

In this article Mr. Cabot was discussing some of the problems of investment companies, particularly the problem of interlocking directors between investment companies and portfolio corporations. What did he find? This article, by the way, is in the record. He says (reading):

In the other company almost any security will get by. The pet issue of each director and officer can find its way in. Director A passes Director B's security, although he may not be very enthusiastic about it, so that Director B will not blackball his issue.

And that is exactly the feeling we have from our study, and it is substantiated by what Mr. Cabot says (reading further):

Another disadvantage to the highly diversified portfolio is either the inability of the management to follow closely so many issues or the expense of so doing.

Then he goes on further to say this (reading further):

Some months ago I was asked by an investment house if I would consider running an investment trust that they had sold to the public some time before. During the course of the discussion I asked if I might see the portfolio. In examining this, I noted a very large block of the shares of a company which, as a banking house, they had recently acquired and sold to the public. I asked the gentlemen with whom I was talking whether, if I were to advise them on their portfolio, and if I could convince the directors that the shares of another company in the same industry were a preferable investment, they would make the exchange.

You will note that he is really discussing not only interlocking but where the investment banker is associated with the investment company:

He replied, "No, not necessarily. This trust is part of our general machine, and if the selling of these shares adversely affected"—

And there is a blank, evidently deleting a name:

"and Co. we would not make the sale." And yet the securities of this trust were sold to the public, whose money was being used not for the best interests of the men and women who had supplied the funds, but for the best interests of ——— and Co. This case brings up two common abuses to which the investment trust is now being put. First, that of being run for ulterior motives and not primarily for the best interests of the shareholders; second, that of being used as a depository for securities that might otherwise be unmarketable. There are, of course, certain trusts that have been formed with avowedly ulterior purposes. Such procedure is obviously beyond reproach. It is only when trust says it is formed to accomplish one thing and then attempts to do another, that it becomes an abuse.

Senator HUGHES. Did he say that that was uncontrollable?

Mr. SCHENKER. His suggestion was, substantially—publicity. You know as much as I do, Senator Hughes, about the value of publicity to deal with this type of situation. We say it is not sufficient. That is the situation we are trying to deal with in section 10 of the bill.

I continue quoting:

The practice by which a house of issue sells a part of its own underwriting to its own trust, although not necessarily unethical and unsound, is extremely dangerous. Those trusts run by banks and brokers are particularly subject to this temptation. In my opinion such companies should have a provision or a firmly established policy that they will in no way deal with themselves as principals; that if they wish to acquire part of an issue in which they as a house may be interested, they will have to acquire it from some entirely outside source.

And we attempt to deal with that in section 10 of the bill.

So the problem is not new. Paul Cabot was conscious of it back in 1929, and our study shows that that problem still exists. I want to reiterate that the fact we talked about certain companies was just

to indicate what we were attempting to do in dealing with this problem also.

Just one other thing, Senator Hughes: We have a provision in the proposed bill that the managers, directors, officers, and partners cannot deal with the investment trust. This bill does not say that these people cannot be the brokers for that company. I indicated that before.

Now, what is our approach? The provision requiring an independent majority of the board is not a tough one because if you take a situation which in my opinion is similar, insurance companies, you will find that the laws of various States have provisions that not only cannot an officer or director have a direct or indirect interest in any transaction as principal, but he cannot even have a direct or indirect interest in any transaction in which he acts as agent and gets a fee.

So that in the insurance company field it is my understanding—and I notice that Mr. Quinn looks at me a little quizzically—it is my understanding that if you are an officer or director of an insurance company you cannot be a broker for an insurance company. And I notice that Mr. Jaretzki shakes his head.

We do not go that far. We say he can be a broker, but that in this situation he cannot control the board and cannot be chief executive officer.

The statute to which I will now refer is broad:

No director or other officer of an insurance company, and no member of a committee having any authority in the investment or disposition of its funds, shall accept, or be the beneficiary of, either directly or indirectly, any fee, brokerage, commission, gift, or other consideration for or on account of any loan, deposit, purchase, sale, payment, or exchange made by or in behalf of such company, or be pecuniarily interested in any such purchase, sale, or loan, either as borrower, principal, agent, or beneficiary, except that, if a policyholder, he shall be entitled to all the benefits accruing under the terms of his contract.

Senator HUGHES. What was that last sentence?

Mr. SCHENKER. That he shall be able to get the benefits of his policy. In the insurance field the law goes much further than this bill.

I will say for the benefit of counsel present if they want to check it, that I am reading from the statutes of New Hampshire relating to insurance; and I will read them from New York if it will make them more comfortable.

Prior to a very recent amendment chapter 30, section 36 of the New York law contained substantially the same language:

No director or officer of an insurance corporation doing business in this State shall receive any money or valuable thing for negotiating, procuring, recommending, or aiding in any purchase by or sale to such corporation of any property, or any loan from such corporation, nor be pecuniarily interested, either as principal, coprincipal, agent, or beneficiary, in any such purchase, sale or loan—

and so on.

Now, on page 25 of the bill, under subsection (c) the problems dealt with by paragraphs (1) and (2) of course are different.

One is the problem which was discussed by Mr. Eberstadt and others: Why should not a person who is a director of an investment company be on the portfolio of the corporation; and (2) of course deals with the situation where that interlocking director is an investment banker.

Now, a great point was made that this paragraph (1) was very confusing, that it seemed to be suffering from astigmatism, because you would naturally feel if an investment company had more than 5 percent it would be in position to exercise a controlling interest. Well, we say, if the investment company has a small interest—does not have a controlling interest—the investment company cannot have a director on the portfolio corporation. If it is the business of the investment company to buy substantial investments in the portfolio corporation, if the business of the investment company is to acquire controlling interests, then certainly the company ought to have representation on the board of directors because that is the only way you can exercise the business purposes for which you invested. It is only where you say you are an investment company and you do not go in for control and therefore you limit your investment to 5 percent that we say in that circumstance you must eliminate all the problems that Mr. Cabot indicated and you shall not be on the board. You must stand aside, be able to scrutinize the activities of the portfolio corporation, and not be tied up with the management. That is the philosophy of that section.

Mr. SMITH. Also may I say that the provision does not cut off industrialists from the board. It merely says, for instance, that if Mr. Chrysler comes in it is not to buy Chrysler Corporation stock. I will say that I had a personal interest in a trust fund and the bank had its own stock. That bank stock was held for a great many years, and went from 110 to 2. I asked why they did not get rid of it. They had the best information about it in the world. It ended up by their paying a surcharge to a certain extent on the income. There is the problem on that. But that is quite different from the investment-banker problem, which is a further complicating factor.

Mr. SCHENKER. Senator Hughes, I think this might be a good place for us to stop for the day.

Senator HUGHES (presiding). That is satisfactory to me. I have been going since 10 o'clock this morning. The subcommittee will now adjourn until 10:30 o'clock tomorrow morning.

(Thereupon at 5:30 p. m. the subcommittee adjourned until 10:30 a. m. Friday, April 26, 1940.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 26, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE OF THE
BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator James H. Hughes presiding.

Present: Senators Hughes (presiding), Townsend, and Taft.

Senator HUGHES. The subcommittee will come to order. Senator Wagner is unavoidably tied up in another very important matter that prevents him from being present this morning. He is counted present in spirit if not in the flesh, so as to make a quorum.

We are ready now to proceed if the witness is ready.

STATEMENT OF CARLILE BOLTON-SMITH, ATTORNEY IN THE GENERAL COUNSEL'S OFFICE, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. BOLTON-SMITH. I am an attorney in the General Counsel's office of the Securities and Exchange Commission.

At the request of the investment trust study the general counsel's office lent me to conduct two hearings for the investment trust study; one with reference to an investment trust run by Mr. Cyrus Eaton of Cleveland, about which I shall speak this morning; and the other about an investment trust which was run by Mr. Hopson of the Associated Gas and Electric System.

Witnesses have expressed the opinion that if the bill before this committee requires that the majority of the board of an investment trust be independent, there is no need of further restricting the membership of the board.

It may throw light on these statements to tell you something of an investment trust, a majority of whose directors were independent of the firm which sponsored it. The facts I shall give you were brought out in a public hearing which I conducted before a trial examiner of the Securities and Exchange Commission as a part of the investment trust study. The witnesses were men connected with the investment trust and its sponsor.

Otis & Co. was a partnership engaged in the brokerage and underwriting business, with headquarters in Cleveland, Ohio. Mr. Cyrus Eaton had a 40-percent interest in the partnership and was its dominant partner.

In 1926 Mr. Eaton and Otis & Co. organized an investment trust called Continental Shares, Inc. Mr. Eaton acquired 15 percent of

the voting stock of this investment trust. In addition to Mr. Eaton, another partner of Otis & Co., and a member of Mr. Eaton's family became members of the board of 7 directors of Continental Shares, Inc.; and, although the majority of the board were independent of Mr. Eaton and his firm, Mr. Eaton became chairman of the board. His relative became president. Together they could control the executive committee. And Mr. Eaton was able to control the investment trust, with results beneficial to himself and Otis & Co.

And I should add at this point that Mr. Eaton controlled 26 percent of the stock of Foreign Utilities, Ltd., a private Canadian investment company.

Continental Shares had raised \$111,000,000, mostly from the public. It had bought heavily in special situations in order to influence policies in large key companies; and by October 9, 1930, had been able to pay off almost all of its bank loans.

For some time, there had been talk in the Street about Otis & Co., and on October 10, 1930, Otis & Co. had about \$11,500,000 of call loans called by New York banks.

About October 10, 1930, Continental Shares, Inc., agreed to purchase most of the portfolio of Mr. Eaton's Canadian company, at a valuation of about \$57,000,000 of which \$35,000,000 was to be paid in cash and the balance in stock of Continental Shares, Inc., the investment trust.

In order to finance this cash payment, Continental Shares, Inc. borrowed \$30,000,000 from the Chase National Bank in New York, and \$5,000,000 from the Union Trust Co. in Cleveland, Ohio. Of course, it pledged securities as collateral for these loans.

It was Mr. Eberstadt, the New York partner of Otis & Co., who negotiated this loan of \$30,000,000 from the Chase Bank to Continental Shares, Inc., the investment trust.

By the night of October 13, 1930, which was only 3 days after the agreement whereby the investment trust was to purchase practically all of the portfolio of Mr. Eaton's private Canadian company, the situation with respect to Otis & Co. had reached such a pass that at a meeting between members of the board of governors of the New York Stock Exchange and representatives of Otis & Co., including Mr. Eberstadt, it was made clear that the New York Stock Exchange would not permit Otis & Co. to open for business the next day unless Otis & Co. raised \$12,000,000 of new capital. This was shown by Mr. Eberstadt's testimony before a Senate committee. And this was confirmed by Mr. Eaton's own testimony before a trial examiner of the Securities and Exchange Commission.

It is interesting to note that at this time the books of Otis & Co. show that Foreign Utilities, Ltd., owed it about \$12,000,000, about the same amount that the New York Stock Exchange required Otis & Co. to raise in the form of new capital.

By the next day, October 14, 1930, the \$35,000,000 which Continental Shares, Inc. had borrowed from banks, had been paid to Foreign Utilities, Ltd., and Foreign Utilities, Ltd., had paid to Otis & Co. about \$33,000,000, which Otis & Co. used to pay off bank loans.

I might explain that \$12,000,000 of this sum represented capital contributed in the name of Mr. Cyrus Eaton, which he borrowed from Foreign Utilities, Ltd., for 8 percent plus a share in his profits.

In this way Otis & Co. met the requirements of the New York Stock Exchange that it raise \$12,000,000 of new capital, and Continental

Shares, Inc., was caused to pledge portfolio securities to borrow the money from which this capital came. Foreign Utilities, Ltd., had paid its \$12,000,000 debt to Otis & Co. and deposited with it a credit balance of about \$21,000,000. Otis & Co. had paid about \$33,000,000 of its bank loans.

In this way Otis & Co. was enabled to continue in business. On the other hand, Continental Shares, Inc., was never able to pay off the \$35,000,000 of bank loans, from time to time additional portions of its portfolio were pledged to secure these loans, and, in June of 1933 the Chase National Bank foreclosed its loan, selling at auction the major portion of Continental Shares' portfolio, so that when Continental Shares went into receivership its portfolio was carried at only \$16,500,000 gross and \$6,500,000 net, after deduction of liabilities.

Although Mr. Eaton claims that the simultaneousness of these transactions was only "a striking coincidence" and that 15 months before he had thought of Continental's buying the Foreign Utilities' portfolio, the actual transactions speak for themselves. And over \$8,000,000 of the \$57,000,000 of securities sold to Continental Shares had just been bought from Otis & Co. by Foreign Utilities, so that Otis & Co. was indirectly selling over \$8,000,000 of securities to Continental Shares.

I might say, incidentally, that Mr. Eaton's Foreign Utilities made a profit of over \$3,000,000.

Besides, as reported in the memorandum from Mr. Sherrill Smith to Mr. Wiggin of the Chase National Bank of New York, Mr. Eberstadt told the Chase National Bank, when arranging for the \$30,000,000 loan to Continental Shares, Inc.:

the \$30,000,000 loan will clean up their (Otis & Co.'s) biggest debit account which is Foreign Shares or Foreign Securities Co. (meaning Foreign Utilities, Ltd.). They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no other debit balances which are large enough to cause them any uneasiness.

Speaking of this same loan to Continental Shares, another Chase National Bank memorandum said:

I really think we are doing Otis & Co. a big service—

And yet the majority of Continental Shares' board of directors was independent.

The effect of this sale of securities to the investment company, which had to borrow the money to pay for them, was responsible for the receivership of the investment company.

W. R. Burwell, former president of the investment company, testified:

Question. And it was the failure of Continental Shares to pay off the \$30,000,000 loan from the Chase Bank and the loan of \$5,000,000 from Union Trust Co. that resulted in the foreclosure on Continental's collateral in June 1933, isn't that right?

Answer. Yes.

Question. So that if Continental Shares had not borrowed that \$35,000,000 from the banks in October, 1930, it would have had no difficulty in retaining its Portfolio throughout the depression, isn't that right?

Answer. That is quite true; yes.

Senator TAFT. I dislike to stop you, but how did they get the money out of Continental Shares and into Foreign Utilities?

Mr. BOLTON-SMITH. Senator, that was done because Continental Shares borrowed money in order to make the \$35,000,000 cash pay-

ment to Foreign Utilities, a Canadian company, 26 percent of whose stock was owned by Mr. Eaton and his wife.

Senator TAFT. And did they get stock of Foreign Utilities, Ltd.?

Mr. BOLTON-SMITH. Portfolio securities of Foreign Utilities were transferred.

Senator TAFT. Then they took over the whole company?

Mr. BOLTON-SMITH. That is right, practically speaking, so far as its portfolio is concerned. Then Foreign Utilities paid off its debt to Otis & Co. and deposited \$21,000,000 in addition, a part of which was used to pay for the \$8,000,000 of securities which Otis & Co. sold to Foreign Utilities to include in the sale to Continental Shares.

Senator TAFT. I came into the committee room a little late and missed that part of it.

Senator HUGHES. Do I understand that during that time the company had an independent board of directors?

Mr. BOLTON-SMITH. It had an independent board, but its management was completely dominated by Mr. Eaton and Otis & Co.; and the management would carry out transactions, which would be ratified in the usual course by the board.

Senator HUGHES. Then where does that leave the argument we have heard that an independent board of directors would be a safeguard; I mean if a management can spring up under it that can control the situation and do these various things?

Mr. BOLTON-SMITH. Senator, it would be a safeguard, but in this case it was not a sufficient safeguard because Mr. Eaton had 15 percent of the stock of the investment company, which was the largest block, and that probably gave him working control. It may very well have been that the majority of the board of directors, which so far as we can discover on paper was independent of Otis & Co., was sympathetic in its ideas with Eaton and Otis & Co. And I might explain that later on, in the Youngstown-Bethlehem merger fight, a majority of the board of directors sided with Mr. Eaton in that fight, indicating that their sympathies were very closely united; but they had no membership in the partnership of Otis & Co.

Senator HUGHES. All right.

Mr. BOLTON-SMITH. Continuing with Mr. Burwell's testimony, he was asked this question, or I should say, he was asked these questions and gave these answers:

Question. That is, it was the borrowing of this \$35,000,000 that put Continental Shares into trouble, isn't that right?

Answer. Exactly so, with the decline in the market, of course, that is understood.

Question. And even with the declining market, if Continental Shares had not had these large bank loans, it would have been able to survive the depression, isn't that right?

Answer. If it had no loans, obviously there would have been no question about it.

Continental's losses as of the beginning of the receivership were about \$97,900,000—

Senator TAFT (interposing). Let me ask you a question right there: Would the common stock have been wiped out anyway? Except for the loan would the preferred stock have absorbed all the assets?

Mr. BOLTON-SMITH. I think the rise in the stock market since the depth of the depression, when the bank loans were foreclosed, would probably have been sufficient to give the common stock an equity again. But they were wiped out in June of 1933.

Senator TAFT. Apart from the loan there was preferred stock and it was worth less than par, is that it?

Mr. BOLTON-SMITH. I have not calculated that, Senator, but I would not be surprised. That is, it was the drop in the market price of the portfolio, most of which was pledged for those bank loans, that put the bank loans under water and necessitated their being foreclosed, from the point of view of the banks. But if there had been no bank loans; that is, if there had not been in effect a margin account, the company would not have been sold out, and when the market rose again the preferred- and common-stock holders would still have had an interest in its portfolio of securities.

Senator TAFT. What I was talking about was this: Under this bill as I remember it the preferred-stock holders could have wiped out the common-stock holders had they had at that time the power given under this bill.

Mr. BOLTON-SMITH. I believe that a diversified investment company is to have only one kind of security outstanding; and then there are other types which might have the preferred.

Senator TAFT. This company was not of the diversified type, if I remember correctly.

Mr. BOLTON-SMITH. Senator, it was organized to invest in special situations where businessmen thought they could make profits and Mr. Eaton could carry out his plans for those companies.

Senator TAFT. That is what I say, it was not one of the diversified investment companies such as are referred to here in this bill.

Mr. BOLTON-SMITH. And it is interesting to note that in the prospectus sent to a small group of businessmen in connection with the first issuance of securities, all that was pointed out. But in the subsequent prospectus, sent to the general public when the stock was widely distributed, that was left out and it was said to be in the nature of an investment company or savings bank.

Senator TAFT. All right.

Mr. BOLTON-SMITH. Continental Shares' losses as of the beginning of the receivership, June 22, 1933, were about \$97,900,000 out of the total capital raised by the sale of stock of about \$111,000,000.

In 1930 Continental Shares organized a subsidiary called Continental Allied to trade in the stock of its parent, Continental Shares. By the middle of the year this subsidiary had lost \$412,000, and by the end of the year over \$600,000, trying to support the market price of the stock of Continental Shares, and this loss was borne, of course, by Continental Shares.

On May 22, 1930, Mr. Rex P. Arthur, the Denver partner of Otis & Co., wrote to Mr. Eberstadt, the New York partner, urging that more money be poured into a more aggressive support of the stock of Continental Shares, and stating as a reason for this contention, the following:

As I see Continental Shares, this company is not only the most important financial vehicle which Cyrus Eaton has at his command, but is potentially a tremendous business incubator for us as bankers.

Failing to support more aggressively the falling market for the stock was described as

the most perfect example of killing the goose that laid the golden egg that has ever come to my attention.

If the committee had the time I would read the entire letter so that all of this could appear in its context; otherwise, I will just cite a few quotations from it. It is two pages long. I think it is all interesting if you would like to hear it.

Senator HUGHES (presiding). Does any member of the committee want to hear it?

Senator TAFT. It will doubtless be in the record. I suppose it shows that those people were using this company for their own banking business?

Mr. BOLTON-SMITH. I think so. I will mention one additional quotation—

Senator TAFT (interposing). That was a letter from the Denver partner of Otis & Co., you say?

Mr. BOLTON-SMITH. Yes, to the New York partner of Otis & Co.

Senator TAFT. All right.

Mr. BOLTON-SMITH. Now, another quotation:

To remedy this situation: First, the market should be placed entirely in the hands of one operator. I don't think the streets of New York need to be combed to find someone talented enough to handle this market, but whoever the operator is he should stay in New York and be given a free hand.

Second, the popgun idea should be definitely abandoned and heavy artillery brought on. The Allied Corporation should authorize the buying of as much as 10 percent of the outstanding capitalization at current levels.

They lost \$600,000 in supporting the market, but his idea was that more money should be poured into an aggressive support of the market. At another place in the letter reference is made to gradually working the market upward, and—

Senator TAFT (interposing). Do you know whether the market was below the asset value at the time?

Mr. BOLTON-SMITH. According to the Denver partner it was somewhat below asset value. The market was about 32 and the asset value was a dollar or so higher than that according to Mr. Arthur's letter.

Senator TAFT. Was the loss to the company, which is the reverse of the situation here, meaning that the loss to the company was to the benefit of the stockholders who were bought out?

Mr. BOLTON-SMITH. To the benefit of those who were bought out, but a loss to those who stayed in.

Senator TAFT. It is the reverse of the situation we had before us yesterday.

Mr. BOLTON-SMITH. I will quote another paragraph from the letter:

Stabilizing the share at a fair value is highly important not only for the reason that we wish to keep our stockholders but from a future financing standpoint. If the stock is stabilized at 40 I believe you will agree that in a rising market it would be easier to take it to 60 than if we start at 20 and attempt to take it to 50. On an offering of rights, one for 4, a difference of 10 points in the market would mean \$6,000,000 to the company.

Senator TAFT. The whole letter will be in our record, won't it?

Mr. BOLTON-SMITH. Yes, sir. The \$412,000 trading loss was specifically shown in the draft of audit report submitted by Ernst & Ernst for June 30, 1930. However, the treasurer of Continental Shares had written a letter dated July 21, 1930, to Mr. Eberstadt, the New York partner of Otis & Co., among other things saying:

Mr. Eaton has suggested that we obtain your opinion on the enclosed balance sheet and account sheets as at June 30, 1930. There are one or two points in