by $40,000,000 of the proceeds of the $48,000,000 bond issue.[40]

The result of the transactions with J. P. Morgan & Co. was that on June 6, 1927, all of the assets of the Chesapeake Corporation and the Vaness Co., which included the stock of the Chesapeake & Ohio, the Erie Railroad, the Pere Marquette Railroad, and the Nickel Plate road, in sufficient numerical amounts to permit the management control of these companies, had been pledged as collateral to secure the

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[34] O. P. Van Sweringen, supra, pp. 691–692.
[35] O. P. Van Sweringen, supra, p. 692.
[36] O. P. Van Sweringen, supra, p. 693.
[37] O. P. Van Sweringen, supra, p. 694.
[38] O. P. Van Sweringen, supra, p. 694.
[39] O. P. Van Sweringen, supra, p. 695.
[40] O. P. Van Sweringen, supra, p. 696.

$35,000,000 J. P. Morgan & Co. loan to the Vaness Co. and the $48,000,000 Chesapeake Corporation bond issue.[41]

(vii) *Geneva Corporation.*—The Van Sweringens organized almost simultaneously with the Alleghany Corporation the Geneva Corporation, on February 12, 1929, to serve the same purposes that the General Securities Corporation served in relation to the Chesapeake Corporation, namely, to permit an exchange of securities by the Van Sweringen interests with the newly organized Alleghany Corporation, with a view to tax exemption under the reorganization provisions of the tax law. To accomplish the plan of the Van Sweringens to transfer from the General Securities Corporation to the Alleghany Corporation the securities owned by the General Securities Corporation, except at that time the Nickel Plate Road stock, a plan or agreement was entered into on February 12, 1929, whereby the General Securities Corporation transferred to the Geneva Corporation 65,000 shares of the capital stock of the New York, Chicago & St. Louis Railway Co. (Nickel Plate) and 160,900 shares of the Erie Railroad common stock, in consideration for which the Geneva Corporation issued and delivered to the General Securities Corporation all of its capital stock, to wit, 10,000 shares of common stock without par value.[42]

The next step in the process of pyramiding corporation upon corporation, investment trust upon investment trust, and holding company upon holding company was the placing of the top holding company, Alleghany Corporation, on the apex of the pile.

O. P. and M. J. Van Sweringen caused the Alleghany Corporation to be organized on January 26, 1929, for the purpose of purchasing and owning stock interests largely in companies owning and controlling railway properties, which holdings were either owned by the Vaness Co., the General Securities Corporation, or the Van Sweringens individually, with full power to such corporation to sell and reinvest from time to time, as the directors of the new corporation might determine.[43]

The Van Sweringens had applied to the Interstate Commerce Commission for authority to acquire stock control of the Erie Railroad and the Pere Marquette Railroad. They did not include the Nickel Plate Road at that time, for they felt that the ultimate desired consolidation could only be obtained step by step. The Interstate Commerce Commission permitted the Chesapeake & Ohio to have control of the Pere Marquette but withheld approval as to the Erie. The Van Sweringens, in order to mobilize, in a financial sense, their activities, looking forward to the ultimate goal of the final upbuilding of the Chesapeake & Ohio, or the "fourth system" for the eastern region, organized the Alleghany Corporation to hold the shares controlled by the Van Sweringen interests and to enable the corporate instrumentality to gather further funds to accomplish their purpose.[44]

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[41] O. P. Van Sweringen, supra, p. 697.
[42] O. P. Van Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, pp. 754–755. For a discussion of the avoidance of tax through the medium of the Geneva Corporation, see O. P. Van Sweringen, supra, pp. 755–759.
[43] O. P. Van Sweringen, supra, p. 700.
[44] O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, pp. 566–567.

(viii) *Alleghany Corporation.*—The Alleghany Corporation had an authorized capital of 7,500,000 shares of no-par-value common stock and 1,000,000 shares of preferred stock, $100 par value.

The Van Sweringens, on January 28, 1929, entered into a contract with J. P. Morgan & Co. whereby the Alleghany Corporation, to be formed, would sell to J. P. Morgan & Co. $35,000,000 principal amount of 5-percent bonds for an aggregate price of $32,750,000, and $25,000,000 par value of 5½-percent preferred stock at $100 per share; and for $375,000 additional consideration, 375,000 nondetachable option warrants entitling the holders to purchase at $30 per share 375,000 shares of common stock.

In addition 1,250,000 shares of the 3,500,000 shares of common stock initially issued were sold to J. P. Morgan & Co. at $20 per share, and there was to be delivered to J. P. Morgan & Co. 375,000 of the 1,725,000 detached option warrants, entitling holders to purchase one share of common stock at $30 per share, issued to the Van Sweringens at an allocated consideration of $1 per warrant.[45]

The Van Sweringen interests purchased, in addition to the option warrants, the remaining 2,250,000 of the initially issued shares of Alleghany Corporation common stock at $20 per share for a total of $45,000,000. Payment was made, not by cash, but by an exchange of 100,000 shares of Nickel Plate common stock, subject to a debt of $1,029,000, and 440,286 shares of Chesapeake Corporation common stock.[46]

The Van Sweringens suggested to J. P. Morgan & Co. that they include in the "preferred list" of the Alleghany Corporation common-stock private offering Newton D. Baker, former attorney for the Van Sweringen interests; D. S. Barrett, Jr., later a director of the Missouri Pacific Railroad; J. J. Bernet, president of the Chesapeake & Ohio and Pere Marquette; Charles Bradley, one of the former associates of the Van Sweringens; Herbert Fitzpatrick, director of the Chesapeake & Ohio and Pere Marquette; Michael Gallagher, director and officer of the Pere Marquette; W. J. Harahan, formerly president of the Chesapeake & Ohio; J. Arthur House, a director of the Nickel Plate road; Henry A. Marting, a director of the Chesapeake Corporation; W. L. Ross, president of the Nickel Plate road; John Sherwin, Sr., a director of the Nickel Plate road; K. D. Steere, partner of Paine, Webber & Co. and a former associate of the Van Sweringens; and John P. Murphy, an attorney and officer of some of the Van Sweringen corporations.[47]

In the exchange of securities by the Vaness Co., through the medium of the General Securities Corporation, with the Alleghany Corporation, whereby the General Securities Corporation acquired the 2,250,000 shares of common stock and the 1,725,000 option warrants at an allocated consideration of $1 per warrant, the Van Sweringen interests were on both sides of the transactions as purchasers and sellers.

Mr. PECORA. Let me put it this way: What interests of the Alleghany Corporation did you think were served by the issuance to yourselves as the organizers of that corporation of these 1,725,000 warrants for $1 apiece?

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[45] Committee exhibit No. 9, May 24, 1933, J. P. Morgan & Co., pt. 1, pp. 150–152.

[46] O. P. Sweringen, June 7, 1933, J. P. Morgan & Co., pt. 2, p. 705. For details of the J. P. Morgan and Van Swerigen "preferred list" in Alleghany Corporation, see ch. II, of this report.

[47] O. P. Van Sweringen, supra, pp. 702–704.

Mr. VAN SWERINGEN. Why, it was a part of the consideration making up the trade by which we put into Alleghany or permitted them to have these railroad interests that I have identified as going to them.

Mr. PECORA. Well, these railroad interests that you refer to were the railroad interests of yourselves—that is, the Van Sweringen interest—weren't they?

Mr. VAN SWERINGEN. Yes.

Mr. PECORA. And the Van Sweringen interests created or organized the Alleghany Corporation, did they not?

Mr. VAN SWERINGEN. Yes, sir.

Mr. PECORA. So that virtually you were doing business with yourselves, were you not, when you organized the Alleghany Corporation?

Mr. VAN SWERINGEN. There is a measure of interlocking relationship there, undoubtedly.

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Mr. PECORA. Well, I notice, Mr. Van Sweringen, that all of the directors of the Alleghany Corporation at the outset were composed of Van Sweringen associates.

Mr. VAN SWERINGEN. Yes.

Mr. PECORA. And these directors coming from the personnel of the Van Sweringen associates, if I may use the term, sat around the directors' table of the Alleghany Corporation and voted to the Van Sweringen interests 1,725,000 warrants for $1 apiece. Is that right?

Mr. VAN SWERINGEN. With the other considerations that I have mentioned; yes, sir.

Mr. PECORA. Of course, the other considerations related to the acquisition by yourselves of other issues of securities or stock of the Alleghany Corporation. Didn't it?

Mr. VAN SWERINGEN. It did.

Mr. PECORA. Yes. Now, confining ourselves for the time being——

Mr. VAN SWERINGEN. But the two were interrelated; that is the point.

Mr. PECORA. They were all a part and parcel of the one transaction?

Mr. VAN SWERINGEN. Yes, sir. That is a very good description.

Mr. PECORA. But referring to that portion of it which related to the issuance to the organizers—and by that I mean to the Van Sweringen interests—of the 1,725,000 warrants at a dollar apiece, what advantages accrued to the Alleghany Corporation from that part of the transaction?

Mr. VAN SWERINGEN. It was a part of the measure that we all felt was fair for them to concede for that which they got.

Mr. PECORA. For whom to concede, and to whom was the concession made?

Mr. VAN SWERINGEN. For the Alleghany to concede and the General Securities Co. to receive.

Mr. PECORA. Well, now, the Alleghany Corporation insofar as it acted through individuals acted through the individuals that were the Van Sweringen associates. So that the Van Sweringen associates were dealing with themselves, were they not, in this whole transaction?

Mr. VAN SWERINGEN. There was some of that in it.

Mr. PECORA. Now, what advantages accrued to the Alleghany Corporation, or did you think the Alleghany Corporation could acquire in the future from the issuance of these 1,725,000 warrants to its organizers for a dollar apiece?

Mr. VAN SWERINGEN. Mr. Pecora, I do not think it was a question of advantage to be had, but it was a question of fairness of trade. While we had a relationship in both directions, that did not interfere with our being able to be fair about what we were doing.

Mr. PECORA. Well, now, on this subject of fairness of trade, didn't it amount to this? The Van Sweringen interests, composing as they did, the board of directors of the Alleghany Corporation, at the time of the issuance of these warrants conferred with the Van Sweringen interests, as represented in the General Securities Corporation, and concluded that it was a fair thing for the Van Sweringen interests sitting as the board of directors of the Alleghany Corporation to issue to the Van Sweringen interests sitting as the owners of the General Securities Corporation, to make this deal?

Mr. VAN SWERINGEN. Yes, sir.

Mr. PECORA. That is it. Well, what did you consider would be the benefits that ever could accrue at any time thereafter to the Alleghany Corporation by that kind of a fair trade?

Mr. VAN SWERINGEN. Again I think I have got to turn back a little bit and say that it was thought to be, and I still believe it was a fair consideration, or, to put it the other way, if you want to, a fair part of the bargain that they conceded in the trade the other way.

Mr. PECORA. But we have seen that the parties to this trade were the Van Sweringen interests, on the one hand, and the Van Sweringen interests, on the other hand.

Mr. VAN SWERINGEN. Right.[48]

The 100,000 shares of Nickel Plate Road were set up on the books of the Alleghany Corporation at $13,035,560.15, and the 440,386 shares of Chesapeake Corporation common stock were set up on the books at $34,718,439.85, or a total of $47,754,000.[49]

On February 15, 1929, the Alleghany Corporation purchased for cash from the Vaness Co. 51,714 shares of Chesapeake Corporation common stock for $4,092,747.50; 26,100 shares of Chesapeake & Ohio common stock for $5,421,205; 215,000 shares of Erie Railroad common stock for $12,900,000, for a total of $22,413,952.50.[50]

The Alleghany Corporation, about the same time, purchased for cash from O. P. and M. J. Van Sweringen 96,000 shares of Buffalo, Rochester & Pittsburgh Railway common stock for $9,600,000 and 43,000 shares of Buffalo, Rochester & Pittsburgh Railway preferred stock for $4,300,000, or a total of $13,900,000.[50]

As a result of these two transactions the Van Sweringen interests sold securities to the Alleghany Corporation for an aggregate cash consideration of over $36,000,000. This cash payment was made by the Alleghany Corporation from the $82,950,000 which it had received from the sale to J. P. Morgan & Co. of $35,000,000 bonds for $32,575,000; $25,000,000 first-preferred stock for $25,000,000; and $375,000 for nondetachable warrants, as provided in the contract of January 28, 1929.

The original cost of all the securities transferred by the Van Sweringen interests to the Alleghany Corporation, namely, 51,714 shares of Chesapeake Corporation common, 26,100 shares of Chesapeake & Ohio common, 215,000 shares of Erie Railroad common, 96,000 shares of Buffalo, Rochester & Pittsburgh Railway common, and 43,000 shares of Buffalo, Rochester & Pittsburgh Railway preferred, in addition to the 100,000 shares of Nickel Plate road stock and 440,386 shares of Chesapeake Corporation transferred at the inception of the Alleghany Corporation, aggregated $52,044,335.70.[51] In consideration for the transfer of all these securities the Van Sweringen interests received from the Alleghany Corporation, either directly or indirectly, cash in the sum of $36,313,950.50 and 2,250,000 shares of Alleghany Corporation common stock and 1,725,000 option warrants for the purchase of common stock of Alleghany Corporation, and the Alleghany Corporation assumed in addition a liability of $1,029,000 of the Van Sweringen interests.[52] The book value on the Alleghany Corporation's books of the 2,250,000 shares of common stock was $45,000,000; the book value of the 1,725,000 option warrants was $1,725,000.

The total consideration received by the Van Sweringen interests for all the securities transferred to the Alleghany Corporation, cost-

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[48] O. P. Van Sweringen, supra, pp. 707–709.
[49] O. P. Van Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, p. 717.
[50] O. P. Van Sweringen, supra, p. 718.
[51] O. P. Van Sweringen, supra, p. 747.
[52] O. P. Van Sweringen, supra, p. 747.

ing the Van Sweringen interests $52,044,335.70, was $84,067,952.50, which included $36,313,952.50 cash, the assumption of the Van Sweringen obligation of $1,029,000, plus securities of a book value of $46,725,000.[53] Oris P. Van Sweringen resisted this computation upon the ground that the $20 per share for the common stock was not a realized gain, although he admitted that a block of 1,250,000 shares had been sold to J. P. Morgan & Co. at $20 per share, and that J. P. Morgan & Co. had not overpaid for this common stock.[54]

The fact is that the market value of the common stock immediately after the sale to J. P. Morgan & Co. and the Van Sweringens was considerably in excess of the $20 cost price. The General Securities Corporation, during the year 1929, had sold in the open market through Paine, Webber & Co. 672,810 shares of Alleghany Corporation stock at an average price of $48.50 per share, realizing a profit of over $23,000,000.[55] The Van Sweringens still retained 1,567,190 shares of Alleghany Corporation common stock of the 2,250,000 shares they had originally received.[56] If a realizable value of $48.50 per share is ascribed to this balance of 1,577,190 shares, the 2,250,000 shares of Alleghany Corporation common stock of the Van Sweringen interests would have had a market value during 1929 of $109,125,000. This ascribed realizable value, together with the $36,313,932 received in cash would give a total of $145,458,932 received from the Alleghany Corporation in the form of stock and cash, as compared to the $52,044,335.70 cost of the securities transferred by the Van Sweringen interests to the Alleghany Corporation.[57]

The Vaness Co., on February 15, 1929, paid to J. P. Morgan & Co. $22,000,000, due on an original loan of $27,500,000 dated June 28, 1927, and $196,777.78 interest. A further loan was made on that day by J. P. Morgan & Co. to the Vaness Co. of $10,000,000.[58]

On June 29, 1929, the original capitalization of 900,000 shares of common stock of the Chesapeake Corporation was increased by 1,600,000 additional shares, for a total of 2,500,000 shares, of which 900,000 were actually issued. A stock dividend of 450,000 shares was declared pro rata to stockholders, and 450,000 shares sold to stockholders at $50 a share, when the market price was $85 per share.[59] At that time the Alleghany Corporation owned more than 70 percent of the entire outstanding capital stock of the Chesapeake Corporation.

Mr. PECORA. So if this stock dividend and the right to subscribe to shares at $50 a share was in the nature of a lemon—of a melon. [Laughter in the room.]

Mr. VAN SWERINGEN. Very good.

Mr. PECORA. It was a melon, and became a lemon—was in the nature of a melon, the greater part of it went to the Vaness Corporation?

Mr. VAN SWERINGEN. Yes; and still is.

Mr. PECORA. Still is?

Mr. VAN SWERINGEN. It still pays its dividends and earns it.[60]

In 1932 the Interstate Commerce Commission approved the plan for rearranging the railroad grouping, coinciding with the "four-

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[53] O. P. Van Sweringen, supra, p. 748.
[54] O. P. Van Sweringen, supra, p. 749.
[55] O. P. Van Sweringen, supra, p. 750.
[56] O. P. Van Sweringen, supra, p. 751.
[57] O. P. Van Sweringen, supra, p. 753.
[58] O. P. Van Sweringen, supra, pp. 720–721.
[59] O. P. Van Sweringen, June 7, 1933, J. P. Morgan & Co., pt. 2, pp. 697–698.
[60] O. P. Van Sweringen, supra, p. 698.

system" plan, and approved as one system the railroads east of the Mississippi, in which the Allegheny Corporation were interested.

Included in the investments originally acquired by the Alleghany Corporation was the control of the Buffalo, Rochester & Pittsburgh Railway, which subsequently, in order to reconcile differences in the eastern groupings, was sold to the Baltimore & Ohio Railroad at cost, and Alleghany Corporation acquired from the Baltimore & Ohio its interest in the Wheeling & Lake Erie at cost. At approximately the same time, the Alleghany Corporation acquired from the New York Central Railroad Co. an interest in the Wheeling & Lake Erie. These acquired interests in the Wheeling & Lake Erie, subsequently transferred to the Nickel Plate road at cost, gave the Nickel Plate road a majority controlling interest.[61]

The Van Sweringens then directed their attention to the railroads in the southwest of the country and determined upon the acquisition of the Missouri-Pacific system. The Alleghany Corporation commenced, in the early part of 1929, to accumulate the shares of the Missouri-Pacific system, acquiring by May, 1930, a majority of the outstanding stock and approximately one-half of the $46,000,000 of Missouri-Pacific debenture notes. With the acquisition of the Missouri Pacific Railroad, the Alleghany Corporation possessed control of all the railroad properties it sought to obtain.[63]

Oris P. Van Sweringen then became chairman of the Missouri Pacific Railroad, resigning from all directorships of the eastern lines.

The total purchases of securities for the account of the Alleghany Corporation from February 15 to March 31, 1929, was $139,004,705.68, a substantial portion of which was Missouri Pacific Railroad common and preferred stock.[64]

Although the Van Sweringens stressed the thought that no consolidation of the Chesapeake & Ohio system in the East with the Missouri-Pacific system in the West, or that any transcontinental railroad was contemplated, the facts were that there was a physical connection between the two systems at St. Louis and the Van Sweringen interests owned the controlling stock in both systems.

Oris P. Van Sweringen urged the distinction between consolidation and ownership of stock; and when interrogated upon this distinction, testified:

Mr. PECORA. Now, Mr. Van Sweringen, you won't deny, will you, that the Alleghany Corporation has management control of the various eastern system so-called "group of railroads" you have been testifying about through its ownership of stock in those roads?

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Mr. VAN SWERINGEN. It has the right as a result of its stock holdings to elect the directors insofar as those holdings are concerned pursuant to the corporate charter and its provisions.

Mr. PECORA. The management control flows from directors, does it?

Mr. VAN SWERINGEN. Yes. And the consequences of that is management from the directors; yes, sir.

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[61] O. P. Van Sweringen, June 5, 1933, J. P. Morgan & Co., pt. 2, p. 567.

[63] O. P. Van Sweringen, supra, pp. 567–568. O. P. Van Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, p. 722.

[64] For a detailed tabulation of the purchases and sales of securities by the Alleghany Corporation from Feb. 15 to Mar. 31, 1929, and a summary of the securities owned by that corporation as of Mar. 31, 1929, see Committee Exhibit No. 47, June 8, 1933, J. P. Morgan & Co., pt. 2, pp. 774–777.

Mr. PECORA. And you won't deny, will you, that as the chairman of the board of the Missouri Pacific system you exercise very strong influence in the policies of that road, of that system—don't you?

Mr. VAN SWERINGEN. Oh, yes; I think that might be so as to Missouri Pacific.

Mr. PECORA. And you are also president of the Alleghany Corporation and have been since its creation, haven't you?

Mr. VAN SWERINGEN. Yes, sir.

Mr. PECORA. Now, would you say, then, that by virtue of your being president of the Alleghany Corporation and of the degree of management control that it exercises through representation on the boards of the various railroad companies that form the eastern group, plus the degree of control you exercise over the Missouri Pacific system as chairman of that system, that you are virtually in position of greatly influencing, if not controlling, the policies, not only of the eastern group but of this western and southwestern group embodied in the Missouri Pacific?

Mr. VAN SWERINGEN. I could agree with practically all of that.

Mr. PECORA. Yes.

Mr. VAN SWERINGEN. At least I hope that is so.[65]

J. P. Morgan & Co., on May 1, 1929, loaned $19,264,050 to the Alleghany Corporation to take up its allotment of convertible notes of the Missouri Pacific Railroad then being sold. As collateral, $19,758,000 of Missouri Pacific 20-year 5½-percent convertible bonds, 50,000 shares of Missouri Pacific common stock, and 50,000 shares of Chesapeake Corporation common stock were deposited. This loan was liquidated on June 1, 1929, out of the proceeds from the sale of $25,000,000 Alleghany Corporation preferred stock at par, $15,783,690 of Alleghany Corporation common stock issued at that time, and $23,947,500 of $25,000,000 principal amount of Alleghany Corporation bonds sold at 95.79.[66]

The Van Sweringens sometime thereafter also organized the Pittston Co., a coal company with approximately 20 distributing units in and around Boston, New England, New Jersey, and New York territory.[67]

(2) *Van Sweringens and the Reconstruction Finance Corporation.*—Railroads, to obtain loans from the Reconstruction Finance Corporation, were required to file an application with the Reconstruction Finance Corporation and a duplicate application with the Interstate Commerce Commission. The Interstate Commerce Commission reviewed the application with a view to the public interest and the necessity of the loan from a railroad viewpoint. The disapproval of the application by the Interstate Commerce Commission automatically barred a loan from the Reconstruction Finance Corporation. If the application were approved by the Interstate Commerce Commission, then the Reconstruction Finance Corporation passed upon the application with the view of collateral security and financial arrangements.[68]

The applications, aggregating approximately $22,000,000, of the Missouri Pacific Railroad loans were approved by the Reconstruction Finance Corporation.[69]

Bank loans of the Missouri Pacific Railroad, totaling $11,700,000, owed to J. P. Morgan & Co., in which loans Kuhn, Loeb & Co. and the Guaranty Trust Co. had participations, were maturing on April

[65] O. P. Van Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, pp. 724–725.
[66] O. P. Van Sweringen, supra, pp. 742–743.
[67] O. P. Van Sweringen, supra, p. 745.
[68] O. P. Van Sweringen, supra, p. 759.
[69] O. P. Van Sweringen, supra, p. 760.

1, 1932. The Van Sweringens had unsuccessfully attempted to obtain an extension of these loans from the bankers, J. P. Morgan & Co., on January 29, 1932, writing:

Referring to your company's indebtedness of $11,700,000, with interest to ourselves representing a group of banks and bankers, we hereby call for the payment of such loan with interest on April 1, 1932, being slightly more than 60 days from the date of this letter.[10]

The Missouri Pacific Railroad, on March 10, 1932, made formal application for loans aggregating $23,250,000, without prejudice to applications for additional loans. This application included a request for an advance to pay bank loans aggregating $11,700,000, due April 1, 1932, which were secured by $15,500,000 principal amount of first and refunding mortgage 5-percent gold bonds and 229,500 shares of common stock of the Texas & Pacific Railway Co. The Reconstruction Finance Corporation, on March 23, 1932, approved a loan of $5,850,000, or 50 percent of the railroad company's maturing bank loans, the resolution stating:

And whereas, in the opinion of this Board, the existing uncertainty as to the disposition of the April 1 maturity of the Missouri Pacific Railroad Co. is detrimental to the general credit situation of the railroads, and whereas the Missouri Pacific Railroad Co. has stated, and it is the opinion of this Board, that the said railroad is unable to obtain funds through banking channels or from the general public in order to pay said bank loans: Now, therefore, be it

Resolved (subject to the approval of the Interstate Commerce Commission), That this Board authorize a loan to the Missouri Pacific Railroad Co. to the extent of $5,850,000, which amount is 50 percent of said railroad company's bank loans maturing April 1, 1932, on condition that the holders of the balance of said bank loans agree to an extension of the payment of said balance of $5,850,000 to a date not earlier than October 1, 1932, and on further condition that there be delivered to this corporation as collateral security for said loan one-half of the collateral now held as security of said $11,700,000 of bank loans, and such additional security, if any, as may be recommended by the Interstate Commerce Commission or as to this Board may hereafter seem advisable.[11]

The Interstate Commerce Commission, in its opinion approving the loan, pointed out that the loans were held for the carrier by the bankers, who had profited largely in the handling of the railroad financing in the past. The opinion stated:

The bankers who hold the loans are bankers for the carrier. As such they have profited largely in handling its financing in the past. It is often represented to us that the relation of the banker to a railroad is very valuable to it because of banking assistance so rendered available in time of stress is such that a railroad can afford to compensate its bankers well in connection with its regular financing in order to have such support available when it is needed.[12]

Commissioner Eastman of the Interstate Commerce Commission, concurring in part, stated that no valid reason existed for using Government funds to bail out the bankers, who refused to extend the loan in time of stress. Commissioner Eastman, in his report, stated:

No good reason has been shown for approving a Government loan to enable the applicant to make a 50-percent payment of the bank loans maturing April 1. I would have no difficulty in joining in such approval if there were any evidence that the loan is needed in the public interest, but no one has made or attempted to make such a showing. Applicant tells us that the banks would not extend the loan. The Reconstruction Finance Corporation now tells us that they will extend 50 percent. The theory is, apparently, that a Government loan

[10] O. P. Van Sweringen, supra, p. 763.
[11] O. P. Van Sweringen, supra, pp. 766–767.
[12] O. P. Van Sweringen, supra, p. 769.

to pay the other 50 percent is necessary in order to prevent the Missouri Pacific receivership. No such necessity exists. Morgan & Co., Kuhn, Loeb & Co., and the Guaranty Trust Co. would not, so long as the interest on these bank loans is paid, force a receivership by refusing an extension. The repercussions would be much too dangerous in other quarters where the private interests of these financial institutions are involved.

I realize that the majority are no more persuaded than I am that there is any need for using Government funds to bail out these bankers. They place the responsibility on the Reconstruction Finance Corporation. It seems to me, however, that we have a responsibility which we cannot thus escape.[73]

J. P. Morgan & Co., in a letter dated January 29, 1932, to the Missouri Pacific Railroad, suggested that the railroad make application to the Reconstruction Finance Corporation to obtain the funds necessary to meet the bank loans of $11,700,000, although J. P. Morgan & Co. were conscious that the railroad was in a critical position, facing a public default.[74]

J. P. Morgan & Co., upon receipt of the $5,850,000 of Reconstruction Finance Corporation funds from the Missouri Pacific Railroad, extended the balance of the $11,700,000 loan to October 1, 1932, and released one-half of the collateral, which was transferred to the Reconstruction Finance Corporation as security. Subsequently, the Reconstruction Finance Corporation and J. P. Morgan & Co. concurrently extended the Missouri Pacific Railroad loans. At the time of the hearings, June 8, 1933, the $5,850,000 of notes of the Missouri Pacific Railroad held by the bankers were still outstanding.[75]

J. P. Morgan testified in defense of the institution of private bankers, pointing out that these private bankers could not rely upon the Reconstruction Finance Corporation for aid.

Another most important duty of the private banker is to take special care that his banking position in regard to his deposits is at all times sufficiently strong, knowing as he does that none of the aids provided by the Government for incorporated banks, such as the Federal Reserve System or the Reconstruction Finance Corporation, are at his disposal.[76]

Yet the $5,850,000 loan to the Missouri Pacific Railroad by the Reconstruction Finance Corporation, for which application had been made at the suggestion of the bankers, was made for the express purpose of paying one-half the indebtedness owed to the private bankers.[77]

5. Abuses

The first important use of the holding company was circumvention of the Sherman Antitrust Law. Individuals and companies interested in the development of a particular industry, in order to obtain the alleged benefits of a diversification of locality of unit operating companies under a central control, employed the holding company as a means of effectuating this purpose. The primary motivation and the ultimate goal of these organizers of the holding company was the promotion and development of a single field or industry.

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[73] O. P. Van Sweringen, supra, p. 765.
[74] O. P. Van Swe?ingen, surpa, p. 771.
[75] O. P. Van Sweringen, supra, p. 764.
[76] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, pp. 4, 772.
[77] O. P. Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, p. 773.

In the past decade, however, promoters have perverted the use of the holding company. The primary motivation for the organization of the holding company has now become the development and financial promotion of security-selling schemes. The holding company per se has become the important unit, and the industry or operating companies merely tools or instrumentalities of financial promotion and security speculation. Industry has been relegated to an immaterial position, one field being the equal of any other field, provided the industry had the requisite popular appeal as an asset of a holding company seeking to sell securities. The holding company, therefore, was not dedicated to the development of industry; rather, industry was dedicated to the development of the holding company.

The consequence has been that holding companies have not been organized or dominated by individuals who possessed the necessary qualifications, training for or interest in industry, which formed the backbone of the holding company, but rather have become the vehicles for the financial promoters, who were particularly adept at borrowing money, pyramiding corporation upon corporation, and selling securities to the public.

The holding company is no longer the parent fostering the unit industries; rather, the infant unit operating companies are nurturing the holding company. The pragmatic result has been that holding companies have not created any economic wealth, but have merely facilitated the concentration of control of wealth.

The top holding company is usually the apex of a complicated, ramified, involved pyramiding of corporations and holding companies. The elaborate corporate and industrial substructure of the top holding company is ofttimes even beyond the grasp of the organizers. Since the equity and nonequity securities of the top holding company, and not of the unit operating companies, are usually listed on securities exchanges and sold to the public, it is futile to expect the public to even approximate the intrinsic value and merit of these securities by an analysis of the assets and capital substructure of the holding company.

The corporate structure of these holding companies facilitated the intercompany manipulation of assets and extension of loans and credit to the holding companies. Successful unit operating companies were subjected to the risks of the speculative transactions of the holding company. Little justification, economic or social, exists for the holding company as presently constituted and conducted. Holding companies, whether employed in the banking, public utility, or railroad field, have been catastrophic to the American public.

The advisability of Federal regulation of holding companies was conceded even by the confirmed adherents of the holding-company system.[78]

(a) PYRAMIDING OF CAPITAL STRUCTURE

By pyramiding corporation upon corporation, promoters with a "shoe-string" investment were enabled to acquire control of the

[78] George Whitney, June 1, 1933, J. P. Morgan & Co., pt. 2, p. 487; Owen D. Young, Feb. 16, 1933, Insull, pt. 5, p. 1519; Oris P. Van Sweringen, June 8, 1933, J. P. Morgan & Co., pt. 2, p. 725.

public's money and the industries of the country. A clear exemplification of this process was the Alleghany Corporation, where the Van Sweringen interests, with an initial investment of $1,000,000, acquired control of one of the four railroad systems in the eastern region and the Missouri-Pacific Railroad in the Southwest.

George Whitney, a partner in J. P. Morgan & Co., when interrogated upon this superimposition of companies, testified:

Mr. PECORA. Isn't it possible, though, Mr. Whitney, through the medium of holding companies superimposed on other holding companies, which in turn have operating companies underlying them, for a group controlling the top holding company to virtually hold in its hands the reins of the operation of all the underlying operating companies at a minimum investment? Does not this scheme of superimposition of holding company on top of holding companies lend itself to that sort of thing?

Mr. WHITNEY. Why, certainly. If you build up a suppositious case of holding companies upon holding companies until it pyramids down, certainly it is possible. I do not pretend to argue with you on that, because we know of instances where it has been done. We have a public record of certain instances. One—well, no use talking about them in particular, but there are cases where certainly it is possible.[79]

The process of pyramiding encouraged overcapitalization.[80] Owen D. Young urged that the holding-company structure must be simplified and ultimately limited to one holding company in the public-utility field.

Mr. YOUNG. I should like to see us work toward the end of having not more than one holding company superimposed on the operating companies in the public-utility field.

Senator BROOKHART. Why have any?

Mr. YOUNG. I think there is a very real reason, Senator, for having a holding company. A public-utility company, in the first place, has to be organized in the State of its operation, and should be. It does, as Mr. Insull, Jr., said this morning, a purely local business. There is a great advantage not only from the standpoint of connecting different units with transmission, but there is a great advantage on the technical side in unifying those different operating companies; and there is also on the financial side justification for it through diversifying the risk. If you take one operating utility in an industrial community and another operating utility in an agricultural section which produces cotton, and another operating utility in an agricultural section which produces wheat, and another operating utility, perhaps, in the fruit district of California, I think you will find that the securities of that holding company, in which all those utilities are grouped——

Senator BROOKHART (interposing). Why do you need to group them?

Mr. YOUNG. Excuse me. Is a safer investment than an investment in any one of those operating companies. For instance, if the cotton crop fails, your utility earnings there may go down; if the fruit crop fails, they may go down there; if the industry of a particular town is paralyzed, they may go down there, but the general average, if you can create a situation where, through holding company, the earnings of these utilities have something like the same diversity that the country itself has, then you get in the security of the holding company a better security through diversification, especially in the common shares, than you would in any one operating company.

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Mr. PECORA. Might not the desirable things that you have referred to be effected through an operating company with branches in the various sections or States?

Mr. YOUNG. You see, in the case of the General Electric Co., which is not a public-utility company, we own plants in Fort Wayne, Ind., in Erie, Pa., in Schenectady, N.Y., in Pittsfield, Mass., in Bridgeport, Conn., in Lynn, Mass., in Philadelphia, Pa., and so we are able to get diversity, because one cor-

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[79] George Whitney, supra, pp. 486–487.
[80] Owen D. Young, Feb. 16, 1933, Insull, pt. 5, p. 1516.

poration may own plants located in different communities. But in the case of public utilities, where each unit has to be incorporated within the State of its operation, and subject to the commission of the State, it is impossible to get the same diversity without the use of a holding company. You can only get the same diversity in the public-utility field through a holding company, whereas in the manufacturing business you are able to get it by one straight operating company.

Mr. PECORA. You think, though, one holding company would suffice for a number of units of operating companies?

Mr. YOUNG. I should like to see us work toward, and I say work toward because it is important in these sensitive times not to disturb more than we are obliged to the existing structures, but I should like to see us work toward the final objective of not having more than one holding company superimposed on operating units in the public-utility field.[81]

(b) INVOLVED INTERCOMPANY ACCOUNTING

The involved intercompany accounting in connection with loans, transfer of cash, securities, or physical properties among the various operating companies, subsidiaries, and holding companies, rendered the financial reports incomprehensible to the average investor and rendered an adequate appraisal of the value of the holding company's securities impossible.

Owen D. Young testified:

Mr. PECORA. Mr. Young, would you say that the system of superimposition of company upon company in a structure of that kind would easily lend itself to overcapitalization of the various companies?

Mr. YOUNG. It would lend itself, I think, to overcapitalization, but it is not that aspect or not that so much which disturbs me. It is this: If I am right in thinking that Mr. Insull himself was not able ultimately to understand that structure, how can the ordinary investor buying shares or buying obligations, especially of the last companies, on the top—how can they be expected to know or even to inform themselves, conscientious and able as they might be, really as to the value of those securities?

Senator BROOKHART. On that proposition, Mr. Young, isn't there some duty on the stock exchange where those things are dealt in to protect the public from losses in buying that sort of stock?

Mr. YOUNG. I am not casting reflections on those shares, Senator, at the moment, or on any shares in these holding-company groups. All I am pointing out is that I think it is unfortunate that we should have developed such a complicated financial structure.

Senator BROOKHART. Well, is it right that those stocks and bonds should be listed on stock exchanges and sold to the public at large without a duty or any obligation of that kind?

Mr. YOUNG. Well, I think it would be better, stock exchange or no stock exchange, to try and work toward the objective in this country of having these structures simplified.[82]

The transfer of funds as between operating companies, the payment of money, and the loaning of funds by the operating companies to the holding companies, which are all objectionable transactions, were facilitated by the involved holding-company structure.

Owen D. Young testified:

Mr. PECORA. Mr. Young, in the course of your testimony, in which you made reference to the Insull structure, you pointed out, as I recall it, that one of the evils emanating from that kind of structure was the impossibility of one through any system of accountancy to really soundly appraise the value of the securities sold to the public by the various units of this great structure. Do you recall that?

Mr. YOUNG. Yes, sir.

[81] Owen D. Young, supra, pp. 1517–1518.
[82] Owen D. Young, supra, p. 1516.

Mr. PECORA. Have you any suggestion to advance to the committee with respect to the curbing or elimination of that evil, by means of legislation?

Mr. YOUNG. Well, even if we were to succeed ultimately in having only one holding company in the public-utility field, I would like to see it so provided that money should move only from the holding company toward the operating companies, except as the operating companies paid for services rendered by the holding company, or paid for capital investment by the holding company. In other words, I should like to see the transfers of funds as between operating companies, and certainly any loaning of funds by operating companies to the holding company prohibited.

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Mr. YOUNG. I think if you had one holding company, probably complete publicity regarding its affairs would furnish the necessary check.

Mr. PECORA. Well, such a holding company would be a State organization.

Mr. YOUNG. But I am saying that I think publicity there might furnish the necessary check.

Mr. PECORA. But that would be dependent, wouldn't it, on the law of a particular State in which the holding company was locally domiciled?

Mr. YOUNG. It would. And if there were not adequate provision for full publicity in the State, then it seems to me the Federal law should in some way, if it may be constitutionally done, provide either for commission approval in advance, or, what I think is perhaps as good, provide for very complete publicity, so that investors themselves may know exactly the situation.[54]

6. Concentration of Control of Wealth

An added impetus has been given to accumulation of the control of wealth by the aborted employment of the corporate entity as investment trusts and holding companies.

The marked increase in the popular participation in securities transactions has definitely placed under the control of financiers the wealth of the Nation. The diffused distribution of nonequity stocks among the disorganized stockholders, who cannot effectively assert concerted action, has resulted in the domination of corporations by small groups of individuals controlling a comparatively insignificant part of the voting stock. These groups dictate the selection of directors and consequently the management and control of these corporate institutions.

A schematic graph of the corporate directorships of financiers and of their interlocking directorates of industrial, public utility, and banking and holding corporations, depicts the usurpation of the wealth stream of the Nation to its very capillaries.

The partners of J. P. Morgan & Co. and Drexel & Co. held 126 directorships and trusteeships in 89 companies, excluding subsidiaries, with \$19,929,396,475.39 total resources for 75 of these companies. These directorships included 20 directorships on 15 banks and trust companies, with total resources of \$3,811,411,000; 14 directorships on 7 miscellaneous holding companies, with total resources for 3 of these 7 companies of \$83,786,475.39; 9 directorships on 5 utility holding companies, with total resources of \$3,404,555,000; 10 directorships on 8 utility operating companies, with total resources of \$2,818,147,000; 12 directorships on 10 railroad companies, with total resources for 9 of these 10 companies of \$3,436,666,000; 55 directorships on 38 industrial companies, with total resources for 29 of these 38 companies of \$6,037,644,000; and 6 directorships on 6 in-

[54] Owen D. Young, supra, pp. 1518, 1519.

surance companies, with total resources for 5 of these 6 companies of $337,187,000.

The boards of directors of 82 of these 89 companies contained 537 nonmember partners of J. P. Morgan & Co., who held directorships in 2,175 companies in addition to the companies of which J. P. Morgan & Co. partners were partners. The total resources of 1,003 of these 2,175 additional companies was $100,890,413,407, and included 217 banks and trust companies, with total resources for 166 of these 217 companies of $20,895,574,304; 129 security companies, with total resources for 62 of these 129 companies of $3,103,669,926; 316 railroad companies, with total resources for 219 of these 316 companies of $23,832,697,000; 262 public-utility companies, with total resources for 173 of these 62 of these 129 companies of $3,103,669,926; 316 railroad companies, with total resources for 219 of these 316 companies of $23,832,697,000; 262 public-utility companies, with total resources for 173 of these 262 companies of $20,332,950,000; 831 industrial companies, with total resources for 278 of these 831 companies of $15,290,561,000; 154 insurance companies, with total resources for 119 of these 154 companies of $15,556,274,177; and 266 miscellaneous companies, with total resources for 36 of these 266 companies of $1,878,737,000.

Of all these companies, 29 had deposits with J. P. Morgan & Co. of $1,000,000 or over, and 37 companies had deposits of $100,000 or over.[84]

The partners of Kuhn, Loeb & Co. held 59 directorships in 42 companies during the period from 1927 to 1931, inclusive, and 6 directorships in 5 banks and trust companies.[85]

Similarly, the partners of Dillon, Read & Co. held numerous directorships in various corporations, banks, and trust companies.[86]

The community of interest between the financier and his codirector was cemented by the extension of loans and the benefits of "preferred

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[84] A chart of the irectorships of the members of J. P. Morgan & Co. and Drexel & Co. and of their interlocking directorates is contained in the record, pt. 2, J. P. Morgan & Co., facing p. 904.

Exhibit A, p. 905, contains a list of the banks and trust companies of which partners of J. P. Morgan & Co. and Drexel & Co. are members of the board of directors or trustees.

Exhibit B, p. 905, contains a list of the miscellaneous holding companies.

Exhibit C, p. 905, contains a list of the railroad companies.

Exhibit D, p. 906, contains a list of the public-utilities companies.

Exhibit E, p. 906, contains a list of the industrial companies.

Exhibit F, p. 907, contains a list of the insurance companies.

Exhibit G, pp. 907–910, contains a list of the banks and trust companies of which nonpartners of J. P. Morgan & Co. and Drexel & Co. are members of the board of directors or trustees.

Exhibit H, pp. 910–911, contains a list of the security companies.

Exhibit I, pp. 912–917, contains a list of the railroad companies.

Exhibit J, pp. 917–921, contains a list of the public-utility companies.

Exhibit K, pp. 921–934, contains a list of the industrial companies.

Exhibit L, pp. 934–936, contains a list of the insurance companies.

Exhibit M, pp. 936–940, contains a list of the miscellaneous companies.

Exhibit N, pp. 940–942, gives the names of the corporations in which the partners or representatives of J. P. Morgan & Co. and Drexel & Co. are directors or officers.

Exhibit C, pp. 942–946, gives the names of the nonmember partners of interlocking directorates.

[85] Committee exhibits nos. 26 and 27, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1318–1320, contain the names of all corporations, banks, and trust companies of which any partner or representative of Kuhn, Loeb & Co. was a director or officer during the period 1927 to 1931, inclusive.

[86] Committee exhibit no. 37, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2152, contains the names of all corporations, banks, and trust companies of which any partner or representative of Dillon, Read & Co. was a director or officer during the period 1927 to 1931, inclusive.

lists" to such directors. The "preferred lists" of J. P. Morgan & Co. included 82 codirectors.[87]

Thomas W. Lamont, a member of the firm of J. P. Morgan & Co., expressed the belief that no concentration of wealth existed, but admitted a distinction between the concentration of wealth and the concentration of control of wealth.

Senator COSTIGAN. In any event, you do recognize a growing and substantial concentration of wealth in the United States, do you not, Mr. Lamont?

Mr. LAMONT. I really do not think I should have said so, Senator Costigan. I have a general belief, and my experience is, that the shares of our industrial and railroad companies are being distributed further and further among the investors. If you will look at the annual reports of most of our leading companies you will see, I think, that year by year the number of stockholders increases steadily.[88]

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Mr. PECORA. Mr. Lamont, in the course of the very interesting discussion that has been brought here through the medium of your examination by Senator Costigan and Senator Fletcher, reference has been made to and use has been made of the term "concentration of wealth." You have indicated your opinion firmly to be that there is no concentration of wealth. Do you recognize that there is a distinction between concentration of wealth and concentration of the control of wealth?

Mr. LAMONT. Well, yes; there might be. There might be.

Mr. PECORA. And it would be possible to have a concentration of the control of wealth without having a concentration of the wealth itself, would it not?

Mr. LAMONT. Under our present system of corporation management I should agree even to that extent, Mr. Pecora.

Mr. PECORA. Well, Mr. Lamont, it has been testified to here by other witnesses, and I believe you, too, have made some acknowledgement of the fact in the course of your testimony this afternoon, that it was possible for an organized minority—I think that was the term used—to control, at least to the extent of management, a corporation. That would afford an instance of concentration of control of wealth as distinguished from concentration of wealth itself, wouldn't it?

Mr. LAMONT. Yes; that would, but I don't know any examples. I said in answer, I think, to a question of Senator Costigan's, who asked about the percentage that would constitute control, that an organized minority could control, but as a matter of fact I do not know such instances.[89]

To obtain a concentrated control of the corporate wealth of the Nation, ownership of a numerical majority of the common stock of the corporation is not necessary.

Senator COSTIGAN. You do concede, however, do you not, that it is not necessary to have 51 percent or more than 50 percent of the common stock of a corporation in order to determine, at least most of the time, the policies of such a corporation?

Mr. LAMONT. Oh, I should be inclined to agree with you, Senator Costigan, that if an organized minority, must less than 51 percent, were available it could probably run the company. But our stock holdings are not only minority; they are fractional.

Senator COSTIGAN. How small an organized minority in practice controls the policies of our major corporations?

Mr. LAMONT. I would not know how to answer that, and I do not think, in the sense you said, it could be done. And in practice it is not done. I mean by

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[87] Exhibit C, J. P. Morgan & Co., pt. 2, pp. 942–946, contains the names of the officers and directors of corporations, banks, and trust companies to whom loans were made by J. P. Morgan & Co. and Drexel & Co. during the period 1927 to 1931, inclusive. Committee exhibit no. 28, June 30, 1933, Kuhn, Loeb & Co., pt. 3, pp. 1320–1322, contains the names of such officers and directors to whom loans were made by Kuhn, Loeb & Co. during the same period. Committee exhibit no. 37, Oct. 13, 1933, Dillon, Read & Co., pt. 4, p. 2154, contains the names of such officers and directors to whom loans were made by Dillon, Read & Co. during that period.

[88] Thomas W. Lamont, June 9, 1933, J. P. Morgan & Co., pt. 2, p. 840.

[89] Thomas W. Lamont, supra, p. 857.

that, we have a difficulty in the conduct of our corporations, you know, Senator Costigan, in the fact that the ordinary common-stock holder does not take an interest in the affairs of his company; and it is natural that he should not so long as the company is properly and well managed. So that in the case of a large corporation, if its affairs are well managed, the proxies go out and they are given year by year without any let or hindrance.

Senator COSTIGAN. They ordinarily sustain the governing officers?

Mr. LAMONT. Quite; and that does not mean that there has been a minority organized to do that at all.

Senator COSTIGAN. It is this tendency of the ordinary stockholder to support the executive officers which enables the organized minority in the long run to determine policies, is it not?

Mr. LAMONT. Yes; except that when you say that you rather intimate—the idea that there are a great many organized minorities; and that I do not think is correct.

Senator COSTIGAN. Whether organized or not—and I can understand that the minority may not be organized—it may not even be necessary to organize a small group who come together, let us say, at the time of the annual elections or the elections of officers and who are sustained by votes of absent stockholders who send in their proxies—they are in a very favorable position?

Mr. LAMONT. Yes, sir.[90]

Ownership of 73,000 shares of Chesapeake & Ohio Railway common stock, which represented not more than 15 percent of all the outstanding stock endowed the Van Sweringen interests with control of the railroad.[91]

The numerous directorships held by financiers was further objectionable, for these individuals could not devote the requisite time and attention to the performance of the vital duties of these directorships. The directors, to whom are delegated the authority to manage corporations, do not adequately perform their duty merely by passively participating in such management.

Mr. MORGAN. Well, my idea of the duties of a director is to watch the company, to pay strict attention to the general policies of the company, but the most important duty of the director is to get an executive power, a president and the executive officers of the company, and then see that they go on and do their duties. It can be no director's duty to run the company. It must be the duty of the executives. The duty of the board is not to run the company and mess into the little details of running it.

Mr. PECORA. The directors have the power to define and determine the policies of the company, have they not?

Mr. MORGAN. Yes; they do as a rule.

Mr. PECORA. And that power and that policy is carried out by the executive officers in accordance with the wishes of the board of directors, as a rule, is it not.

Mr. MORGAN. As a rule; yes. But as a rule the policies are generally brought up for discussion by the executive so that the directors and the executive are not in opposition to each other.[92]

It is difficult to perceive how the members of the firm of J. P. Morgan & Co., with 167 diversified directorships, including railroads, insurance companies, banks, trust companies, industrial corporations, holding companies, and public-utility companies, could adequately fulfill their directorial duties.

Clarence Dillon testified:

Mr. PECORA. Considered from the broad standpoint of public policy, Mr. Dillon, would you care to give this committee your opinion or judgment as to the advisability of private bankers or investment bankers, while actively conducting such a business, sitting on the boards of commercial banks?

[90] Thomas W. Lamont, supra, pp. 848–849.
[91] O. P. Van Sweringen, June 6, 1932, J. P. Morgan & Co., pt. 2, pp. 592–593.
[92] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, p. 55.

Mr. DILLON. From our own point of view, we do not like to sit on any board. We are busy enough running our own business, and we try to serve on as few boards as we can. Since the passage of the Glass-Steagall bill, I think it is called—the banking bill—we are glad enough of the opportunity of relieving ourselves of the responsibility of serving on bank boards. We serve on very few industrial boards for the same reason. We feel that it takes all our time to run our own business.[98]

A conflict of interest frequently exists between the banking firm and the corporation of which the banker is a director.

Mr. PECORA. At various meetings and conferences and discussions of the members of the firm of J. P. Morgan & Co., are matters brought up for discussion relating to the business affairs of the various banks and corporations upon which your partners sit?

Mr. MORGAN. At times. When the company has a critical question up, a question of policy, they are very apt to ask the director of the company, or he himself will come and do it naturally, to get the general opinion of the firm as he represents the firm on the board, so to speak.

Mr. PECORA. You recognize, of course, that a director of a corporation, particularly if it is a corporation actively engaged in business, occupies a position of trusteeship to that corporation, do you not?

Mr. MORGAN. Well, within limits, in my opinion.

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Mr. PECORA. Do you recognize that there is any limitation whatsoever upon the duties of trusteeship which a director owes his company to discharge his duties in the manner best calculated to promote the interests of the company?

Mr. MORGAN. If his duties are such as I have laid down, yes; I think you are quite right.

Senator COUZENS. May I ask Mr. Morgan at that point: In discussing these matters with your partners, what sort of policies are discussed? Mainly financial?

Mr. MORGAN. Well, I should think, for instance, in these last times the question might come up in this way with such and such a company: Should we go on paying the dividend or should we cut it down? What is the best policy? Now, we are not quite certain. And——

Senator COUZENS. I say, it is a financial policy?

Mr. MORGAN. That is a financial policy. Well, most of the questions that come to the directors that are my partners are financial questions, obviously.

Senator COUZENS. Are there any cases where the policy of the company might conflict with the policy of the Morgan house who had a director on the company?

Mr. MORGAN. Oh, I think they might very well.

Mr. PECORA. Well, in such instances, Mr. Morgan, is there not an anomaly in the situation of a partner of your firm discussing a matter of policy in behalf of the firm or for the interest of the firm which may be in conflict with the policy or interest of a corporation upon which that member may sit as a director?

Mr. MORGAN. No. There is no impropriety. He knows what he has to do.

Mr. PECORA. No; I did not ask about impropriety, but conflict of interests.

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Mr. PECORA. Well, Mr. Morgan, your partners as members of the firm owe a duty to the firm to conserve its interests, do they not?

Mr. MORGAN. Yes; a duty to themselves, so to speak.

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Mr. PECORA. And they have a selfish interest in the discharge of that duty to the best of their ability as participants in the firm's profits or income?

Mr. MORGAN. Yes.

Mr. PECORA. Is that right?

Mr. MORGAN. That may be so.

Mr. PECORA. Yes. Now, as directors of any corporation they owe a corresponding duty, at least, to the corporation, do they not?

Mr. MORGAN. Yes.

Mr. PECORA. You said this morning, if I correctly recall your testimony, in substance that most of the corporations upon the boards of which your partners

[98] Clarence Dillon, Oct. 3, 1933, Dillon Read & Co., pt. 4, p. 1550.

sit are corporations with which your firm has had or still has business transactions or dealings?

Mr. MORGAN. Quite often.

Mr. PECORA. And, generally speaking, is it fair to say that the nature of those business transactions or dealings is the financing of those corporations or the promotion of any of its issues?

Mr. MORGAN. It might be; it might not. It might be a simple deposit interest.

Mr. PECORA. But it also might be what I have indicated?

Mr. MORGAN. It might be; certainly.

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Mr. PECORA. Well, let us take the case of a corporation on the board of directors of which sits a member of your firm.

Mr. MORGAN. Yes.

Mr. PECORA. Let us assume that that corporation is negotiating for financing in its behalf with your firm.

Mr. MORGAN. Yes.

Mr. PECORA. The question of the terms upon which the financing is to be done becomes an important one both to the firm and to the corporation, does it not?

Mr. MORGAN. Yes.

Mr. PECORA. And that member of your firm who may also be a director of that particular corporation must take a position as director for the best interests of the company——

Mr. MORGAN. Yes.

Mr. PECORA (continuing). And as a partner of your firm for the best interests of your firm, must he not?

Mr. MORGAN. They need not necessarily conflict, need they?

Mr. PECORA. But they may very easily conflict, may they not?

Mr. MORGAN. I do not see it.[94]

Mr. PECORA. And in an instance where a member of your firm was also a member of the board of directors of a corporation seeking to do its financing through your firm, he would have to help settle it for the interests of the corporation on the one side and the interests of your firm on the other, would he not?

Mr. MORGAN. Yes. He probably would sit on the side of the corporation, I should think, from what I know of him.[95]

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Mr. PECORA. All right. Now, hasn't the situation arisen on occasion, Mr. Morgan, where a corporation like a railroad company, upon the board of directors of which sits a member of your firm, is in the market for a very substantial amount of equipment, supplies, and so forth, like rails, and there are other members of your firm who sit on the boards of directors of steel-producing and manufacturing companies; that is so, isn't it?

Mr. MORGAN. I presume so.[96]

Clarence Dillon, unlike J. P. Morgan, did not deem it important or advisable that the banker be a director of a corporation whose securities the banker issued.[97] Dillon testified:

Mr. PECORA. What would you say to this committee as your judgment or opinion concerning the advisability, from the standpoint of public policy and general public welfare, of investment bankers, such as your house is, sitting on the boards of industrial corporations or business corporations with whose securities they have been identified?

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Mr. DILLON. From our point of view as investment bankers, we have not felt it necessary to sit on boards for the purpose of protecting or looking after the securities which we have issued. We have found, either from contractual obligations with those companies, or from our association with them, or both, that we are able to get all the information that we require about their operations to properly follow their business, and it has been our experience that we were often in a better position to criticize the management or policy if we were not members of the board, than if we were.[98]

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[94] J. P. Morgan, May 23, 1933, J. P. Morgan & Co., pt. 1, pp. 55–57.
[95] J. P. Morgan, supra, p. 59.
[96] J. P. Morgan, supra, p. 62.
[97] Clarence Dillon, Oct. 3, 1933, Dillon, Read & Co., pt. 4, p. 1553.
[98] Clarence Dillon, supra, pp. 1550–1551.

The cure for our corporate ailments, circumvention of the law, investment-trust and holding-company abuses, and interlocking directorates, may lie in a national incorporation act.

CHAPTER VII. CONCLUSIONS

In making this report, it is not the purpose of the Committee to recommend a definite program of legislation which it deems indispensable to adequately safeguard industry and the public. However, a detailed and comprehensive outline may form the subject of a subsequent formal report. The Committee at this time merely desires to recapitulate succinctly the problems which merit further consideration.

The Securities Act of 1933 and the Securities Exchange Act of 1934 have vested in the Securities and Exchange Commission jurisdiction over the source of and traffic in securities. The vigilant administration of these acts should materially abate, if not eradicate, abuses that have caused much economic distress. The establishment of an honest and true securities market is dependent upon the effective enforcement of the legislative mandates in these acts.

In the field of banking, three major principles have been dealt with in recent legislation, namely, the separation of monetary policy from banking, the creation of deposit insurance, and the separation of investment banking and the securities business from commercial banking. There remain for our immediate consideration, however, vital matters relating to the conduct and management of banking institutions, such as truthful and adequate financial statements, nature and diversification of loans and security, proper banking reserves, trust function of banks, effective governmental examination of banks, employment of bank examiners, window-dressing activities of banking officers, and other similar problems.

Investment trusts conducted in accordance with the underlying principles responsible for their creation, diversification of investments with the view to investment return rather than capital appreciation, may have a place in our investment system. The facility of perverted uses of these companies requires that these trusts be circumscribed with protective safeguards. The record indicates that it may be necessary to simplify the capital structure of investment trusts to prevent the organizers from usurping control and a disproportionate part of the equity and yield of these trusts; to limit and prescribe the concentration of securities in a particular industry; to prevent the diversion of these trusts from their normal channels of diversified investment to the abnormal avenues of control of industry; to prohibit pyramiding of investment trusts; to completely divorce investment trusts from investment banking; to eliminate the conflict of interest between investment managers and the public; to compel full and complete disclosure of the organization, capital structure, and management of the conduct of investment trusts.

The magnitude of a corporation is no justification for its existence or propagation, nor reason for its abolition or curtailment. The determinative factor is social and economic utility. Holding companies serving no productive function, but organized merely to pervert the use of controlled companies and to evade their legal limitations, are detrimental to the public welfare. Holding companies are a major problem meriting immediate consideration and action.

This Committee, actuated by a genuine desire to be helpful in solving our economic difficulties, has conducted, without animus, this comprehensive inquiry into our financial institutions. Legislation has been enacted, designed to eradicate those factors which may adversely affect our economic conditions. Further legislation may be necessary to fully accomplish this purpose. Certain it is that legislation alone cannot completely eliminate these disturbing elements. The undivided cooperation of industrialist, financier, and investor, with a mutual recognition of their reciprocal rights and duties, is indispensable to a fulfillment of this desired end.

Respectfully submitted.

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Chairman Senate Committee on Banking and Currency.