We sent out a questionnaire to all of the investment trusts registered with us that we had any idea might be active, about 176 in number.

We got back replies showing that about 78 of them were active in the sales of the so-called equity securities.

We made a very careful study of those 78 and we found that those 78 trusts did many times as much business as is normally done on that 1 day, whereas the volume of business on the New York Stock Exchange was twice as much. We found, for example, that on September 5 these 78 trusts did 83 times as much business as was normally done by them in 1 day. More particularly, we found that certain well-organized trusts which had been in operation for a number of years sold more in that 1 day than during the entire previous year.

In one instance we found that a trust, organized and operating since 1933, with an effective selling group, sold 11½ times as much in that 1 day as had been sold in the previous year, or practically 4,000 time the normal sales of 1 day. Several other companies sold amounts varying between as much as and 9 times as much in that 1 day as in the entire past year.

Of the 78 companies—this will be restricted still further, Senator—approximately 15 do not employ, or on this 1 day did not allow, sales under the two-price system, so the figures I have given you relate to practically 60 companies, and as a result these 15 companies did not effect sales larger than sales normally made on the average day, whereas the remaining 60 companies accounted for this great increase in sales.

Let me give you one actual example. Beginning at 10 a. m., on September 5, the value of each outstanding share in this trust, which had been computed at the close of the market on September 2—you will remember the 3d was a Sunday and the 4th was Labor Day—was $5.60, and by 3 p. m. on September 5—that is on September 5 the market for that particular share opened at $5.60, and that was the price because it was the price computed at the close of the last market day on September 2—the value of each share so outstanding had risen to $6.70 a share by 3 p. m., an increase of 19.6 percent, or $1.10 per share.

The company, however, continued to sell shares at $5.60 until 10 a. m. the following morning, with the result that approximately $133,045 did not go into the trust which would have gone in had the shares been sold at their true value.

The dilution of this trust in that 1 day was more than $133,000. However, the effect upon the shareholders, who had been in the trust for many years in many instances, was disastrous. For many years they had been waiting for just such an appreciation, which apparently took a war to cause. In other words, the man in that trust, instead of having a value, after that day's sales were over, of $6.70 per share, which he would have had at 10 o'clock on the morning of the 6th, had a value in them of only $6.04. The other shares, in other words, that had been sold in that day had diluted him until his share was $6.04.

Senator WAGNER. Where did the $133,000 that should have gone into the trust go?

Mr. BANE. They did not pay it. They sold the share for $5.60 when the share was worth $6.70, so the $133,000 should have gone into the trust in return for the share as a price for the share to the new buyers. It did not go into any particular individual's hands. It resulted from the failure to sell the share at the value of the share. The shares sold for $133,000 less than they should have been sold for, that is, what they were worth.

Senator WAGNER. What was the motive for that?

Mr. BANE. One of the chief motives, as the investment trust people say and as they used it, is to promote sales.

Senator WAGNER. That is what I had in mind.

Mr. BANE. One of the principal motives is that, and there are other advantages, of course. When you promote sales in this way you increase underwriting commissions. When you increase the size of the trust by the addition of these new sales, you increase management fees, because management fees are generally based upon the size of the trust.

The total dilution in these 60 trusts on that 1 day, September 5, 1939, was $1,585,484, and this one example I gave you, Senator, of over $133,000 dilution of one trust in 1 day was not by any means the largest dilution that we encountered for that day.

We found one trust in which the dilution ran as high as $392,182.

On September 11, 1939, and September 19, 1939, similar studies were made, and it was found that dilutions aggregating $72,000 on September 11 and $104,000 on September 19 were suffered by these trusts. Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal. As a matter of fact, over the past 9 years the Dow-Jones industrial averages change more once each 3 weeks than the changes in the market of September 11 and September 19.

As an over-all picture, the 78 trusts suffered dilution or, in other words, were weakened, more than one and three-quarter million dollars in these 3 days in September, and the old purchasers, the holders of the shares, were deprived of a substantial part of the appreciation that would have accrued to them.

Many of these trusts that I am talking about will redeem their securities at the net asset value of such securities, less a small charge, as of the close of the day on which the shares are presented for redemption.

Senator HUGHES. Excuse me just a minute, if I may interrupt you.

Mr. BANE. Yes, sir.

Senator HUGHES. That money was lost?

Mr. BANE. It was lost insofar as the trusts were concerned.

Senator HUGHES. It went into the fees and commissions, and things like that?

Mr. BANE. No, sir; I do not want to give you that impression.

Senator HUGHES. What?

Mr. BANE. No, sir; I do not want to give you that impression. When I say that one and three-quarter million dollars was lost, I mean the trusts lost it. I do not mean that any particular individual in the trusts got that money. He did not. I mean that the shares sold on those 3 days in those trusts were sold at a million and three-quarter dollars less than they should have been sold for, and to that extent you lessen the interest of the man who already held in the trust.

Senator HUGHES. They brought in more purchasers, they brought in more stockholders, and that is the way it was diluted?

Mr. BANE. That is right.

Senator HUGHES. And that did increase the fees?

Mr. BANE. But not to that extent.

Senator HUGHES. Not to that extent?

Mr. BANE. It increased the underwriting commissions. They made large underwriting commissions.

Senator HUGHES. I was trying to find out what became of that loss, whether somebody got it.

Mr. BANE. I did not hear you, Senator.

Senator HUGHES. I say, I was trying to find out what became of that loss, whether it really was a loss of whether somebody got it. It was a loss of the people who had an interest in it?

Mr. BANE. That is right. To that extent these trusts, or the interests of the shares of the holders in those trusts, were diluted, so if he attempted to sell those shares, the shares were worth that much less—not exactly that, because the other ones would have to go into that—but it is true that that amount of money did not go to the managers of the trusts. The underwriters of the trusts did make on that day something over a million dollars in underwriting fees. Because the size of the trusts increased and the management fee is based upon the size of the trust, the management would get increased management fees, but I do not want to indicate that one and three-quarter million dollars went into the hands of those particular persons.

All of these companies will redeem their shares. Many of them will redeem their securities at the net asset value less a small charge as of the close of the day on which the shares are presented for redemption.

Senator HUGHES. Is that what is referred to here as the open-end?

Mr. BANE. I am talking about the open-end; yes.

Thus, in a rising market, when the rise results in an asset increase of the share, greater than the load that is added to cover sale commissions and profits; a person can buy a security, after the two prices are known and established, at the lower of the two prices and almost immediately turn in the share for redemption for a higher price without any chance or risk of loss; he can't lose.

For instance, let us assume that this company—and many of them will—redeemed its outstanding shares at the price of the share on the day on which it is presented. Take the same figures that were used before. We will assume that the share is sold on that day for $5.60. He presents some shares he has for redemption. They are redeemed at the prices at which the market closes that day, and it closed that day at $6.70. Now, you have got that $5.60 and $6.70 price in existence from 3 o'clock until 10 in the morning. This is something which, of course, the average person to whom a security is offered does not understand.

He can buy that share or a thousand of those shares at $5.60 and he can turn them right back and say, "Give me my money. Give me $6.70 for them."

We know companies that do it, and it has been done. There are companies that redeem their outstanding shares as of the price of the share at the close of the market on the day on which the share is presented for redemption up until 4 o'clock in the evening. If this company is selling shares at $5.60, you can buy your share at $5.60—and the price has risen to $6.70 during the day, we will say—present it for redemption before 4 o'clock, and get \$6.70, and that has been done—another result of the two-price system.

In other trusts where they do not redeem except on the basis of the next day's sale price, and there are some of them, the same thing will follow. He can wait, having bought today, after the close of the market, at \$5.60, or he can wait until a quarter of 10 tomorrow morning and buy at \$5.60, and when it opens at 10, hand his share in and get \$6.70. There are trusts that redeem upon that basis.

There are other investment companies which will not redeem shares except at the net asset value less a redemption charge as of the close of the day succeeding that upon which the shares are offered for redemption. In such cases, of course, there is a slight risk involved, but in a generally and rapidly rising market such as occurred in September the risk is very slight.

We found in our study for September that some insiders—that is officers of the sponsors, managers, and underwriters—took advantage of the two-price system to buy shares before the advance price went into operation and then almost immediately redeemed them at the higher known price.

Senator WAGNER. Were they substantial sales?

Mr. BANE. Only in a few instances.

Senator HUGHES. You would have had to have money to do that; you could not manipulate that from a shoestring?

Mr. BANE. I presume the trust made them pay for it, but being inside the trust, I do not know how good their credit was.

Senator HUGHES. Very good, I would say.

Mr. BANE. I would say so.

We also discovered that there were sometimes dealers—and I do not mean dealers selling these securities now—who made a more or less regular practice of purchasing shares and immediately offering them for redemption, at a profit.

There were two or three of those dealers in this period in September who made a substantial—they, however, were not connected with the trusts—profit by doing just that on September 5—in other words, raiding the trust.

Senator HUGHES. It is a wonder there were not more.

Mr. BANE. That is the marvel of it, Senator Hughes. Of course, the type of person to whom this security is ordinarily offered and sold very seldom does it because he does not realize that he can do it.

We found that approximately one-third of all the shares sold on September 5, 11, and 19 were redeemed before September 22, leading to the conclusion that purchasers of about one-third of the shares sold did not purchase for investment but rather for trading; and let us see what the effect of that trading allowed under this two-price system was on the trust:

The trusts paid out for those shares redeemed \$338,119 more to redeem those shares than the trusts received for them. Possibilities of profiting through the two-price system are almost unlimited for unscrupulous dealers, sponsors, and others able to buy in large quantities and avoid part of the load, because when you buy in a certain quantity there is a smaller load. Of course, on days like September 5 you could buy the shares, pay the full load, sell them back almost immediately, and still make a substantial profit without any chance of loss except to the trust.

In about 90 percent of the cases we studied the same persons act as investment managers and also as underwriters. They receive a fee which in most cases is about one-half of 1 percent of the total net asset value for managing the trust and protecting the assets, whereas in another capacity, as underwriters, they sell the shares at a value which dilutes the trust assets, and receive the "load" on the sales.

It is to their advantage, of course, to increase the size of the trust, because that increases the management fee. It is to their advantage to sell as many securities of the trust as they can, because that increases the selling commission.

During the period in September I referred to, numerous telegrams were sent by these sponsors and underwriters pointing out to dealers that shares could be bought at a price substantially below what they were then worth and urging that advantage be taken of this situation before the price changed. In one instance the underwriters offered dealers additional commissions on all sales they could secure and ended the telegram by saying in effect that this provided a wonderful opportunity for trading.

It is apparent that this opportunity to buy something for less than it is apparently worth at the time is one of the main selling arguments used by the trusts. It is also apparent that this conflict of interest has worked to the detriment of the trust and to the security holders in the trust.

These trusts always use other people's money. Very few sponsors, underwriters, or managers have substantial investments in these trusts. Many of the persons whose money these trusts have been using had undoubtedly been in these trusts for years, waiting for some real appreciation. It took a war to produce such. And what happened? The managements they had paid to look after their interests sold them down the river so that they lost anywhere from less than 1 to 60 percent of their appreciation, which they had been waiting for. The new purchasers on September 5 bought their shares at a price based on a net asset value of 11 percent, on the average, below the actual net asset value at the time of the purchase.

It is only fair to say that since our questionnaires were sent out in October on the September situation I have been talking about some companies have attempted to rectify the matter by reducing the number of hours two prices exist. One or two companies have attempted even to go further and price their shares twice a day. Many of them, as I say, have reduced the number of hours in which the two prices are in effect. However, it is obvious that a mere reduction in the number of hours does not prevent dilution but merely causes the dealer and his customer to act more quickly if advantage is to be taken of the two-price set-up.

Further, some dealers and underwriters have worked out a method which to a large extent sees to it that their new purchasers do not lose, buy at the higher of the two prices, but still they work a greater hardship on the man in the trust, and that is a continual thing from day to day, from year to year. They mark their orders N. A. or S. L., when they send them in, meaning that the order is to be held until just before the next advance in price, meaning still that the more you buy, the more you dilute the interest that the man has in it, and meaning, in the case of S. L., that the orders are to be held if the market is looking down. In the same way, in some of these trusts, you can present your share for redemption and ask that it be held to be redeemed at the next advance instead of at the time you offer it.

It seems almost incredible that after paying 8½ percent to cover selling cost and a profit to the distributor and paying in addition the same person, as manager, one-half of 1 percent per year of the money which you have invested, for the purpose of having him handle in a fiduciary capacity, and protect and enhance your assets, he would sell an interest comparable to yours worth $6.70 for $5.60 and thus lessen the value of your interest, so that he might make himself an additional underwriting commission and an additional management fee. It doesn't make sense, but investment trusts do it.

In addition, there are dealers under this system who can, and some do, withhold orders until these two prices are determined and known, and if the price to go into effect next morning, for example, is lower than the price at which the dealer accepted the order, he will hold the order until the lower price goes into effect and send the order in at the lower price, pocketing the difference. He can't lose.

If the next price is to be higher, he will send the order in at the lower price at which he accepted it, a practice by which he cannot lose but he is not bound to win.

Likewise the dealer, when he knows these two prices and the next day's price is to be higher, can, and many do, buy in advance of orders at the lower price and sell the shares the next day at the higher price, pocketing the difference, all to the detriment of the trust.

In the 78 cases that we studied that replied to our questionnaire, practically all of the underwriters also act in a fiduciary capacity as managers or sponsors of their respective trusts, and yet in 50 of the 78 cases no effort was made to prevent dealers thus taking positions against the trust.

I would like to give you an actual illustration of a case we had in the Registration Division. Sometime ago we encountered an investment trust sponsor and underwriter who was found to be purchasing shares in advance of the orders received by him and conversely holding back orders placed with him by dealers and purchasers until such time as it was advantageous for him personally to fill these orders or sell from the shares purchased by him in advance of orders.

This sponsor sold trust shares to the public directly and to four or five so-called installment plan companies. Each day after 3 p. m. this particular sponsor or underwriter valued his portfolio as of the close of the New York market. He found the net asset value and divided it by the total outstanding shares. This gave the net value per share. Let us assume that this is Tuesday, and he finds that each share is worth $1.10 without the load charges. This price of $1.10, however, does not go into effect until Wednesday morning. This sponsor employed dealers and salesmen and they begin selling at $1.10 net.

Generally, about 3:30 p. m. Wednesday afternoon they begin to send in the orders. Orders are accepted by the sponsor all afternoon, evening, and until the next morning at 10 o'clock. The sponsor knows the sales are being made at $1.10 net.

Shortly after 3 o'clock p. m. on Wednesday he figures the price again of the net asset value of the shares and finds that it is $1.06. He has gotten orders at $1.10 a share. Does he fill them? No; he puts them in his drawer, so to speak, until the next day, when he can fill them at $1.06 and make a profit of 4 cents a share.

Thursday's orders come in and he has received orders on the $1.06. He values them again and sees they have declined to $1.03. He has got more orders by Thursday. Does he fill them at $1.03? He does not. He has figured his price and found it is lower again, so he puts them in his drawer again.

This particular sponsor did it for 19 consecutive days. The price kept sinking until it declined from $1.10 to 88 cents per share. On the nineteenth day the market jumped up to 96 cents, and then at 88 cents he bought all the shares necessary, something over 190,000 shares, to fill the orders he had, and put the difference in his pocket, and to that extent diluted that trust.

Senator WAGNER. That amounted to a substantial sum of money?

Mr. BANE. A substantial sum of money.

Senator WAGNER. Do you know how much?

Mr. BANE. For a short period it amounted to $25,000. We figured out that for a period of 10 months it amounted to about $60,000.

Senator WAGNER. This one case?

Mr. BANE. This one case. He did not stop there at merely filling all those orders that had been accumulated at higher prices at 88 cents. He knew the price was going to be 96 cents the next day, so he bought another 190,000 shares at 88 cents to offer them the next day at 96 cents. If he could not sell them all and the market took a sudden drop, he might take a loss, but it was unlikely, because he knew that the large volume of investment-trust shares is sold on a rising market, and here he had these 190,000 shares at 88 cents and he had these four or five installment plan companies that were buying from him, and he knew he could dispose of part of them there, as he could gage their orders.

The effect, of course, of all of that was to impair very seriously the interest of the shareholder already in the trust, the man who had been paying him to look after his interest, and he, the fiduciary, taking a position against him on which he could not lose. It was impossible to lose on the short position; he might have lost on the long position, by a long chance.

We issued a stop order against him, and that was as far as we could go. We obtained a stop order to discontinue sales because of his failure to disclose material facts. The Commission wrote an opinion in that case, known as the case *In the Matter of T. I. S. Management Corporation*. If you would like to have that opinion for the record, I have a copy of it here.

Senator WAGNER. It may be inserted in the record.

(The document is as follows:)

[For immediate release Friday, February 25, 1938]

SECURITIES AND EXCHANGE COMMISSION,
Washington.

(Securities Act of 1933, Release No. 1689)

UNITED STATES OF AMERICA, BEFORE THE SECURITIES AND EXCHANGE COMMISSION

In the Matter of T. I. S. Management Corporation. File Nos. 2-1303, 2-2316, and 2-3485

FINDINGS AND OPINION OF THE COMMISSION

This is a proceeding under section 8 (d) of the Securities Act of 1933 to determine whether stop orders should issue suspending the effectiveness of three registration statements on Form C-1 filed by the T. I. S. Management Corporation, hereafter referred to as the "registrant". These covered blocks of 862,069 shares, 3,000,000 shares and 18,000,000 shares of "Trusteed Industry Shares," an unincorporated investment trust of the restricted management type. The registrant acts as depositor and sponsor of the trust and hence is the "issuer" of the trust shares.[1] The registration statements became effective on April 20, 1935, as of April 15, 1935, August 8, 1936, as of August 5, 1936, and November 29, 1937, respectively.

These proceedings were commenced through confirmed telegraphic notices to the registrant on December 4, and December 6, 1937, citing misstatements or omissions in items 28, 36, and 38, exhibit D, and the prospectus of each registration statement. The principal deficiencies are alleged to result from the registrant's failure to disclose its practice of trading for its own account in the registered shares in connection with their distribution and the full extent of the profits which it had thus realized at the expense of the trust and the shareholders. In accordance with the notices a hearing was held before a trial examiner on December 14, 1937, at which it was stipulated that the evidence introduced should be applicable to all three registration statements.

At the hearing the alleged omissions were admitted and consent was given to the entry of stop orders. However, the registrant specifically denied the materiality of the omitted information.

On December 2, and December 10, 1937—that is, before the commencement of the hearing—the registrant filed proposed amendments to all three statements in an attempt to correct the alleged omissions. Under section 8 (c) of the act these amendments become effective only upon declaration by the Commission.

The trial examiner has filed an advisory report in which he found that the registration statements omitted to state material facts as alleged. Although registrant has filed exceptions to this report, it subsequently stated in a letter to the Commission dated January 12, 1938, that instead of pressing its exceptions it desired to petition the Commission:

"(1) To declare effective forthwith the amendments filed by the registrant after the effective date of the latest registration statement, and (2) to exercise its discretion in favor of a dismissal of the stop order proceedings."

In support of this petition, the registrant argued that the omissions were not material; that there is no evidence of an attempt to mislead or defraud investors but only, at most, mistakes as to matters concerning which reasonable men might differ. that in sympathy with the purposes of the Securities Act the registrant has attempted to cooperate with the Commission and to correct promptly the alleged omissions; that the registrant will promptly supply all its shareholders with copies of the post-effective amendments if they are declared effective; that the issuance of stop orders would in this case cause an irreparable injury to the registrant; and, finally, that niether the public interest nor the protection of investors would be served by stop orders.

Therefore, as the case now stands, we need only determine whether the admitted omissions are material, and, if so, whether we should consider the post-effective amendments in reaching a decision on whether stop orders should be issued.

[1] Section 2 (4) of the Securities Act of 1933. See *In the Matter of Underwriters Group, Inc.*, 2 S. E. C. — (1938); Securities Act Release No. 1653.