PART II

II–A. SALE OF PENN CENTRAL STOCK BY INSTITUTIONS

Introduction

During the optimistic period before and shortly after the merger, Penn Central stock was favored by many institutional investors including mutual funds and banks. As Penn Central's fortunes declined, most of these institutions sold their holdings. A number of these institutions had possible means of obtaining confidential information.

To explore the possibility of sales based on inside information, the staff sought the identity of these institutions through questionnaires sent to brokers, through reports to the Commission from registered investment companies, and through various other means. Where a pattern or relationship raised some question, further information was sought. Over 100 institutions were subpenaed for the production of documents. This information was analyzed to determine whether trading on inside information had occurred.

The analysis of possible insider trading was made difficult by the existence of some public adverse information throughout the period. Although there was significant adverse information that was nonpublic, sellers were able to cite the public information as a reason for selling. The staff, therefore, paid particular attention to trading at significant times or where there was a significant relationship between the company and the seller. Affidavits or testimony were sought where unresolved questions existed.

As a result of the analysis, the inquiry focused on five institutions which sold stock at a critical period (late May and early June 1970) and which had, or may have had, a relationship to Penn Central: Chase Manhattan Bank, Morgan Guaranty Trust Co., Continental Illinois National Bank & Trust Co., Investors Mutual Fund and Alleghany Corp. The staff's findings on these institutions are described separately in this section.[1] Testimony was taken from officers and employees of these institutions. The witnesses denied that inside information was used in any way in the decision to sell Penn Central stock. In each case they cited public information or particular internal circumstances as the reason for the sales. It is clear, however, that the sales of the banks point up inherent conflicts of interest. As a lender to corporations, a bank is obviously entitled to nonpublic information. As a manager of trust accounts, a bank seeks out information to advance the interest of these accounts. It is clear, however, that no

[1] Investors Mutual Fund and Alleghany are described together because of common control of Alleghany and Investors Diversified Services, Inc. (management company for Investors Mutual) and because of relationships in the timing of the sales.

confidential information gathered in a commercial banking capacity may be used to benefit the trust accounts. Banks have an affirmative duty to see that appropriate procedures are established to prevent any transmittal of information. In the case of these banks, Chase described certain procedures it had instituted to separate the functions, whereas Morgan, on the other hand, had no such meaningful procedures. Officers from both units routinely attended joint meetings, and, until almost the hour of Morgan's sales, one analyst served both the commercial and trust departments.

There is also a question of confidential information passing by way of interlocking directors. Stuart Saunders was a common director of Penn Central and Chase. Thomas Perkins and John Dorrance were common directors of Penn Central and Morgan. Although any conveyance of confidential information by this route was denied, on at least the Morgan board and its trust committee a common director spoke on Penn Central's affairs in the presence of trust officers. Interlocking directors should not be put in the position where they might disclose confidential information to bank trust officers.

Although at this point serious questions exist about whether sales were made on inside information, it should be noted that proof of insider trading is always difficult. The difficulty is increased where, as here, there is some public adverse information which might explain the trade. Unless direct testimony or documents can be obtained on the use of inside information it is difficult to sustain a charge of misuse of information.[2]

Chase Manhattan Bank, N.A.

Chase Manhattan Bank, N.A., as one of the largest commercial banks in the United States, had extensive relationships with Penn Central, including among others, participation in various term loans to Penn Central by banking syndicates and an interlocking directorship in that Stuart Saunders, chairman of the board of Penn Central, was a member of the board of directors of Chase.

During the period of May 1–June 21, 1970, Chase sold 7,618 shares for its personal trust[3] accounts and 3,597 shares for its investment advisory[4] accounts. During the period May 6–June 21, 1970, Chase sold 543,500 shares[5] from its pension trust accounts.[6]

The activity in these various accounts at Chase may be illustrated by the following table:

TABLE I.—HOLDINGS OF PENN CENTRAL STOCK

Date	Pension	Personal Trust	Advisory	Total
Mar. 26, 1970	566, 320	40, 226	72, 673	629, 219
June 23, 1970	48, 000	32, 840	69, 061	149, 901

[2] Both of the commercial lending departments of Morgan and Continental had inside information at the time the trust department was selling Penn Central stock, but the parties to the decision to sell deny under oath that the trust department had access to the information.

[3] In personal trust accounts Chase usually did not have discretionary authority but rather was limited by the terms of the trust instrument and by the control exercised by the co-trustee(s).

[4] In investment advisory accounts Chase merely furnished advice with no authority to purchase or sell securities for the account.

[5] From figures made public by Chase. It should be noted that a staff review of the confirmation sheets submitted by Chase indicates a lesser total. However, we will assume that public statistics are correct.

[6] In almost all pension trust accounts, Chase acted as Manager, i.e., it had full discretionary authority to purchase or sell securities held by the Trust as it deemed appropriate.

Thus, holdings of Penn Central stock decreased by 529,318 shares or 78 percent.[7] The foregoing figures should be compared with the following table II, which indicates Chase's holdings at various dates prior to this period:

TABLE II.—HOLDINGS OF PENN CENTRAL STOCK

Date	Pension	Personal Trust	Advisory	Total
Mar. 21, 1968	743, 060	46, 996	132, 857	922, 913
Mar. 4, 1969	425, 550	37, 864	76, 953	540, 307
June 12, 1969	197, 980	29, 770	70, 194	297, 944
Nov. 19, 1970	592, 725	38, 548	73, 026	704, 299

Moreover, it should be noted that Chase as a bank subject to regulation by the Federal Reserve Board and subject to the restrictions of the Glass-Steagall Act did not own or trade any Penn Central stock for its own account.

As the foregoing statistics indicate, the overwhelmingly majority of sales by Chase of Penn Central stock were made for its pension accounts. The following table indicates also that these sales were clustered during the period May 6–June 10, 1970.

TABLE III

Date:	*Number of shares sold*	Date:	*Number of shares sold*
May 6	9, 900	May 29	63, 700
May 15	1, 000	June 1	27, 000
May 19	8, 000	June 2	50, 000
May 20	7, 000	June 3	45, 700
May 22	125, 400	June 4	30, 600
May 25	57, 100	June 10	7, 800
May 26	31, 850		
May 27	39, 700	Total	543, 550
May 28	38, 800		

Thus, during the period from May 22 to June 4, 1970, Chase sold from its managed pension accounts a total of 509,850 shares or approximately 94 percent of the total Penn Central sales made by Chase in the period May 1–June 21, 1970.

In order to examine the reasons why these transactions occurred, four employees of Chase were deposed. They were Paul T. Walker, Vice President, U.S. Department (commercial division of Chase); James M. Lane, executive vice president, Fiduciary Investment Department (trust division of Chase); Paul P. Lehr, financial analyst, Fiduciary Investment Department; and James S. Martin, vice president, Fiduciary Investment Department.

Walker was a vice president in the commercial division of Chase who had responsibility for the commercial and correspondent bank business in certain mid-Atlantic States. One of his accounts was the Penn Central complex.

Chase was a participant in various term loans and revolving credits made to Penn Central and was also a depositary bank for Penn Central. However, Chase did not directly loan funds to Penn Central as Stuart Saunders was a member of the board of directors of Chase, and apparently a direct loan would constitute a conflict of interest.

[7] However, it should be noted that the apparent discrepancy between the amount held at Mar. 26, 1970, and the amount held at June 21, 1970, may be attributable to a number of factors, including purchases of Penn Central stock, and transfer of accounts holding Penn Central to or from Chase.

Walker normally represented Chase in its dealing with other banks relative to loans to Penn Central. Walker did not attend nor was he aware of the content of the May 21, 1970, meeting between David Bevan and First National City and Chemical banks, wherein Bevan discussed Penn Central's current financial condition, the postponement of the Pennsylvania Company's $100 million debenture offering and Penn Central's intent to seek a $225 million Government guaranteed loan.[8] Walker did attend the May 28, 1970, meeting of the banks regarding Penn Central.

Walker maintained that the only persons he ever talked with at Chase about Penn Central financial matters were other officers of the commercial department. Walker specifically denied talking with Mr. Lehr or Mr. Martin of the Fiduciary Investment Department of Chase about Penn Central. Moreover, although Chase was represented at the May 28, 1970, meeting and although it did receive the "Confidential Memorandum" dated May 22, 1970, regarding the financial condition of Penn Central, it was claimed such information was not given to the Fiduciary Investment Department.[9] Walker made reference to Chase's internal policy regarding communication between the commercial and trust divisions of Chase. This policy was stated by David Rockefeller in testimony to Congress as follows:

> By executive letter, last revised under date of November 4, 1968, which was issued by the chairman of the board and the president of the bank, all personnel were instructed that there is to be no flow or incidental communication of inside information from the commercial departments or divisions of the bank to the investment department or the pension or personal trust divisions of the trust department.

Chase has erected a "Chinese wall" between its commercial and trust divisions with the intent that neither act with or for the other, and that although, organizationally, they are divisions of the same bank, they should be functionally independent.

Lane, as executive vice president, was in charge of the Fiduciary Investment Department of Chase. Lane was chairman of the investment policy committee which had the responsibility for determining broad investment policy and strategy. Lane was also chairman of the trust investment committees, which were four committees, one each for pension, personal trust, corporate trust, and discretionary investment management accounts.

The investment policy committee in addition to setting broad policy has final authority to accept or reject the specific market ratings of the Fiduciary Investment Department's research group. Thus the investment policy committee in setting broad investment guidelines and approving specific ratings of particular securities determines the parameters within which the individual portfolio managers may act, subject to any applicable restrictions in a trust instrument. However,

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[8] Walker did receive a telephone call from Jonathan O'Herron at his home on Saturday night, May 23. O'Herron apologized to Walker about Penn Central's not having kept the banks adequately informed. Walker considered this to be an extraordinary call.

[9] In a letter dated Mar. 3, 1971, addressed to William Kuehnle, Roy C. Haberkern, Jr., Counsel to Chase states:

"After investigation, we have determined that the "confidential" memorandum dated May 22, 1970, concerning Penn Central Transportation Co. was received by one or both of two officers in the Commercial department of the Chase Manhattan Bank (National Association), Paul T. Walker and Peter E. Lengyel, both vice-presidents. It is their recollection that said memorandum was received from representatives of First National City Bank at a meeting held at First National City Bank on May 28, 1970, or shortly thereafter. We are further advised by Messrs. Walker and Lengyel that neither of them had any conversations with any officer or employee of the Fiduciary Investment Department of Chase with respect to said memorandum or with respect to any other subject involving either Penn Central Co. or any of its affiliates. [illegible] ...randum was not contained in the files of the Fiduciary Investment Department."

the immediate responsibility for managing the account is that of the portfolio managers. The other members of the investment policy committee are the senior officers of the various Fiduciary Investment Department divisions.

Lane discussed the various aspects of the internal Chase system for rating specific securities. Lane noted that the investment policy committee must approve a change in rating of a specific security before the change is made. With respect to the rating of Penn Central common stock, Lane stated that the research department submitted a proposed change in rating for Penn Central to the investment policy committee on May 22, 1970. The proposed change was to reduce the rating of Penn Central from "D3" to "D4", which in terms of the Chase rating system would be a reduction from a permissible sell to a recommended sell. The proposed change of rating consisted of a two-page memorandum which detailed the analyst's reasons for recommending the change.

This recommendation would be received by members of the investment policy committee and certain senior officers but not by all the portfolio managers.

The investment policy committee met on May 26, 1970, according to their usual schedule and approved the downgrading of the Penn Central rating. This change of rating and the analyst's detailed dissection of the Penn Central situation was, in accordance with customary procedure, then disseminated to all investment department personnel.

Lane noted that the effect of a change from a "D3" to a "D4" rating was that:

> If the account manager does not sell, he has got to answer for his decision not to sell, in terms of the policy guidelines that have been given to him . . . He not only has the delegated authority to sell a 4, if he doesn't sell, he has a lot of explaining to do.

These investment policy guidelines applied to all accounts held by Chase, including nondiscretionary accounts. Also, this guideline would apply to Chase's investment advisory service.

Thus, as of May 26, 1970, by virtue of the action of the investment policy committee, Chase's Fiduciary Investment Department personnel were strongly advised to sell any Penn Central stock held by accounts they managed or advised.

In order to determine the evolution of this change of rating, the staff deposed the financial analyst who recommended the change and provided the reasoning therefor.

Paul P. Lehr was a financial analyst in the Fiduciary Investment Department of Chase. After approximately 1 year's experience in financial analysis and management training, he was assigned in April 1970 as the analyst for the surface transportation industries with which he had no previous experience. Lehr stated that he had:

> . . . full investment responsibility. . . . I have the full scope of responsibility for my particular securities.

Lehr noted that he was prohibited by Chase's internal policy from talking with the commercial department of the bank. Lehr could speak to the technical research department which serviced both the trust and commercial departments. However, the technical research department was prohibited from discussing specific companies and

In executing his investment responsibilities with respect to railroads, Lehr utilized as his principal sources of information, brokerage research reports, Moody's Manuals, reports of the Interstate Commerce Commission, and reports of the American Association of Railroads, as well as any annual and quarterly reports maintained in Chase's research files. Additionally, Lehr would review any documents, e.g., prospectuses, relative to a public financing.

Lehr would receive a monthly computer printout of holdings of various Chase accounts of a particular security which would indicate any changes from the previous month's holdings.

In the ordinary course of his duties, Lehr was expected to prepare and disseminate to the Fiduciary Investment Department personnel an informal document known as a flash report which would inform them of any current information about a specific company which he deemed significant. These flash reports, and also information memoranda (merely a longer version of a flash report), would not be submitted to or approved by the investment policy committee, but merely by the director of research.

If a change in rating were to be made, an analyst such as Lehr would initiate the process. The next step would be a review by the research review committee.

However, Lehr stated that it was his normal procedure that before this rating review and change process was initiated and/or completed he would speak with the portfolio managers regarding a specific security. Lehr stated:

> I try to talk to portfolio managers who I know have a large interest, whether it be in a number of shares or the importance within a single account.

With respect to Penn Central in particular, Lehr's first written document was a flash report dated May 13, 1970. Lehr, in describing the circumstances surrounding this flash report, stated that the predecessor surface transportation analyst had received a call from James Reynolds, an institutional salesman for Butcher & Sherrerd. Reynolds told the analyst that Butcher & Sherrerd was recommending a switch which Lehr interpreted as a change from a buy recommendation to a permissibe sale recommendation.

After this call, Lehr was instructed to call the research director for Butcher & Sherrerd, a Ted Bromley, to find out what the main points were that he thought made Penn Central a switch in recommendation.

According to Lehr, this conversation took place on May 12 or May 13, 1970. Lehr stated that:

> . . . everything Mr. Bromley discussed was either information available in the annual report of Penn Central [*or*] was just knowledge you gain by experience.

It is important to note that although this conversation took place on May 12 or 13 and although Bromley discussed the April 27 prospectus, the revised prospectus of May 12 was not discussed by Bromley and Lehr was unaware of it. In fact, according to Lehr the earliest he was aware of the May 12 revised prospectus would have been May 22, 1970.

After this conversation with Bromley, Lehr decided to make an extensive analysis of Penn Central. He spoke with Chase's research director and received his approval to make the analysis his first [illegible] proceeded to make an extensive analysis of data

provided by Moody's Transportation Manual and the April 27, 1970, prospectus for the $100 million Pennsylvania Co. debenture offering.

Lehr had been aware of the first quarter loss of Penn Central but had not been alarmed, partially due to the fact that a loss was expected and due to his experience in the area. Consequently, he had not done anything more than note the loss and informally discuss it with his predecessor who shared his lack of alarm.

The flash report of May 13, 1970, was essentially a report of the conversation with Bromley, the fact that Butcher & Sherrerd was recommending a change and certain financial data which Lehr had obtained from various public sources. Lehr noted in the flash report that Butcher and Sherrerd was a firm which knew Penn Central well.

Lehr stated the importance of this was that:

> I was putting this out to the portfolio managers in order to give them an idea that this isn't only Paul Lehr with 1 month's experience informing them that the situation deserves a scrutiny, but that here was a firm that knew Penn Central supposedly well as witnessed by their being bullish on the stock and writing this bullish report . . . here was a firm going out saying we are no longer recommending purchase.

After distributing the flash report, Lehr arranged to see Jonathan O'Herron, vice president of Penn Central, to try to obtain further information such as the sources and uses of funds. However, the meeting which took place on May 15, 1970, was aborted by O'Herron without any substantial discussion.

Lehr then resumed preparing his detailed analysis of Penn Central's financial condition. He tried to reach O'Herron by telephone repeatedly but was unsuccessful.

By May 22, Lehr's recommendation for a change in rating of Penn Central stock had been prepared. Lehr also spoke with portfolio managers, including James Martin, about Penn Central during the week of May 18–22, 1970. Lehr discussed Penn Central's financial situation, both present and projected, and his proposed change in rating. Lehr spoke with portfolio managers in the pension, personal trust, and investment advisory areas.

Although the portfolio managers did not receive Lehr's memorandum of May 22, he had orally conveyed the substance of same to a large number of them prior to May 22.

Lehr did not recall whether the research review group approved the change in rating on Friday, May 22, or Monday, May 25, but in any event the investment policy committee did in fact approve the change in rating on Tuesday, May 26. The information regarding the change in rating would have been disseminated to all Fiduciary Investment Department personnel by Wednesday, May 27, However, the portfolio managers had begun selling during the week of May 18–22.

Lehr stated that he and Louis J. Kleinrock of the research group met with Burt Habgood, vice president in charge of the Pension Trust Department. Lehr spoke with Habgood and with Martin, who was also present at the meeting, about the substance of the May 22 memorandum regarding Penn Central.

However, Lehr could not recall exactly when the meeting occurred but felt that it probably was the week of May 25 or later. This fixing of the time of the meeting was due to the fact that Lehr recalled that Martin stated that he had sold out most of his position in Penn Central, which according to Lehr would have May 26 at the earliest.

Lehr stated that purpose of the meeting was to provide Habgood and his department with the analyst's latest information and judgment about Penn Central and to inquire whether holdings of Penn Central had been reduced to an extent commensurate with the risk.

Lehr spoke with Don Berry, vice president in charge of the Personal Trust and Investment Advisory Departments the day following his meeting with Habgood. Essentially, this conversation covered the same points Lehr had previously discussed with Habgood.

Lehr's conversation with Berry occurred at the request of Kleinrock who felt that both areas of the Fiduciary Investment Department should be equally informed.

After this meeting and conversation, Lehr issued a flash report dated May 29, 1970, which essentially announced the cancellation of the $100 million debenture offering.

After these events and prior to the reorganization, Lehr did not issue any other written reports about Penn Central and his involvement, if any, would have been limited to discussions with the portfolio managers about Penn Central.

Martin had four portfolio managers reporting directly to him as well as personally managing certain pension accounts. Martin was one of two officers who had responsibility for supervision of the pension trust portfolio managers, subject to the supervision of the head of the Pension Trust Department, Habgood.

Martin stated that his:

> . . . primary responsibility is the accounts which are directly assigned to me, which are 13 in number. Secondarily, I have responsibility for the administration of the division of which I am head.

Additionally, Martin was a member of the pension trust investment committee.

Martin recalled that he had met with Lehr, Kleinrock, and Habgood regarding Penn Central, but he could not remember the date of the meeting. However, he did indicate that it probably was prior to May 26 when the change in rating of Penn Central was officially made.

Martin stated that at the meeting they discussed:

> What course of action we should be taking with respect to Penn Central stock that we held, and we really debated as to whether or not the stock should be sold and should be sold across the board within the pension department.

Martin noted that the information discussed at the meeting was based upon the first quarter report of Penn Central and the first offering circular for the $100 million debenture offering.

Martin recalled that they did discuss at the meeting that Lehr was recommending a change in the rating of Penn Central stock.

Although Martin could not recall the precise date of the meeting he was certain that it occurred before he began selling Penn Central stock on May 22. His recollection differs from Lehr on this point. Martin's memory appears more accurate since Lehr remembers being told to convey information to the head of the personal trust department after the meeting with Martin. That sequence appears more consistent with conveying information than with checking on the progress of sales.

Martin noted further that he did not see the revised offering circular until after he had begun to sell Penn Central stock.

In discussing the management of his accounts, Martin noted that he had in the spring of 1969 sold substantially all of the shares of

Penn Central in these accounts at above $50 a share and then in November or December 1969 he bought approximately 250,000 shares at about $25 a share.

With respect to the sales of Penn Central stock commencing on May 22, 1970, Martin stated that his order to his trading desk was at a "level indication", which he explained as sales within a reasonable range of a specific price but not a limit price. Martin stated that he gave the trading desk:

> An amount of shares to work with at the outset rather than specific orders with respect to specific amounts. . . . As I recall when the orders were first entered the stock was in the 12 area and we used that as a level. The implication there is roughly within half a point of that in that kind of situation.

According to Martin all sales made for his accounts were within the range of 11½ to 13. These sales occurred during the period May 22–June 1 and during this entire period Martin had an outstanding order to sell.

Martin stated that "6 or 7" of the 13 accounts he managed held Penn Central stock in May, 1970, and that he placed oral orders with his trading desk to sell 100,000 shares beginning on May 22, 1970.

At the time of placing his initial order to sell on May 22, Martin indicated to the trading desk the approximate amount of his holdings of Penn Central but did not tell them that he wanted to sell all his holdings. Martin stated that:

> I would have indicated to them the 100,000 shares and that there possibly was another hundred behind it. The decision I made at that time was not one to sell all the stock I had as far as I could sell it. It was to begin moving out of the stock, particularly in those accounts where it represented significant exposure. There was at that time the possibility that some of the stock would have been retained

Martin stated that he would not have sold all his holdings on May 22 if such a sale were possible:

> I didn't feel at that time that it was that critical a matter to move all the stock as fast as I could. I felt that if it was a stock I wanted to be out of I was willing to take a period of time to do it. I didn't think I was in any imminent danger of losing all my money. There was a great deal of interest in the stock at the time. By moving more slowly and without putting undue pressure on the market it was likely I could get a better price overall.

The trading desk was able to unload a major part of this 100,000-share order on May 22. Martin continued to give orders for the sale of Penn Central until June 1 when his accounts were sold out.

Martin stated that he did not know at the time he placed the order whether the trades would be made that day or for which specific accounts he would be selling. At the time Martin placed the initial order to sell he had a specific order of his accounts that he wished to sell out first. Martin listed the specific accounts he sold out first and reiterated his reasons for selling out these specific accounts. Martin stated that his:

> . . . interest was to allocate to those accounts in whom-in which it represented a material position, which were, in my view, at least more conservative in terms of their investment approach.

Further Martin noted that:

> The allocation was made to those accounts first which I felt either had the greatest exposure in the stock in terms of percentage holding or to those accounts which I felt could assume the least risk by their nature.

Normally the allocation would have been made on a pro rata basis for all accounts selling Penn Central by the trading desk on the basis of order tickets submitted by the portfolio managers.

Martin noted that his decision to sell Penn Central was known by his fellow portfolio managers and also that the Penn Central situation had been extensively discussed by them. He also noted that only one other individual portfolio manager in his division held Penn Central stock. This was a Michael Hoben, whose account which held approximately 7,500 shares was sold by him on May 19 and May 21.

Although Martin was unaware of the reasons why Hoben sold, Chase has represented that Hoben sold on the basis of the May 13 "flash report" and his conversations with Lehr.[10]

Chase had a possible avenue for the transmission of inside information aside from the commercial lending department. James O'Brien, who was a partner at Salomon Brothers and who was involved in the Pennco debenture offering that was aborted on May 28, 1970, attended the May 21, 1970, meeting in Bevan's office. At that meeting, the underwriters were told the offering was being abandoned and that a government loan was being sought. O'Brien was formerly head of the Chase trust department. He knew all the individuals involved in the decision to sell Penn Central stock and in the normal course of business spoke with them about transactions in which Salomon was acting as broker. O'Brien testified that he did not recall the information disclosed at the May 21 meeting but that he is certain he never discussed Penn Central or its securities with Chase officers.

SUMMARY

It would appear that the commercial department of Chase would and did as a customary part of its loan arrangements have certain inside information about the financial condition of the borrower, Penn Central. However, Chase has claimed that, pursuant to its written internal policy, such confidential information was not communicated to its trust department and that the sales of Penn Central stock by Chase Manhattan Bank in May and June of 1970 were not occasioned by the receipt and use of inside information but rather were caused by an internal analysis of Penn Central which resulted in a downgrading of its rating to a point where it became an almost mandatory "sell" situation.

Morgan Guaranty Trust Company of New York

Morgan Guaranty Trust Company of New York (MGT), a wholly-owned subsidiary of J. P. Morgan & Co., Inc., was the largest single shareholder of Penn Central (PC) at the end of 1968 with 849,275 shares held in nominee name for its trust accounts. This represented 3.4 percent of the total PC shares outstanding. By December 31, 1969, MGT had increased its holdings to 1,173,078 shares of PC stock. In 1970, prior to May 28, 1970, MGT sold 208,287 shares of PC stock, but continued to hold 847,308 shares in pension trusts administered by the trust department. But between May 29, 1970, and the filing for bankruptcy by PC on June 21, 1970, MGT sold 371,000 shares held for the pension accounts. The basis for these sales in May–June,

[10] Letter of Howard A. Scribner, Jr., vice-president, Chase Manhattan Bank, N.A., dated May 5, 1972.

1970 was a trust department decision to sell PC held in all pension accounts.

MGT also provided a significant amount of banking services for PC with $35 million in various commercial debt obligations, and it also was part of a consortium of banks meeting at the end of May, 1970 to seek methods for additional financing for PC. Furthermore, MGT was the sole issuing agent [11] of PC commercial paper and two of MGT's directors were also directors of PC.

Taken as a whole these factors raise questions on possible use of inside information obtained as the basis for the trust department's sales of PC stock just prior to PC's bankruptcy.

INTERLOCKING DIRECTORS

There were two interlocking directorships between MGT and PC. John T. Dorrance, Jr., a director of both Penn Central Co. and Penn Central Transportation Co., was a director of both J. P. Morgan & Co., Inc. and MGT in early 1970. He also was chairman of the board of the Campbell Soup Co. and served on the boards of John Wanamaker (Philadelphia) and the Penn Mutual Life Insurance Co. The other interlock, Thomas L. Perkins, an attorney with the New York law firm of Perkins, Daniels and McCormack, served also on the boards of American Cyanamid, Duke Power, Discount Corp. of New York and General Motors Corp.

Dorrance was the senior MGT director, having joined the board of Guaranty Trust Co. in the mid-1950's, but not until about 10 years later, after the PC merger, did he become a PC director at the invitation of Stuart Saunders. Several companies Dorrance was affiliated with had investment accounts managed by MGT, but none of the accounts had any transactions in PC securities. Although Dorrance was aware of MGT's participation in First National City Bank's (FNCB) $300 million revolving credit arrangement with PC, he testified that he was not aware of the MGT holdings of PC securities, of the FNCB meeting, of the decision to sell PC stock on May 29, or of the sales by MGT in May or June 1970. Dorrance attended the May 27 PC board meeting when the PC directors were informed that the debenture offering was to be postponed, and the June 8, 1970, meeting when certain PC officers were replaced.

Perkins, who served on the finance committee of the PC board, was quite familiar with PC's financial condition. Like Dorrance, Perkins had served as a MGT director before becoming a director of New York Central prior to the merger with the Pennsylvania Railroad. Perkins was aware of the significant PC holdings by MGT in early 1969 when, as a director of Discount Corp. of New York, he learned that MGT had purchased PC for Discount's pension plan. Upon inquiring, he learned that MGT's trust department was optimistic about PC's future, and he informed the trust department that he didn't care how they felt about PC, he didn't want any more PC purchased for the Discount pension fund. However, Perkins stated that he was not aware of the sales by MGT of PC in May or June and did not talk to anyone at MGT during May or June about PC, except for his discussions with John M. Meyer, chairman of the board of MGT,

[11] The issuing agent processes the physical issuance of the notes and receives and disburses the cash involved. The issuing agent is to be distinguished from the commercial paper dealer, Goldman, Sachs in this case, who has responsibility for marketing the paper.

about Perkins' resignation from the PC board of directors. Perkins testified that it was the practice for MGT directors to periodically attend trust committee meetings at MGT to discuss other companies which they also served as directors, although no information of a confidential nature was given the trust committee. In a May 3, 1972, letter, MGT's counsel stated:

> With respect to meetings of the full Trust Committee, we are advised that it was not the practice at any of these meetings to discuss affairs of a particular company of which one of the members of the Trust Committee was a director, but rather the general industry being presented for review.
>
> More specifically with respect to Mr. Perkins we are advised that he did not attend any meeting of Morgan Guaranty's Trust Committee during the period of May 1, 1970, through the bankruptcy of Penn Central. We are further advised that there was no discussion of Penn Central or the railroad industry in any meeting of the full Trust Committee held during this period.

COMMERCIAL DEPARTMENT

Kenneth E. MacWilliams, vice president of MGT, assumed client responsibility for Penn Central in April of 1970. MacWilliams reported that his duties regarding a particular client were to be aware of the client's financial needs and to participate in the extension of credit when it is necessary. Before credit is extended by MGT two members of the credit policy committee must approve any loan involving $5 million or more, or any loan with a maturity date of over 1 year. Any officer can commit the bank up to these limits without committee apprcval.

In February 1970, MGT declined to participate in a $50 million bridge loan to the Pennsylvania Co. for additional cash needs.[12] The loan was to have been unsecured, and was to have been repaid out of the proposed $100 million Pennco debenture offering.

On May 6, 1970, Jonathan O'Herron, vice president of finance of Penn Central, met with representatives of the MGT's banking division to discuss Penn Central's financial condition and to make a preliminary inquiry as to MGT's potential participation in a 60-day bridge loan of $20 million. Apparently MGT declined to participate in this loan for the same reasons it declined participation in the $50 million loan in February.

The major loan to Penn Central by MGT was a $25 million participation in the $300 million revolving credit loan which was secured by Pennsylvania Co. stock. At the beginning of May 1970, MGT had extended $20,833,333 out of its $25 million participation; $4,166,667 remained available for Penn Central prior to the bankruptcy.

On May 25, 1970, MacWilliams was informed by FNCB of a meeting to be held involving the revolving credit loan to Penn Central because Penn Central had estimated it needed a new loan of approximately $225 million if the debenture issue had to be postponed. Approximately $100 million of this amount was to be used to repay commercial paper, the balance was to go for operating losses. MacWilliams was also told that Saunders, Bevan, and O'Herron of Penn Central were in Washington with Treasury Secretary Kennedy and White House Special Counsel Flanigan to try to obtain a Government guarantee on the new debt.

[12] A bridge loan is a loan to bridge the creditor over until a pending public financing is completed. In this instance the loan was to be repaid from the proceeds of the $100 million debenture offering.

A memorandum of these conversations was sent to Dewitt Peterkin, president of the bank, Stuart Cragin, chairman of the credit policy committee, and Frank Sandstrom, senior vice president because of the importance MacWilliams had placed on the telephone call. MacWilliams testified he did not talk to anyone in the trust and investment division or the research department during the time between the telephone calls and the FNCB meeting on May 28 and to his knowledge neither did his immediate superiors.

The FNCB meeting took place at mid-morning on May 28, 1970. MacWilliams and G. Kenneth Crowther, both bank officers, and Bruce W. Nichols of MGT's counsel, Davis Polk & Wardwell, represented MGT. Upon returning from the FNCB meeting, MacWilliams wrote a confidential memorandum dated May 28, 1970, to the credit department files reporting the events that had occurred. This memorandum contained a good deal of information about the financial and operational condition of Penn Central which at that time had not been publicly disclosed. It specifically referred to the existence of the negotiations regarding the Government guaranteed loan, the postponement of the $100 million debenture offering, and the serious financial condition of Penn Central.

Copies of this memorandum were directed to Meyer, Cragin, and Peterkin in addition to the normal distribution in the credit department. MacWilliams testified that he did not talk to anyone in the trust and investment division concerning Penn Central on May 28 or May 29 nor was he aware of any events involving Penn Central that occurred at the bank on May 29, for example, the global order directing sales of Penn Central stock in all pension accounts.[13] Crowther testified that he could not recall specifically speaking to anyone at MGT upon returning to the bank after the FNCB meeting but someone, such as chairman Meyer, might have contacted him to find out what happened. Crowther and MacWilliams were cautioned to say nothing concerning the meeting.

THE TRUST AND INVESTMENT DEPARTMENT

The trust and investment department administers investments in connection with basically three types of accounts: personal trust accounts; investment advisory accounts; and pension accounts. For the personal trust and investment advisory accounts, the bank normally shares the investment responsibility with a cotrustee, while in the case of most pension accounts, the bank has sole investment responsibility. An advisor is responsible for the investment decisions for the account, but he is guided by two committees within the trust department: the committee on trust matters and the common stock committee.

The internal committee on trust matters meets twice each week to review accounts, to consider recommendations presented by the officers of the trust and investment department and to formally ratify actions taken between regular committee meetings. The investment officers base their recommendations to the committee on trust matters on conclusions of the common stock committee (a committee of eight officers of the investment department), on information received from the research department, the economics department, and on previous

[13] See pp. 85 ff.

decisions of the committee on trust matters. The total committee on trust matters usually meets twice a month prior to meetings of the board of directors or executive committee of the bank. These meetings are limited to consideration of general investment policies and no discussions are held regarding individual accounts or approval or disapproval of specific investments.

The common stock committee considers both individual securities and industries. Although there is no rating system fcr individual securities the common stock committee recommends by categories a particular issue as a "fielder's choice" to sell, or a "fielder's choice" to buy or to hold. When the common stock committee determines that a particular security falls within one of these categories, each account manager considers the recommendation in relation to the circumstances of the individual account, for example, the tax effect, the client's wishes, the company trustee's instructions and such. A recommendation is not a mandatory instruction for the account manager, but the manager must satisfy the committee on trust matters that acting in a contrary fashion to the recommendation of the common stock committee is best for a particular account in light of all the circumstances.

MGT had purchased most of the Penn Central shares held in its various trust accounts just prior to the Pennsylvania Railroad and New York Central merger. Nearly 900,000 shares of Penn Central were acquired in 1966 when the yearly high was 73 and the low was 40. The stock was purchased primarily because of the savings expected to result from their merger. MGT's research department had determined the PC would earn $5 per share during a good economic year and the merger should increase PC's earnings an additional $5 per share from cost savings. Other reasons included the high book value of Penn Central as compared with the then current price of PC stock, and the tax shelter which would result from the peculiarities of railroad accounting. No shares were acquired after 1969.

The following table shows shares held by MGT in various accounts at the end of 1969 and at the time of the May 28, 1970, meeting of banks:

	Dec. 31, 1969	May 28, 1970	Sales
Personal trust	49,329	[1] 15,308	31,692
Investment advisory	173,613	[1] 42,770	129,843
Pension	950,136	[1] 847,308	46,754
Total	1,173,078	[1] 905,386	208,289

[1] Besides sales, certain shares were delivered to clients by the bank for various reasons.

Between December 31, 1969, and May 28, 1970,[14] MGT sold 64 percent of Penn Central securities in the personal trust accounts, 75 percent of the Penn Central stock in the investment advisory accounts and 5 percent of the Penn Central stock held in the pension accounts. Included in the pension sales was the sale on May 19 of the entire position of 7,600 shares held for the Morgan Guaranty Trust Co. of New York and Affiliated Companies Retirement Plan for the U.S.

[14] Between May 25 and May 28, MGT sold 7,000 shares of Penn Central. May 28 was chosen for analysis of Penn Central trading because it was the day of the FNCB meeting when confidential information concerning Penn Central came from Bevan.

Employees. This sale was represented as necessary to provide the funds necessary to pay for a recent purchase of Federal National Mortgage notes, because the fund is a static fund and most purchases must therefore be offset by a sale of other securities in the fund.

The common stock committee considered Penn Central on January 21, 1970, and again on May 19, 1970. A report by the research department, distributed prior to the January meeting, contained the following information:

> It now appears that the railroad operating deficit for the fourth quarter of 1969 will equal or exceed the $47 million loss reported for both the third quarter of last year and the fourth quarter of 1968. The credibility gap between management and the investment community seems to be widening, since these anticipated results are in direct contrast to the recent remarks of Mr. Saunders. In a letter to stockholders on December 1, it was stated that the merger was progressing satisfactorily and that railroad operating losses will show a favorable trend in the fourth quarter. Our estimated final quarter results would put the operating deficit for the year at about $170 million, compared with $122 million for 1968 ($153 million including the New Haven). No special transactions by the railroad or real estate subsidiaries took place during the fourth quarter. Thus, consolidated earnings for the year 1969 could be as low as $0.50 pershare, compared with the $3.91 reported for 1968.
>
> The lack of meaningful published information and the reticence on the part of management to thoroughly discuss the now-sensitive area of railroad operations makes us more uncertain about the near-term prospects for Penn Central than at any time in the recent past. Heretofore, our conclusions have been based on an analysis of management's documentation of the swing variables—i.e., severance and overtime, abnormally high per diem charges, and the attainment of merger savings. Despite the recent rate increase and management's statements that merger costs were being reduced and that merger savings in the fourth quarter were running at an annual rate of $34 million, it is quite evident that the net benefits are being lost to yet to be defined areas.

The common stock committee at the January 21 meeting categorized Penn Central common stock as a fielder's choice to sell.

A report prepared for the May 19, 1970, meeting concluded that:

> Penn Central does control nearly $7 billion of assets on which it should be able to earn a reasonable return, but we do not think it will happen in 1970. Because of the poor first quarter results, we are reducing our earnings estimated for this year to $1.00 per share, from the previous $2.00. However, we do not have much confidence in our estimate, because of the many variables involved and management's continued credibility gap.

The research analyst who prepared these reports, John C. Holschuh, did not recall speaking to anyone at Penn Central, other analysts, or anyone at MGT. The common stock committee at the May 19, 1970, meeting continued Penn Central stock as a fielder's choice to sell.

MGT normally exercises sole investment discretion for pension accounts; thus transactions in these accounts differ slightly from the procedures for effecting transactions in personal trust and advisory accounts. Each pension account is reviewed quarterly by the committee on trust matters, but most of the activity occurs between the formal review and is approved by the officer in charge of the pension account managers and later ratified by the committee on trust matters.

A global order is used to designate a security to be bought or sold for all pension accounts managed by MGT. In the case of a global order to sell, all shares held by the pension accounts are sold at the best price obtainable with allocation of specific sales to individual accounts done on an equal basis, each account receiving a daily average price for the shares sold. A global order thus, in effect, preempts the opinions of all individual account managers and it does not take into

On May 29, the day after the FNCB meeting, Samuel R. Callaway, executive vice president and head of the trust department, Harrison V. Smith, senior vice president, and Carl E. Hathaway, senior vice president met in the morning and decided to place a global order to sell all the Penn Central shares held by the pension accounts. All three men met shortly after arriving at work and discussed what they felt was the serious financial condition of Penn Central. While Callaway and Hathaway could not recall the specific details of the meeting, Smith testified:

Question. Then after you arrived at the bank on the morning of the 29th, you met with Mr. Callaway and Mr. Hathaway?

Answer. That's right. And we decided despite the decline in the price in the stock, it should be sold for pensions on a global basis, and Hathaway implemented that decision.

Question. Now was this meeting the first thing in the morning, do you recall?

Answer. I don't recall exactly. It was probably sometime after our routine 9:15 meeting of the entire department, so I would place it at half past nine or 10 o'clock, something like that.

Question. Do your recall where you met?

Answer. Somewhere on the fourth floor, but I can't recall whether it was Mr. Callaway's office or in the space outside of it where the rest of us sit.

Question. How long did this meeting last?

Answer. I believe it lasted 2 or 3 minutes at the most.

The decision was reached without contacting the research department at MGT because all three felt they knew enough to make an informed investment decision. The sale was not discussed at the routine staff meeting that morning, but according to Hathaway such a sale would not normally be discussed at the staff meeting.

The decision to sell was based primarily on the disclosure in the May 29, 1970 Wall Street Journal of the postponement of the debenture offering. Smith testified concerning the significance of the postponed offering:

Question. And there was a very real feeling, then by those making this investment decision for the bank, that if Penn Central could have gotten the $100 million they possibly might have been able to survive?

Answer. It mght have given them enough breathing space to bring some order into the operation of the railroad, and salvage somethng from the situation.

Question. In view of the fact the debenture had is rating lowered to Double B, and in view of the fact that the interest rate was set at 10½ percent, could it not have been fairly anicipated at this time that this offering would not go through? Did it come as any surprise to you, Mr. Smith, that the debenture offering was postponed?

Answer. Yes, I was surprised that it had gone this far, and it would have been more usual if First Boston, who are the principal investment bankers involved in a situation like this had said early on there is no point in this. And they had gone so far as to schedule the issue for early in June. So it was surprising to us that they couldn't sell it. Because, of course, that was the situation that caused the postponement of the offering was that they didn't have the buyers.

Question. Did you attach importance to the fact that they had gone so far and did this have any effect on your investment decision on the morning of the 29th?

Answer. I can't remember any discussion along those lines. The significance of it was that when the offering was scheduled in May, the underwriters felt there was a possibility or they wouldn't have done so. By the time May 29 came alon the sentiment had deteriorated so that it was no longer possible to do so.

In arriving at the decision to sell Penn Central, all three men testified that they did not contact anyone else either at Morgan Guaranty Trust or outside the bank concerning Penn Central. Smith and Hathaway testified that they were not then aware of the negotiations concerning the government guaranteed loan or the meeting the previous day at FNCB attended by representatives of Morgan Guaranty Trust.

After the decision to sell was made, Hathaway placed by telephone a global order to sell approximately 800,000 shares of Penn Central with the trading desk at Morgan Guaranty Trust[15] with no specific instructions concerning the price, the timing of the sales or the manner in which the stock was to be sold. Standard procedure at Morgan Guaranty Trust is to sell as much as possible at the best price obtainable without affecting the market.

Between the institution of the global order and the bankruptcy petition, Morgan Guaranty Trust sold 371,000 of the 847,308 shares held for the pension accounts on March 29. In the personal trust accounts, only 4,102 shares out of 15,308 were sold during this period, and 29,660 shares in advisory accounts were sold out of 42,770 shares. In all, sales due to the global order represented 92 percent of all the Penn Central sales druing the period between May 29 and June 19.

The table on the next page shows the sales by Morgan Guaranty Trust during the period:

Date	Shares		MGT sales as a percentage of exchange volume
	Sales	Exchange volume	
May 29	45, 930	212, 545	21. 6
June:			
1	32, 000	117, 008	27. 3
2	25, 900	151, 921	17. 0
3	24, 435	119, 478	20. 4
4	42, 300	126, 771	33. 3
5	41, 000	113, 410	36. 1
8	0	48, 595	0
9	96, 450	253, 804	38. 0
10	52, 087	258, 515	20. 1
11	30, 775	117, 413	26. 2
12	360	399, 457	. 09
15	0	151, 746	0
16	425	114, 957	. 3
17	200	113, 086	. 1
18	11, 600	88, 783	13. 0
19	0	77, 786	0

The majority of the sales were placed through Dean Witter, but on two occasions sales were executed through Eastman Dillon, Union Securities & Co.

The orders for sales were normally given to Dean Witter to sell "at market" in 5,000 and 10,000 lots. When a particular lot was sold, the trader would give Dean Witter another order and vary the instructions as to whether it was to be a limit order or a market order. Ronald C. Ivory, the trader, testified that he tries to sell about one-third of the volume when attempting to liquidate a large position because he has found this to be the best procedure to follow so as not to depress the market price of the security. Furthermore, he would not try to sell a position as large as the Penn Central holdings in several block transactions because a broker positioning a block would compete in the marketplace with Morgan Guaranty Trust when it unloaded the block subsequently.

As the table reflecting the trades by Morgan Guaranty Trust reveals, roughly half of the global order was sold between May 29 and June 11. The only day Morgan Guaranty Trust did not trade was on June 8. Ivory testified that he was instructed not to sell any shares of Penn

[15] The exact amount to be sold was later determined after checking the bank's records.

Central on that date by his immediate superior, who gave no reason for the instructions. Apparently Meyer had ordered the trading stopped. In a memorandum supplied by counsel, the reasons for not trading on June 8 are set forth:

EVENTS LEADING TO DECISION TO SUSPEND SELLING OF PENN CENTRAL STOCK ON JUNE 8, 1970

On Saturday and Sunday, June 6 and June 7, 1970, a series of meetings were held at the Federal Reserve Bank in New York City which were attended by representatives of the U.S. Department of Commerce, counsel for the U.S. Department of Transportation, officers of the Federal Reserve Bank of New York, representatives of three New York banks (Morgan Guaranty, First National City, and Chemical), and representatives of First National Bank of Chicago and Mellon National Bank & Trust Co. In attendance from Morgan Guaranty were John M. Meyer, Jr., Chairman of the Board, and Kenneth E. MacWilliams, a Vice President, who were accompanied by Bruce Nichols of Davis Polk & Wardwell, counsel for Morgan Guaranty.

During the course of these meetings, several statements were made which led Mr. Nichols to conclude that at some time on Monday, June 8, a Board of Directors meeting of the Penn Central Company would be held at which important top-management changes might be made, changes which would be of such an unusual nature as clearly to indicate that Penn Central was in the gravest financial difficulty.

No one from the Trust and Investment Division of Morgan Guaranty was in attendance at any of the meetings over this weekend, and neither Mr. Meyer, Mr. MacWilliams, nor Mr. Nichols informed any member of the trust and investment division of what had occurred. Nonetheless, Mr. Nichols was concerned that, because of the quasi-public nature of these meetings, which he felt might attract attention by reason of their being held on Saturday and Sunday at the Federal Reserve Bank with so many prominent persons in attendance, information as to the possible impending management change might leak out and come to the attention of someone in the Trust and Investment Division from some other source. He was further concerned that if sales were made on June 8, someone might later contend that information relating to such change had come to them from Mr. Meyer or Mr. MacWilliams. Under these circumstances, he felt that the safest thing to do was to advise the Trust and Investment Division not to make any trades in Penn Central on June 8.

On the afternoon of June 8, the news of the management shakeup was publicly announced and this news was prominently featured in the New York Times and the Wall Street Journal on June 9. In view of the public disclosure of this information, it was felt that there was no longer any reason to refrain from making sales under the global order and the Trust and Investment Division was so advised before the opening of trading on June 9.

After resuming trading on June 9, Morgan Guaranty Trust all but ceased selling PC in significant amounts on June 12 until after the bankruptcy petition. By June 21, 44 percent of the shares under the global order had been sold.[16] Hathaway testified that a hold was placed on the sales because the market price of Penn Central had fallen approximately 25 percent from the time the global order was placed, and because he believed that the Federal Government would not permit a company the size of Penn Central to fail. It was Hathaway's responsibility to obtain the best price possible once the decision to sell was made and he felt the price of PC would regain some of the 25 percent decline.

Although Penn Central was discussed at the corporate office meeting on June 10, the discussion did not involve the sales of Penn Central other than the change in Penn Central management on June 8. Meyer did not attend the meeting and although Callaway was present at the

[16] Practically all the remaining 468,500 shares of Penn Central held for the pension accounts were sold between June 25 and June 30. Morgan Guaranty Trust sold the rest of Penn Central for the pension accounts after the bankruptcy petition because it felt there would be nothing left for the shareholders in any type of eventual liquidation. Selling was not immediately resumed beeause the initial news of the bankruptcy petition depressed the price of Penn Central. After several days the price of Penn Central rose somewhat

meeting, he stated that no one instructed him to cease selling Penn Central.

By June 19, Morgan Guaranty Trust had sold 57 percent of the total Penn Central shares held for the various trust accounts at the beginning of 1970. Specifically, 77 percent of the shares held in the personal trust accounts, 92 percent of the investment advisory holdings, and 50 percent of the pension shares had been sold. In the accounts for which Morgan Guaranty Trust exercised sole investment discretion 50 percent of the shares had been sold. Eighty-nine percent of the shares had been sold in the accounts in which Morgan Guaranty Trust shared the investment responsibility with a cotrustee.

The allocation of the sales under the global order to particular pension accounts was done in a manner so as to affect each account equally. The percentages of Penn Central held in each pension account were substantially identical on May 29 and June 19.

At the time of the filing of the bankruptcy petition, there were 19 personal trust accounts and nine advisory accounts which still held Penn Central. Documents submitted by Morgan Guaranty Trust indicate that the appropriate party for each such account had been contacted by his adviser before June 19 with the recommendation to sell Penn Central, but the person sharing the investment responsibility declined to sell Penn Central at the time. Smith testified concerning the decision to place the global order and the effect of this decision on the nonpension accounts:

Question. Now, during the discussions which occurred at this very brief meeting [when the global order was placed] was any thought given to the accounts still holding Penn Central which would not have been involved in the global order?

Answer. I don't recall any discussion of those accounts, however, entering the global order did change the situation for the nonpension accounts, because it meant that there was unanimity among the trust committee members, who were in the trust investment division, that it should be sold. And I am satisfied that John McGinnis and Harry Barbee, who are in charge of the nonpension side, put additional pressure on the investment advisors who report to them, to try to get their clients to sell the stock.

The nonpension side had been selling the stock for months, and as I mentioned earlier, they sold 70 percent, roughly, of what they had . . . we were down to what seemed to be a hard core of accounts. It was difficult to move the stock out because of the attitude of the client or cotrustee. In addition, I was going to say, there is a certain amount of latitude, even under these circumstances, allowed to the investment manager in charge of specific accounts, the interpretation of instructions, such as fielder's choice to sell, and some of the investment advisors on the nonpension side were not so eager to sell the stock as some others.

And while I am sure they had all contacted their clients as they had been instructed to, I don't know how forcefully they had to put it, but in any case, after the global order was entered on the pension side, and McGinnis and Barbee had put additional pressure on all the investment advisors to go back to their accounts and see what they could do to get it out.

Smith stated that it was unlikely that each nonpension account cotrustee or beneficiary was told that Morgan Guaranty Trust had placed a global order for the pension accounts but that increased emphasis was put on obtaining the approval of the cotrustees to sell Penn Central.

Since the bankruptcy petition, 27 of the 28 trust accounts have sold their Penn Central holdings. Most of the accounts liquidated their positions in June and July after filing of the bankruptcy petition; several held their Penn Central securities until October, 1970.

MGT POLICY OF SEPARATION OF TRUST AND COMMERCIAL DEPARTMENTS

Morgan Guaranty Trust has an established policy regarding the treatment of confidential information obtained by its representatives in the normal course of their duties. The bank's general rules and regulations prohibit the improper use of such information. Rule 1 concerning confidential information states in part:

> In the case of confidential information received from a customer, disclosure within the company must not extend beyond those persons who need to know the information in order to serve the particular customer from whom the information was received. In the case of confidential information of other types [including but not limited to such matters as customer identification, balances other account information, security trading activity and investment programs] disclosure must not extend beyond those persons within the Company who require such information for the efficient performance of their duties.

In addition to the general rule, Morgan Guaranty Trust has circulated memoranda concerning special responsibilities to both the general banking division and the trust department.

The memorandum to the general banking division, which was first issued on November 8, 1968, specifically prohibits the transmitting or providing confidential information obtained from a client of the banking division to anyone making an investment decision for Morgan Guaranty Trust. Procedures adopted to implement this policy include a prohibition against transmitting trip reports or conversations with clients to the trust department and the research department, and the denial of access to the banking department files to the trust department. In addition, a memorandum to the trust department originally circulated in September 1968, requires each member of the trust department to clearly identify himself as requesting information from an investment standpoint and not from a commercial banking standpoint.

Before May 27, 1970, the corporate research department at Morgan Guaranty Trust served both the banking division and the trust department. The research department was divided at the end of May to serve the trust department and the remainder of corporate research was moved to the banking division to serve that division exclusively. This separation was represented as designed to ease the administrative burden and to remove the problems caused by having one research department serve two entities. Smith also conceded that another purpose was served:

> Answer. * * * Of course, I am also aware that while the research and corporate research personnel had seemed to be able to handle problems of potential conflicts of interest arising from their working for more than one part satisfactorily, it put us in the position that somebody might say that this was a hole in the wall that existed between us [the Trust Department] and the commercial bank.

The timing of the division of the research department, it was testified, has nothing to do with Penn Central.

Holschuh was a vice president of Morgan Guaranty Trust, and its analyst in charge of railroads. During April and May of 1970, he met with officers of both the banking division and the trust department concerning Penn Central. Holschuh met with MacWilliams of the banking division on several occasions. During the course of these meetings, Holschuh briefed MacWilliams on the operational history [illegible] structure of Penn Central, but Holschuh stated

that MacWilliams did not tell him anything about Penn Central. Holschuh further testified that he never was aware of the size of loans to Penn Central by Morgan Guaranty Trust nor was he aware of any banking arrangements between Penn Central and Morgan Guaranty Trust and that MacWilliams never sent any information to Holschuh about Penn Central. On May 27, the day before the FNCB meeting, Holschuh was transferred permanently to the banking division and assigned to do statistical studies on Penn Central to assist Morgan Guaranty Trust in evaluating its loans in light of Penn Central's financial condition. He did not, however, learn of the sale of the pension shares or the trades of Penn Central during May and June until some 2 years later.

SUMMARY

Admittedly the commercial department of Morgan Guaranty Trust Co. was in possession of nonpublic information regarding the financial condition and future viability of Penn Central prior to the global order sales by the trust department on May 29, 1970. However, Morgan Guaranty Trust personnel stated that such information was not passed to the trust department and that the global order and the subsequent sales were based upon information which was available from the news media.

CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO.

Continental Illinois National Bank & Trust Co. of Chicago, Ill. (CINB) was involved with Penn Central both by virtue of loans extended to Penn Central and its subsidiaries and by its holdings of common stock of Penn Central in trust accounts managed or advised by its trust department. As of June 1, 1970, the commercial department of CINB held outstanding debt of approximately $24 million of Penn Central and its subsidiaries and during early June it became a member of a 10-bank steering committee which was participating in a plan to secure a federally guaranteed loan to Penn Central. CINB's trust department held for various pension and profit sharing trusts, personal trusts, and agency trusts approximately 422,000 shares of Penn Central common stock as of June 11, 1970. The overwhelming proportion of CINB's holdings of Penn Central stock were sold between June 12, 1970, and June 19, 1970, at which time the commercial department was receiving information regarding the financial situation of Penn Central and the status of negotiations for the Government guaranteed loan. That the bank was the recipient of significant nonpublic information which would reflect on the value of Penn Central securities while the trust department was engaged in a program of selling Penn Central securities raises questions as to whether such information was passed on to the trust department forming the basis for sales of Penn Central stock.

COMMERCIAL DEPARTMENT

CINB's commercial department for a number of years prior to 1970 had participated in various lending arrangements to Penn Central and its subsidiaries. In June 1970, CINB held outstanding loans to Penn Central and its subsidiaries of approximately $24 million com-

million revolving credit loan which was secured by 100 percent of the common stock of the Pennsylvania Co.; (2) a $4 million participation in a $50 million unsecured revolving Eurodollar commitment; (3) $3,898,000 of direct equipment lease financing arrangements; (4) $735,000 of equipment financing comprised of conditional sales contracts; and (5) a $140,000 equipment financing comprising a conditional sales contract to the Indiana Harbor Belt Railway Co.

Thus, CINB with $19 million of outstanding loans was the ninth largest lender to Penn Central excluding direct equipment loans and a Swiss franc loan.[17]

CINB first became involved in attempts to raise additional emergency financing for Penn Central when it was invited to a May 28, 1970 meeting called by First National City Bank and Penn Central. Although the invitation was extended to a senior officer of CINB's main office in Chicago, Donald Myers from the New York City office attended. Myers had not been previously involved in loan arrangements with Penn Central, but he attended the meeting because Gerald Mast, the officer most closely associated with Penn Central, was only just returning to a partial work schedule after an illness. Myers, the only CINB representative to attend the May 28, 1970, meeting, was generally unfamiliar with the particulars of Penn Central financial affairs.

At the May 28 meeting, David Bevan, chief financial officer of Penn Central, outlined the causes of the liquidity crisis as the result of merger problems, namely an inability to keep refinancing its commercial paper in quantities greater than repayments due on maturity dates and Standard & Poor's downgrading of the Pennsylvania Co. debenture offering to a double "B" rating. Bevan stated that Penn Central required an aggregate of $263 million of cash in 1970 primarily to meet maturing debt obligations including $100 million of commercial paper, and to underwrite anticipated losses. Bevan proposed that the necessary funds could be rasied by a $225 million bank loan guaranteed by the Federal Government, a $25 million increase of an existing $50 million loan to the Pennsylvania Co. and $13 million from Penn Central's continued sales of real estate or cutbacks in compensating bank balances. With regard to future prospects, Bevan expressed the view that the diversification program of Penn Central should produce increased profits in coming years and that he anticipated that railroad operations could break even in 1971. Following this general meeting, First National City Bank and Chemical Bank were to meet with Bevan to structure a banking lending committee to work out the details of bank participation in the refinancing program.

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[17] The 10 largest lending banks based upon composite bank loans excluding direct equipment loans and a Swiss franc loan were:

	Million
First National City Bank	$63.2
Manufacturers Hanover	40.0
Chase Manhattan Bank	34.2
Chemical Bank	31.2
Irving Trust Co	30.0
First National Bank of Chicago	28.0
Morgan Guaranty Trust Co	25.8
Mellon Bank	22.0
CINB	19.0
Bankers Trust	15.0
Subtotal	308.4
	494.0

At the next meeting of banks on June 3, 1970, called by First National City Bank for the 10 largest bank lenders to Penn Central,[18] interim developments were reviewed including the June 2 application for the $225-million loan, the rejection by the various banks of the proposed $25-million increase in the Pennsylvania Co.'s revolving credit, and the drawing down by Penn Central of the remaining $33 million of a $300 million revolving bank credit arrangement. Also discussed at this meeting were plans to secure the $225-million loan and a proposed interim measure consisting of the 10 participating banks each providing $5 million as a forerunner of the Government guaranteed loan. Six of the banks attending the meeting had previously agreed to their ratable share; Chase, Irving Trust, Morgan and CINB were still uncommitted. The loan policy committee of CINB on June 5 reviewed the Penn Central liquidity crisis and the plans for refinancing, and approved the bank's $5 million participation "If a proper spread of collateral could be arrived at to improve our present position." (All CINB loans were secured except for the $4 million Eurodollar loan.)

The next meeting of participating banks was held on June 10 at the Federal Reserve Bank of New York at which three representatives of CINB attended. Paul Gorman, chairman of Penn Central,[19] made a presentation of Penn Central's financial and operational plans while a representative of First National City Bank reported that the 10-bank steering committee had reached general agreement on the $225-million loan, with each bank taking a prorata share, and on a moratorium on present debt. The final speaker was Paul Volcker, Under-Secretary of the Treasury, who reviewed the administration's intentions to utilize the Defense Production Act to guarantee the loan with a maturity to October 31, 1971, at which time new legislation was anticipated to provide financing for Penn Central and other railroads.

In between these meetings, CINB personnel involved in the negotiations for the loan to Penn Central kept contact with the primary banks involved and kept officials at the Chicago office appraised of developments of the plans for the Government loan. However, each of the witnesses from the commercial department and the trust department denied that there was any contact or flow of information between these departments. The first time that CINB apparently became aware that the Government was not going to support the loans was on June 19.

TRUST DEPARTMENT

The trust department of CINB is divided into three groups by general classification of types of accounts managed or advised, namely employee pension or profit-sharing trust, personal trust, and agency trust. Account advisers have responsibility for the investments in specified accounts. Their discretion regarding investment decisions, however, is guided by the trust department's stock selection committee (SSC) which has the responsibility for conveying to the portfolio managers information given out by security analysts from the trust department and from outside brokerage firms, and making recommendations for the purchase and sale of securities. The SSC transmits

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[18] See list of banks in previous footnote on page 223.

[19] Stuart Saunders, chairman of Penn Central and David Bevan, chief financial officer, had resigned on June 9, 1970.

its recommendations to account advisers by weekly "buy" and "source of funds" lists. Changes in these lists are brought to the attention of the advisers by flash memoranda (so named because of the word flash imprinted on them), which are intended to denote matters which should be given immediate attention.

Although the scope of authority of an account adviser to authorize a purchase or sale does not appear to be formalized in the trust department, generally he can buy securities from the buy list and sell securities from the source of funds list by virtue of the SSC recommendation. In other situations, he must obtain the approval of a superior. The group head of the personal trust group, however, indicated that it was his policy to allow account advisers latitude to trade broader than that contained solely to the buy or source of funds list. This position is relevant to the Penn Central situation in that several account advisers within this group authorized sales of Penn Central stock on June 11, 1970, that is, prior to the issuance of a June 12 flash memorandum of the SSC which for the first time recommended the sale of Penn Central.[20]

Whereas the SSC concentrates on recommendations for specific securities, the trust investment committee (TIC), to which the SSC is responsible, promulgates policy guidelines based upon economic and industry analysis and establishes such priorities as the percentage of investments which should be in equity versus debt securities and the percentage of overall investments by industry groups. Normally the TIC is not involved with investment decisions concerning individual securities, but where a recommendation of the SSC relates to a major holding of the department the TIC's approval is solicited by the SSC.

In 1969 and 1970, personnel in the trust department were aware of the deteriorating financial condition of Penn Central. The predominant source of their information was apparently articles in the financial press including the Wall Street Journal, the newspaper which witnesses uniformly identified as a daily source of information. However, except for a short page and a half report of the trust department analyst relating a visit in January 1970 with Stuart Saunders, chairman of Penn Central, it does not appear that any in-depth analysis was performed. Sometime in early 1970, the analyst responsible for transportation securities was reassigned to an area outside the trust department and his responsibilities were transferred to another analyst, Samuel Sylvester. Except for an analysis in May 1970 of the financial impact of the Railway Passenger Act legislation, Sylvester was not involved in any analysis of Penn Central until after the bankruptcy. The SSC had placed Penn Central as a "hold" security in September 1969, but as events indicated the deteriorating condition of Penn Central, this status was not altered nor did the SSC or anyone else cause any in-depth analysis to be performed. When asked who was responsible for investment analysis of Penn Central, personnel from the trust department indicated that Sylvester had that responsibility, but in explaining why he had in fact not performed such analysis, Sylvester indicated that he concentrated during the first half of 1970 on an analysis of the airlines industry.

In certain individual situations the sale of Penn Central stock was recommended even though the overall trust department position was

[20] None of the three account advisers who wrote sales order slips on June 11, 1970, could recall the circumstances surrounding the preparation of these slips.

a continued "hold" on Penn Central securities. At an initial meeting on April 20, 1970, after the opening of an account for a church organization, members of the trust department indicated that Penn Central was "under consideration" as a sale candidate. Subsequently, on May 15, 1970, 7,000 shares of Penn Central common stock were sold from this account. In another account, CIIT Equity Fund, CINB's pool-type common stock fund for smaller employee benefit trusts, CINB, on May 19, 1970, sold 20,000 shares out of a position of 60,000 shares of Penn Central held by that account. These sales were made to raise funds to meet the anticipated withdrawal of one of the larger participants in the CIIT Equity Fund. Other than these two instances, it does not appear that any substantial sales were made of Penn Central securities in accounts managed by CINB's trust department.

As of June 11, 1970, CINB held 422,337 [21] shares of Penn Central stock for accounts managed and advised by its trust department, as follows:

	Number of shares
Personal trusts	54, 920
Pension trusts	206, 485
Profit-sharing trusts	11, 000
Investment agency	27, 817
Managing agency	2, 615
Pension—agency	17, 800
Profit-sharing agency	36, 700
Other fiduciary (pooled funds, other)	65, 000
Total	422, 337

Specifically relating to Penn Central, the members of the SSC were concerned about Penn Central for some time, but did not issue a sell recommendation until the morning of June 12, 1970, at which time they issued a flash memorandum which concluded regarding Penn Central:

> [The SSC] recommends the sale of the common stock in all accounts.
>
> Commentary: Recent events indicate that the likelihood of returning to a profitable basis appear quite distant at this point in time. Despite the possibility of government aid in securing additional financing, the basic operational problems of the railroad company will still remain and it is doubtful that substantial losses can be avoided for the foreseeable future.

Personnel from the SSC and TIC, including Thomas Larocca, chairman of SSC, Joseph Alaimo, member of SSC, and Philip J. Dambach, chairman of TIC and head of the trust department, were unable to recall precisely the sequence of events which led to the issuance of the June 12 "flash memorandum." Generally, these and other witnesses were able to recall some of the information reported in the press relating to the financial condition of Penn Central, including the omission of dividends, quarterly earnings reports, the cancellation of the proposed $100 million debenture offering of the Pennsylvania Co., the maturation of Penn Central commercial paper at a rate faster than it could be refinanced, and the resignations of Stuart Saunders, David Bevan, and Alfred Perlman. However, other than representing that these events evidenced to them a deterioration of Penn Central financially, they could not relate specific discussions among the members of the SCC, the TIC, or with other

[21] These figures were supplied by CINB with a caveat that "despite the apparent specificity of the figures, complete accuracy cannot be guaranteed."

members of the trust department other than the fact that they were certain that Penn Central had been discussed.

The SSC concluded that Penn Central securities should be sold some time prior to June 12, but whether this was a few days prior or a week or more prior was not specifically recalled by any of the witnesses. In any case, at least by June 10, 1970, at the regular meeting of TIC, the SSC communicated its view to the TIC that it wanted to issue a sell recommendation. The SSC sought the concurrence of the TIC because of the substantial holdings of Penn Central by trust department accounts. The TIC continued to believe that Penn Central stock should not be sold, but again witnesses did not recall the specific views of individual members of the TIC. Apparently, Dambach, as the head of the trust department and chairman of the TIC, was the last to be converted to the view that Penn Central should be sold. Dambach believed that because the Federal Government had been so instrumental in the merger of the Pennsylvania Railroad and the New York Central Railroad the Federal Government would come to the aid of the distressed Penn Central and not allow it to go bankrupt.

On the morning of June 12, 1970, Larocca reiterated his concern to Dambach that Penn Central should be sold. Dambach finally agreed apparently because of a news item in that day's papers which indicated that there was congressional opposition of a Government guaranteed loan to Penn Central. With Dambach's decision thus changed, Larocca relayed this to Alaimo who then contacted a trader for the trust department with instructions to execute a 100,000 share block trade. A "flash memorandum" was then drafted by an analyst and circulated throughout the trust department.

The initial trade after the decision to sell Penn Central was consummated through Salomon Bros., which sold shares in the market down to $10 per share and positioned the remaining 45,000 shares. The average price per share for the block was $10.18975. Alaimo testified that he contacted the group head of pension and profit sharings trusts so that he could have the advisors execute sale authorizations and allocate the trade among the accounts in this department. This department was chosen because it had the largest proportion of Penn Central common stock. Of this initial trade, 3,200 shares were allocated to profit sharing trusts, including 2,000 shares for the Continental Illinois Employees Profit Sharing Trust, and the remainder for various pension trusts including 6,800 shares for Continental Illinois Employee Pension Plan Trusts. Later trades on June 12 and in the following week were executed at prices slightly higher than the $10 for the initial block trade. The distribution of sales among the various accounts administered by the trust department is set forth in the following table:

Trade date	Pension trusts	Profit-sharing trusts	Personal trusts	Other	Total
June 11			1,000	600	1,600
June 12	103,500	4,100	2,000	14,100	123,700
June 15	46,800	6,100	6,500	2,700	62,100
June 16	27,700	8,600	1,600	1,400	39,300
June 17	42,100	2,300	600	4,800	49,800
June 18	24,600	900		1,000	26,500
June 19	23,500		200	2,200	25,900
Total	268,200	22,000	11,900	26,800	328,900

Except for the 100,000 share trade on June 12 initiated by Alaimo as director of portfolios, sales were made upon the initiative of individual account advisors.

An advisory service offered by the bank recommended by a letter dated June 16, 1970, that its clients sell Penn Central and invest the proceeds in Howard Johnson securities. CINB also contacted other accounts over which it did not have discretionary authority in the usual manner by telephone.

SUMMARY

Although the commercial department of Continental Illinois National Bank and Trust Co. possessed nonpublic information concerning Penn Central's financial problems by virtue of its role as one of the banks attempting to secure emergency financing for Penn Central, personnel of the commercial and trust departments denied that such information was passed to the trust department. Rather, CINB maintained that the sales of Penn Central common stock between June 12 and June 19, 1972, were based upon publicly available information.

ALLEGHANY CORP. AND INVESTORS DIVERSIFIED SERVICES, INC.

Alleghany Corp. (Alleghany), a public corporation whose predominant business activity is investing in corporate securities, and Investors Mutual Fund, Inc. (IM), a mutual fund managed by Investors Diversified Services, Inc. (IDS), were included in this investigation because both sold substantial quantities of Penn Central common stock on May 27, 1970, a day prior to the announcement of the cancellation of the Pennsylvania Co. $100 million debenture offering.[22] Because until a few months prior to this, three Alleghany directors had served as Penn Central directors, and because Alleghany controls IDS, the sale of a combined total of 212,000 shares of Penn Central common stock by Alleghany and IM raises questions as to whether these sales were prompted by knowledge of adverse nonpublic information and whether there was coordination in the sales of Penn Central stock by these affiliated entities.

ALLEGHANY CORP.

Background

Traditionally, Alleghany's principal business has been investing in corporate securities with particular emphasis, other than its investment in IDS, on the railroad industry. For instance, as of December 31, 1967, approximately 21.7 percent of Alleghany's assets of $187,794,396 was invested in railroad securities and approximately 58.8 percent of its assets were comprised of noncarrier securities including 40.7 percent of its assets invested in the capital stock of IDS.[23] Even though the nature of Alleghany's business was somewhat altered in 1970 by the acquisition of the operating rights and licenses of a motor carrier (the Jones Motor Co.), as of December 31, 1970 investments in securities were $127,178,072 as compared to total assets of $176,465,-

[22] On May 27, 1970 the Penn Central board of directors was informed that the proposed debenture offering was to be canceled. This information was not publicly released until May 28.

[23] See Alleghany Corp.'s 1967 annual report.

216. In that year, securities transactions accounted for net profits of $1,800,753 and net income exclusive of securities transactions was $1,943,143.[24]

In 1954 and early 1955, Alleghany purchased 384,100 shares of New York Central Railroad (Central) stock. It increased its holdings by purchasing 600,000 shares of Central stock between 1955 and 1959 (200,000 shares were also acquired at the same time by Allan P. Kirby, Sr.). By 1966 Alleghany owned 984,000 shares of Central (15 percent of the total outstanding voting shares) and Allan P. Kirby, Sr., chairman of Alleghany at the time, owned 300,100 shares of Central or approximately 4.5 percent of the total outstanding. Seven of the 10 Central directors were members of Alleghany's board of directors, and, in addition, three of the five members of the executive committee of Central had joint affiliations with Alleghany.

On March 28, 1966, after the approval of the merger between the Pennsylvania Railroad Co. and Central, but prior to the actual consummation of the merger, Alleghany offered the Central securities in its portfolio to Alleghany shareholders in exchange for their Alleghany securities.[25] As a result of this offer 833,181 shares of Central common stock were exchanged so that Alleghany continued to hold 150,919 shares of Central stock. The reasons for the exchange offer as stated in the offering circular were the inadvisability of maintaining a substantial portion of its portfolio in stock of a corporation Alleghany would not control; the ability to liquidate the Central holdings without incurring a substantial capital gains tax; the changing nature of Alleghany's portfolio from that of a railroad holding company to a more diversified portfolio. Although not so stated, another reason was that the Kirby family control of Alleghany would be ultimately increased.[26]

After the Penn Central merger, Alleghany owned 196,195 shares of Penn Central common stock representing .85 percent of the total outstanding and Allan P. Kirby, Sr., owned 390,130 shares of Penn Central common stock or 1.69 percent of the total outstanding shares. Although Alleghany and the Kirby family might not be considered in control of Penn Central, they had a substantial interest in its affairs as evidenced by the fact that five of Penn Central's 22 directors were also Alleghany directors: James S. Hunt, Fred M. Kirby, William G. Rabe, Carlos Routh, and Daniel E. Taylor.

This close relationship was obvious on its face and admitted by Fred M. Kirby at an Alleghany shareholders meeting on April 26, 1968, when he stated in response to a shareholder question: "We have incidentally very fine representation on the Penn Central Board and are very close to that situation and feel that we're in a very good position to appraise the desirablity of it as a continuing investment." [27]

[24] From the above figures, it is readily apparent that more than 40 percent of Alleghany's assets are investment securities, thus placing the company within the definition of an investment company under Section 3(a)(3) of the Investment Company Act of 1940. However, Alleghany was exempted by the Commission from regulation as an investment company in 1945 and again in 1970 by reason that Alleghany was subject to regulation by the Interstate Commerce Commission and thus excluded from the Commission's jurisdiction as provided in Section 3(b)(7) of the Investment Company Act of 1940.

[25] Allan P. Kirby, Sr. did not include his Central shares in the offer nor did the Kirby family interests exchange any of their Alleghany securities.

[26] Whereas on February 28, 1966, Allan P. Kirby Sr. owned 40.4 percent of the common stock of Alleghany, on April 15, 1966 after the exchange offer he was the beneficial owner of 55.36 percent of the Alleghany common stock. Notice of annual meeting to shareholders of Alleghany, April 19, 1966.

[27] Fred M. Kirby became chairman of Alleghany in 1967 after his father, Allan P. Kirby, Sr., suffered a severe stroke. F. M. Kirby and Allan P. Kirby, Jr., were appointed guardians of their father's property also in 1967.

Unheeded investment advice

Information and documents received by Penn Central directors at board meetings did not permit sufficient time for thorough analysis by them. F. M. Kirby frequently relied upon John J. Burns, vice president of finance for Alleghany, for his analysis of the financial condition of Penn Central. Although Burns was not a rail expert as such, his background in motor carriers and his responsibilities at Alleghany for investment analysis of present and potential holdings included expanding his knowledge of railroads.

Beginning sometime in the spring of 1969 and continuing into 1970 Burns was formulating the belief that Alleghany should sell its Penn Central stock because of the operational and financial problems. The earliest evidence of the crystalization of Burns' growing belief that Alleghany should sell its Penn Central holdings is found in a March 11, 1969, memorandum to F. M. Kirby in which Burns stated that he regretted not having strongly recommended sale at a higher price and that he had "not firmly made up my mind but feel the odds favor a sell rather than a hold some time soon." The subject of selling Alleghany's Penn Central stock was presented at Alleghany's March 1969 board of directors meeting at which time Burns outlined the "pros" and "cons" of a sale. The minutes of that meeting reflect that counsel to Alleghany pointed out that substantial legal problems existed in that prior to a sale, Alleghany might have to announce its intention to sell, followed by a waiting period before the sale. The sense of the directors was to not dispose of the Penn Central holdings at that time.

Following the April 23, 1969, Penn Central board of directors meeting F. M. Kirby forwarded to Burns Penn Central's consolidated income statements for the first quarter of 1969 and an income statement for the parent railroad company. Kirby in an attached note to those statements said:

> Directors impressed today with MGT position that Penn Central foul-up has been largely corrected. Will not show up in earnings for some time unless unexpected surge of volume develops.
>
> I believe the attached figures, entrusted to you in confidence, contradict Wall Street assumptions.

In a reply memo Burns, using these first quarter figures, calculated the net railway operating income after fixed charges as a $20 million loss in the first quarter of 1968 and a $36 million loss in the first quarter of 1969. Annualizing these figures, losses would have been $80 million in 1968 versus $144 million in 1969. However, Burns pointed out that losses in 1968 were actually $150 million. Thus apparently $130 million of losses were attributable to the last three quarters of that year. Accordingly, with first quarter 1969 showing no turnaround, losses were predicted by Burns to be close to $200 million for 1969. In concluding this memorandum Burns referred to the legal problems of a sale by stating:

> Since we have apparently no choice but to hold on to Penn Central for the time being, this memo is somewhat unnecessary, nonetheless, I did feel constrained to briefly comment on the confidential figures which you gave me.

In July 1969 Burns had reached the conclusion that Alleghany's holdings should be liquidated, but again this necessitated overcoming the legal problems which counsel had previously presented. Burns again wrote a memo to Kirby with a new approach of securing a

private placement of Alleghany's Penn Central stock as well as the IDS and Kirby family Penn Central shares:

For various reasons I have been interested in seeing Alleghany Corporation dispose of its investment in Penn Central. In conversation with John Tobin it has developed that one feasible way for a sale of our holding to be effectively accomplished in a manner that would minimize the possibilities of any successful litigation, would be for Alleghany, the Kirby family and IDS to sell all of their shares, preferably at the same time, to a group who could be considered sophisticated institutional-type buyers.

I have determined that IDS has partially completed a selling program of its IDS shares, and that they would be interested in participating if a block transaction was to be accomplished to the extent of all of their remaining 440,000 shares.

Counting our shares, the Kirby family shares and IDS shares, we would need to sell approximately 1,136,000 shares of Penn Central to dispose of all of the stock. If such a sale is to be contemplated, timing if of prime importance. At the present time, I understand that since Penn Central stock is an "exempt security" (because of its ICC status). A sale of Alleghany and the family's stock would not require either an investment letter of a registration statement. However, once the Penn Central shares are turned in for the new holding company shares (probably later this summer) the new shares will have lost their "exempt" status and will have to be sold on either an investment letter or a "registration" basis. This could possibly make a sale both awkward and expensive.

Therefore, timing is very important.

In order to accomplish a major sale such as this, I feel the cooperation of the railroad's management will be almost essential. Since we cannot induce buyers ourselves (for obvious legal reason), large institutional purchasers would probably be most easily found by an enthusiastic management who should have a real interest in seeing a large block of the company's stock successfully placed in good hands.

Accordingly, I would like to discuss this matter with Mr. Saunders at once,[28] assuming that you and the family are seriously interested in a sale at this time and under these circumstances. If you are not interested on behalf of your family holdings, I would like to see if another way can be found to enable us to sell our shares in a manner which would minimize potential legal problems.

Comments would be appreciated.

This view that a sale of their Penn Central stock should be made was presented by Burns again in a July 15, 1969, memorandum to F. M. Kirby reviewing the status of Alleghany's investment portfolio:

You know my opinion of this one (Penn Central). I feel the sooner we get out the better, even at these prices, since in my opinion, the company with its current inept management and large, uneconomical, ungainly, high cost, rail system will be particularly vulnerable to the impending labor squeeze I see forthcoming in the early 1970's. If we must maintain a railroad investment of some kind, it would not be this one, in my opinion.

Burns continued to press his method of selling the Penn Central holdings to a sophisticated investor or financial institution especially because when the Penn Central holding company would be created it would fall within jurisdiction of the Securities and Exchange Commission rather than the Interstate Commerce Commission. A Burns memorandum of September 25, 1969, to Kirby presents this view:

According to the attached announcement[29] our Penn Central shares (now representing shares in a carrier corporation) will be automatically exchanged for noncarrier holding company shares on October 1. I feel that this plan is detrimental to Alleghany Corporation since, according to counsel, once our Penn Central shares no longer represent shares in an "ICC regulated carrier corporation" they will either have to be registered, or an investment letter will have to be obtained, if and when sale is to be effectuated. As I understand it, *right now*, assuming resolution of various other problems, we could sell our Penn Central shares to a knowledgeable buyer without either a registration statement or an investment letter.

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[28] ... 1971, Burns stated he at no time met with Saunders.

I do not know what we can do about this situation but it appears to me that this "automatic" exchange of Penn Central railroad shares for Penn Central holding company shares without any vote or registered exchange offer to shareholders is unfair to stockholders, such as Alleghany Corporation.

In furtherance of his view that Alleghany should sell its Penn Central stock, Burns discussed in October 1969, such a sale during the course of a general conversation on the condition of Penn Central with E. Clayton Gengras, chairman of the board of Security Corp. of New Haven, Conn.,[30] Burns thought perhaps Gengras might be interested in purchasing Alleghany's stock, but again this approach was not followed up. A number of other memoranda in 1969 and 1970 to Kirby continued to emphasize the poor condition of Penn Central and that the Alleghany holdings should be sold.[31]

Events leading to sale of Penn Central common stock

At the same time that Burns was recommending sale of Alleghany's Penn Central shares, Alleghany in April 1969, had filed an application with the ICC for authority to acquire control of Jones Motor Co. and its subsidiary so as to be able to have the operating rights to act as a motor carrier.[32] During the course of the hearings before the ICC on this matter it became apparent that Alleghany would probably be required to divest itself of any other interests in an ICC-regulated carrier. At various times Burns had suggested that to improve its position with the ICC, Alleghany should sell its Penn Central shares.

By order of Janaury 27, 1970, the ICC granted Alleghany's application to acquire the operating rights and properties of Jones Motor Co., but because of the close relationship between Alleghany and Penn Central, Alleghany was directed to place its Penn Central securities in a trust and within 5 years sell them, and also to terminate all joint director affiliations between Penn Central and Alleghany. Although the Penn Central shares owned by Allan P. Kirby, Sr. did not have to be sold, they also were directed to be placed in a voting trusteeship.

Joint directorships were terminated by Daniel E. Taylor resigning from the Alleghany board in March 1970, and F. M. Kirby and Carlos J. Routh resigning from the Penn Central board in March 1970. Those Alleghany directors serving on boards of Penn Central subsidiaries likewise resigned from those positions.

The trusteeship of Alleghany's shares was placed with Irving Trust Co. by an initial agreement of March 26, 1970. Various amendments were made to the trusteeship agreement with the final agreement executed on April 27, 1970. Basically the trusteeship provided for initiative for sales to rest with Alleghany at the early stage of trusteeship, with consultation with the trustee.[33]

Apparently the decision by Alleghany to sell its Penn Central shares was made shortly before the May 15, 1970, Alleghany board of directors meeting. The minutes of that meeting reflect that the sale of Penn Central Co. capital stock was discussed at length and Burns stated that, "it was management's intention, if given suitable market conditions, to dispose of this investment."

[30] Gengras in December 1969 became a director of Penn Central.

[31] One memorandum of Apr. 16, 1970 from Burns to F. M. Kirby summarized a meeting with David Bevan, chief financial officer of Penn Central, in which Bevan "did not seem shocked at my suggestion of the possibility of future insolvency if current trends continue much longer."

[32] Alleghany made a successful tender offer for Jones Motor Co. shares in 1968.

[33] This was set forth in a plan for accomplishing the disposition of Penn Central shares owned by Alleghany and held in trust by Irving Trust Co. which was drafted on May 26, and submitted to Alleghany on May 27, 1970.

That Alleghany was interested in selling its Penn Central stock was communicated to an institutional sales representative, John Shepherd, who handled Alleghany's account at Goldman, Sachs. Although the time has not been precisely fixed, Burns told Shepherd in February or March 1970 that Alleghany would be in a position to sell its Penn Central stock. However, no action was taken either by Goldman, Sachs or by Alleghany to sell the Penn Central stock.[34]

On the evening of May 26, 1970, at a dinner hosted by Shepherd for his clients, Burns had occasion to discuss Penn Central with the head block trader of Goldman, Sachs; Robert Mnuchin. Burns recounted the discussion with Mnuchin on the evening of May 26 and the sale on May 27 as follows:

> During the course of the evening, he mentioned to me he knew I had been listed by Jack (John Shepherd, an institutional sales representative for Goldman, Sachs) as a possible seller of Penn Central,[35] which I had been, and that in his opinion, the market was active in Penn Central and that he might be able to make me a good bid if I was still interested in selling and I asked him why and as I recall his answer was: there are plenty of buyers in Penn Central and I think it is a good trading stock right now.
>
> So before the evening was over, I asked Mr. Mnuchin to give me a call the next day, which was the 27th and if he had a bid to make, possibly I would entertain it. I went home that night. The next day Goldman, Sachs phoned, Jack Shepherd did call, put Bob Mnuchin on the phone, and gave me the opening in Penn Central, and said I can give you a bid for approximately 200,000 shares at somewhere—at a discount, would you be interested in entertaining a bid?
>
> Now, this was the first time anybody had told me that, (A) I could sell this much stock, and, (B) in effect, put up or shut up. My recollection is that I went in and had a general discussion with one of my associates—a discussion which lasted about an hour concerning the state of the market, the decline in the stock on the one hand and our pessimistic feeling concerning the losses for this year of the railroad and [sic] the other, that we thought it would be a good idea to sell half of our position, about half of our position.
>
> I then went back, call Mr. Mnuchin directly and asked what he was prepared to do on 96,000 shares—roughly 96,000. Maybe exactly 96,000, and after checking the market, as I recall, he came back and said that—I am not sure of the exact figure, so you will have to forgive my inaccuracy, the last sale was 13¾, that he would like to make a position bid on or around 13¼ and that he would give me the benefit of any sales that he was able to get off in brining the stock down to the 13¼ level where he would be the buyer and I would be the seller and the block would cross.
>
> I believe we negotiated a little, he might have given me a bid and I got him up to 13¼, he might have given me 13⅛ and I got him up to 13⅜. I am not sure of the facts. I told him that would be acceptable, but I had to speak to the Irving Trust Company who was the record holder of the stock (trustee for Alleghany's Penn Central stock).
>
> I called Mr. McCabe and spoke with him and in line with our trust agreement, I was recommending a sale at this particular time and Goldman, Sachs and Company had made us a bid and that I would recommend that he go along and accept the bid on behalf of us as beneficial owner.
>
> He said he thought that was all right. I then called Mr. Mnuchin and asked him to get in touch with Mr. McCabe or one of his assistants directly. The trade was consummated somewhere around 12:00. The stock closed that day higher and there was quite a bit of buying.
>
> Those are the circumstances under which I accomplished that trade.

The sale of 96,000 shares of Penn Central was executed by Goldman, Sachs at $13¼ per share for 70,000 shares, with the remainder sold in the market at prices ranging from $13¼ to $13⅞ per share. The balance of Alleghany's 100,000 shares of Penn Central were sold in

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[34] Goldman, Sachs was a dealer in Penn Central's commercial paper and was in frequent communication with Penn Central during this period, especially in late May.

[35] Mnuchin's recollection somewhat differs in this regard as he believed Burns initiated the conversation about selling Penn Central, although Mnuchin did not specifically recollect who initiated the discussion on Penn Central.

January 1971, and the Kirby family holdings of Penn Central were disposed of on September 22, 1970.

INVESTORS MUTUAL FUND, INC.

Investors Diversified Services, Inc. provides, among its other lines of business, advisory and distribution services for six open-end mutual funds with assets as of September 30, 1971, of approximately $6.6 billion. Three of these funds, Investors Mutual Fund (IM), Variable Payment Fund (VP), and Investors Stock Fund (IS) sold common stock of Penn Central in 1969 and 1970. In September 1968, Penn Central common stock owned by IDS-managed funds totaled 1,020,-000 shares divided as follows between the funds: Investors Mutual—500,000 shares; Variable Payment—200,000 shares; and Investors Stock—320,000 shares. These positions had been accumulated over a period of time commencing in 1967. The following table shows the holdings of Penn Central of the three funds, beginning on January 1, 1968, and showing subsequent purchases and sales.

PURCHASES AND SALES OF PENN CENTRAL COMMON STOCK BY MUTUAL FUNDS MANAGED BY INVESTORS DIVERSIFIED SERVICES

	Holdings on Jan. 1, 1968	Purchases Jan. 1, 1968 to Aug. 26, 1968	Sales— Mar. 27, 1969 to July 17, 1969	Oct. 8, 1969 to Oct. 16, 1969	Jan. 19, 1970 to Mar. 26, 1970	May 6, 1970 to May 27, 1970
Investors Mutual	88,700	411,300	108,100	45,600	103,100	243,200
Investors Stock	245,000	75,000	320,000	0	0	0
Investors Variable Payment	200,000	0	200,000	0	0	0

Events surrounding sales by IM

Whereas IS and VP began to sell their Penn Central stock in March and April 1969, respectively, and had completely sold out their holdings in May 1969, IM continued to hold all of its Penn Central shares in its portfolio until June 13, 1969, when the investment committee of IM authorized the sale of 100,000 shares of Penn Central from its holdings of 500,000 shares. Such an authorization permits the fund's portfolio manager to sell the stock at his discretion. This authorized sale of 100,000 shares was completed on July 8, 1969, and the sale of an additional 100,000 shares was authorized on July 9, 1969, by IM's investment committee. After the sale of the initial authorization was completed, sales of Penn Central stock were intermittent during the remainder of 1969 and until May 1970.

It is apparent that the portfolio managers of IS and VP were more strongly convinced that Penn Central stock should be sold than was the portfolio manager of IM. Harold A. Schwind, portfolio manager of IM with responsibility for Penn Central, commented on the long period of time it took to sell the Penn Central stock:

Answer. I think the most important reason was I didn't feel that I had enough information and a strong enough feel of the situation to warrant holding it. It sounds like reviewing the problem from a little different focus, but at no time did I have hard, fast, specific reasons for selling it. If I had, I think I would have sold it quickly.

One of the unusual things about the sale of this stock is it took us 11 months to sell it. I can't remember ever taking that long to sell anything before.

Question. What was the most important reason for your not selling it quickly?
Answer. I guess I was never sure that I was making the right decision. In fact, when we sold the final block of the stock in May, there was no feeling of elation because I wasn't sure I was doing the right thing.

After the additional authorization to sell 100,000 shares of Penn Central was made on July 9, 1969, only 8,100 shares were sold before IM ceased selling. The reason for this is associated with a conversation between Stuart F. Silloway, president of IDS, and Jack L. Nienaber, vice president of IDS. Nienaber recalled the conversation:

He (Silloway) noted that we were selling additional Penn Central Stock. * * * And he urged that we take another look and not sell it, because he thought there were good reasons on the basis of conversations he had with people he considered well informed who felt the company, if you will, had a very real chance to turn around.

This information was relayed to the portfolio manager of IM, Harold A. Schwind:

My superior, Mr. Nienaber, came to me one morning—it was early in the day—and related a conversation he had just had with Mr. Stuart Silloway, the president of IDS, and Mr. Silloway had told him that he had a contact—some acquaintance or broker, some contact—that was never identified to me—who apparently was aware that we were selling Penn Central and felt that we were making a mistake and would like to tell us more about the situation and the attractiveness of the stock.
We discussed it, Mr. Nienaber and I, and felt that under the circumstances we had better put a hold on the stock and stop selling it.

Silloway's well informed source was Fred M. Kirby, chairman of IDS and Alleghany Corp. and a director of Penn Central. Silloway's version of the conversation with Kirby was similar to Nienaber's in that as he recalled the conversation:

He (Kirby) expressed a point of view that, well, maybe there will be some improvement that you will see. Perhaps there will be something; maybe the thing is not as bad as you think it is—nothing tangible or nothing specific.

Later in his testimony Silloway restated Kirby's view as more of a hope some progress would be made by Penn Central in its operations.
This information was apparently of sufficient import that IM made no sales of Penn Central until October 1969. As Schwind stated, he decided to sell Penn Central again because:

Well, nothing was ever heard back from Mr. Silloway or Mr. Nienaber with regard to the original comment of talking to some contact with regard to Penn Central. * * * I didn't really consult with anyone about resuming of the sale. I believe—I'm sure I mentioned it to Mr. Nienaber. So we just simply opened up the balance of the stock and began to sell.

After the authorization for sale was again approved in October 1969, sales were sporadic: between October 8–16, 1969, IM sold 45,600 shares and between January 1, and March 26, 1970, 103,100 shares were sold. The hiatus from selling in November-December 1969 was not explained by any of the witnesses, other than being based on indecision.
However, another contact this time with Charles Hodge, chief investment adviser to Penn Central and a partner of Glore Forgan, William R. Staats, may have resulted in this cessation from selling. Silloway called Hodge after seeking guidance from a friend in Philadelphia as to the name of someone who "really knew Penn Central inside and out * * * somebody who had done a lot of work and had access perhaps to people within management who would help them put infor-

mation together." Silloway was supplied the name of Hodge as one who could provide such information. Silloway then called Hodge in late September or early October of 1969, but was unable to obtain answers to his specific questions on operating expense trends of Penn Central other than that Hodge had confidence in the Penn Central situation and was going to recommend the stock to some people who hopefully would purchase substantial amounts of the stock and that then he would be an influence in changing the management.

The lack of sales in April 1970 was explained as caused by an oversight by the portfolio manager in that the authorization for sale of the remaining portion of Penn Central lapsed 6 months after the September 1969 authorization. A new authorization was obtained on May 5, 1970, to sell IM's remaining position of 243,200 shares of Penn Central. When sales commenced on May 6 again there was little urgency in the disposition of the Penn Central stock.

John P. Vervoort, president of IDS securities and the trader of Penn Central for IM, commented on this lack of aggressive selling.

Answer. I do not recall specifically the instructions. However, if I look at the sales as they occurred none of them indicate to me that there had been any urgency, if you wish, or guidance or expression of opinion that this stock should be sold in a very definite manner. None of these trades are of any relative size with the exception being the 27th of May. So I cannot recall any precise instructions.

Question. Can you recall any instructions whatsoever, precise or imprecise?

Answer. I do vaguely recall a number of times having had participating instruction. When, precisely they were, I do not recall.

Question. Could you describe what these participating instructions were?

Answer. Participating instructions are generally construed as meaning to participate in the floor activity on a stock and we generally think in terms of 20,000 and 25,000 shares. Anywhere between that.

Participating sales were accomplished in this situation by a continuing order at the brokerage firm of Mitchum, Jones & Templeton to sell as many shares as possible within a specified price range. At the conclusion of the day, the Mitchum firm would notify Vervoort of sales executed on its behalf that day. Even on days which resulted in the sale of significant amounts of Penn Central stock, a number of smaller trades contributed to the larger total.

INVESTORS MUTUAL SALES IN MAY 1970

Date and number of shares in trade	Price
May 6:	
6,000	18
900	18¼
May 7:	
2,000	18⅛
2,000	18⅜
2,000	18⅝
May 8:	
200	18¾
1,800	18⅝
33,000	15
May 14:	
1,000	15⅛
May 15:	
2,000	15⅜
500	15⅝
May 19:	
1,000	15
2,000	14
32,100	14
600	14½
2,100	14⅛
May 19—Continued	
2,100	14½
300	14⅜
400	14¼
7,400	14⅛
12,100	14
May 21:	
400	13⅛
5,000	13
8,000	13
May 26:	
2,000	13⅜
May 27:	
2,000	13⅜
2,000	13⅝
2,000	13⅞
200	14⅛
[1] 1,000	13⅜
[1] 400	13⅜
[1] 2,100	13¼
[1] 25,000	13
[1] 81,500	13

[1] Trade was for 110,100 with 81,600 positioned by Shields & Co., after trades available at higher prices were executed.

The sale of 110,100 shares through Shields & Co., was a variation from the previous pattern of selling small pieces of IM's Penn Central holdings. From the testimony of a number of witnesses at IDS, the change in selling pattern occurred because of a comment from the IDS analyst of Penn Central to the trader. Apparently at some time during the lunch hour. Richard Warden, the rail analyst for IDS, entered the trading room seeking the trader for Penn Central to discover how much PC stock IM continued to hold. Previously Warden had without success looked for Nienaber and Schwind for this information so he sought out the trader. Warden told the trader: "that I was concerned that this was a possible bankruptcy, and I felt that the stock should be sold." The trader then contacted Shields & Co. for a block bid and thereafter Mitchum, Jones & Templeton to find out how much had been sold that day on the participating sale instructions. Upon learning that 6,200 shares had been sold, the remaining order was canceled. Vervoort stated his reasons for the decision to sell:

> My decision to sell that stock on that day was based upon a long period of selling this stock, passing a number of opportunities to have sold stock before, to have seen the price deteriorate constantly over a rather long period of time, having been involved in the wrong decision to purchase part of that stock, to the remark that Mr. Warden made, to the fact that the portfolio managers, Mr. Hal Schwind and Mr Nienaber were not available. I was just sick and tired of this stock and I was sick and tired of the indecisiveness. I probably felt guilty about having been involved in the suggestion that the stock be bought much earlier at much higher prices, that this was—it just reached the peak, if you wish at that time on that day or a combination of all these factors as the trend of the stock indicated that this thing could slip down further and I just took this opportunity to once and for all get it off the books.
>
> To be done with a decision that had been made much earlier but had never been fully executed.

Vervoort had had this feeling of indecisiveness for a number of months, but characterized Warden's comment as the excuse needed to then act decisively. Warden's comment concerning the possible bankruptcy of Penn Central resulted from being told of a report over the Dow Jones on May 26, and an article in the Wall Street Journal on May 27, that Penn Central's commercial paper was maturing faster than it was being sold. While this information was contained in a prospectus dated May 12, 1970, issued by the Pennsylvania Co., Warden testified he did not recall whether in fact he had seen the prospectus and did not learn of the information concerning PC's commercial paper until May 27.

Thus Vervoort made a definite change to clearn out the position by diverting from the prior pattern of selling.[36] Schwind stated that the trader's cancellation of the sales order at Mitchum Jones and the solicitation of a block bid at a discount from the current market price would be somewhat inconsistent with the instructions the trader had and that it is a customary practice for a trader soliciting a discount bid to first talk with the portfolio manager. However, Schwind also characterized a discount of three-fourths of a point as not clearly excessive but in a "gray area" in which the trader could in his discretion make such a decision. Nienaber also stated that the trader's action was within the limits of his discretion.

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[36] A telephone call was made from the Goldman, Sachs trading room to IDS shortly before IDS's sale of Penn Central, but who made or received the call and the substance of the conversation is not known. Mnuchin from Goldman, Sachs testified that this commercial call could have been made because the direct line had broken down.

Additional circumstances relating to IM's May 27 sale of Penn Central

At the initial stages of the investigation of the circumstances relating to sales by both Alleghany and IM of substantial quantities of Penn Central stock on May 27, 1970, coordination between sales was believed to be possibly linked to several telephone calls recorded on telephone toll slips of Alleghany to various personnel at IDS. A certain number of telephone calls should certainly be expected because of the close affiliation between Alleghany and IDS, but most likely such calls would be to management personnel at the higher corporate levels of IDS due to Alleghany's interest in overall corporate policy of IDS. Indeed, this was primarily the situation in that calls normally made were to such individuals as the vice president for public relations, the comptroller, vice president for law, et cetera. However, calls were made on May 25, 26, and 27 which did not follow the prior pattern of calls from Alleghany to IDS.

On May 25, 1970, a call was made to the telephone number of Thomas R. Reeves, vice president for investments, which lasted for 19 minutes. A few minutes after the conclusion of that conversation, a call was made to the telephone number of Robert B. Johnson, vice president—investment research which lasted for 34 minutes. The next day, May 26, at 10:11 a.m. (New York City time), which would be 9:11 a.m. Minneapolis time, Johnson of IDS apparently conversed with someone from Alleghany for 15 minutes. On May 27, the day of the trading by Alleghany and IDS, Silloway's secretary received a call at 11:15 a.m. which lasted for 2 minutes.

The obvious question is what was the purpose of these calls? A reason for focusing on these calls is that neither Reeves nor Johnson had received direct phone calls from Alleghany for the year prior to May 1970. In addition, Silloway received only one phone call from Alleghany on his direct number during the year prior to May 1970. It is possible that these calls bear no relationship to the trading in Penn Central but the suspicions exist in that after Alleghany had placed its order to sell then IDS may have been given the green light for it to sell. Counsel for Alleghany stated that "we are unable to determine who placed these calls but Mr. Burns does not recall making any of them."

From affidavits of Thomas R. Reeves and Robert B. Johnson, it does not appear that either person was the recipient of these calls from Alleghany on those dates. Reeves was in New York City on May 25 through May 27 and stated that it was his practice to use Alleghany's office to keep contact with his office in Minneapolis. In addition, Johnson was not in his office on May 25, but was playing in a golf tournament which was verified to the best of their recollection by three other persons. Both Reeves and Johnson denied discussing Penn Central with anyone on May 25 through May 27.

Other coordination could have existed due to an IDS executive committee meeting on May 26 at Alleghany's office attended by Kirby and Silloway. However no, evidence was uncovered that Penn Central was discussed either informally or formally and furthermore, both these persons denied any conversations occurring on that date or at any other time, other than previously described in this section.

SUMMARY

Officers and employees of Alleghany Corp., Investors Mutual Fund, Inc. and Investors Diversified Services, Inc. asserted that the sales on May 27, 1970, of Penn Central stock were made independently without any communication between these entities and that none of the sales was made on the basis of material nonpublic information.

II–B. TRADING BY OFFICERS AND DIRECTORS

INTRODUCTION

Between the time of the formation of Penn Central Transportation Co. in February 1968 and the June 1970 bankruptcy, as management deliberately and increasingly glazed its public reports with distorted optimism, many members of management succeeded in selling many shares of Penn Central stock.[37] This section of the report deals with the detailed inquiry the staff has made into the sales of Penn Central officers and directors after the merger.[38]

The securities laws, in particular rule 10b–5 of the Securities Exchange Act of 1934, prohibit stock transactions based on material inside information which has not been disclosed to all parties in the transaction or to the public in general. Therefore, any officer aware that the company's prospects were significantly more dismal than the public had been led to believe would have been precluded from trading in Penn Central shares while the disclosure gap existed, even though such officer's unwillingness or inability to correct the disclosure gap could have had the effect of locking him in to his investment.

Other sections of the report analyze in depth the areas in with the Penn Central disclosure gap existed, and the widening of that gap with the passage of time and the decline of the company. This section, which examines the timing and extent of officers' sales, the reasons given for them, and the position of the officers in the corporate structure, is intended to be read in conjunction with the full report in determining whether any officer trading was done on the basis of material inside information.[39] The reader's attention is also called to the chronology of events which accompanies the disclosure report, and which should also used to shed light on the possible culpability of various officers for their sales. Finally, even though very difficult to assess, the existence of rumors should not be discounted. Considering the broad and fundamental nature of the problems facing Penn Central, their impact may well have been widespread and significant.

During the course of this investigation, the trading of over 80 officers and directors was reviewed, including officers and directors who left prior to the bankruptcy and/or joined the company post merger. A large amount of documents of such trading and the reasons for it were submitted and reviewed, and in certain cases outside confirmations of various events were obtained. Any major trading which occurred after the merger was questioned in testimony or through the use of affidavits. The staff found that virtually no outside directors,

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[37] The 15 officers whose trading is summarized in this report held, at the time of the bankruptcy or of their departure from the company prior to bankruptcy, only about [illegible]0 percent of the total amount of Penn Central stock they had owned at the time of the merger. (This figure excludes thrift plan distributions).

[38] The term "officer" in this report means anyone with the title of president, vice president, treasurer, secretary, comptroller of Penn Central Transportation Co. or of Penn Central Co.

[39] Although the news coming out of the company was, in retrospect, optimistic to the point of absurdity it was, even in its watered-down form, mostly bearish. Some officers' trading occurred at times when specific items of bad news were known within the company, but had not reached the public in any form, such as, for example, earnings reports. Where there appears to be a connection between an officer's sale and such specific information, it is discussed below as part of the summary of the officer's trading.

most of whom owned only minimal amounts of Penn Central stock, had made significant sales for their own accounts during the post-merger period.[40]

The investigation revealed that, although the trading carried on by many officers raised few questions concerning its propriety under the securities laws, the conduct of a significant number of officers demanded serious consideration in this regard. The staff has selected from these questionable trades those which appear to raise the most serious questions under the securities laws, and has summarized them in this report.

Many factors complicated this retrospective study.[41] The price of Penn Central stock slid ineluctably from a high of 86½ in July 1968, to a low of 10 in June 1970, just prior to the June 21 reorganization announcement. The 2-year performance of the stock makes it very possible that some officer sales were legitimately made simply on the basis of public adverse information. On the other hand, it must be remembered that there were many investors not bailing out during this period. Indeed the optimism or thoughtlessness of a number of major outside investors found them with large amounts of Penn Central stock in the spring of 1970, the sales of which are dealt with in the previous section of this report.

Apart from insider trading questions, it should be noted that the extent of the bail-out by officers during the steady price decline of the stock is somewhat inconsistent with the concepts underlying the option system, whose supposed purpose of generating and rewarding corporate loyalty was lost in the shuffle as officers bailed out of Penn Central stock to protect their investments and realize their paper profits. Over the years, some Penn Central officers had built fortunes based on the company's large option grants.[42] Although the officers had been allowed to profit from these grants on the theory that they, as key employees, were contributing to the betterment of the company, including the rise in price of the company's stock, many of them felt no compunction against bailing out in the down market, thus providing themselves with extra compensation due to the company's good fortunes and evading penalization for any adverse happenings.

Further, the staff found that certain banks (some with Penn Central connections) had made a number of large, long-term, unsecured loans to high Penn Central officials, mostly in connection with their exercise of Penn Central stock options, and mostly at the very favorable terms of one-half to 1 percent above the prime rate. Even though these were unsecured loans, many Penn Central officers appeared to

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[40] This section is limited to examining officers' and directors' personal holdings of Penn Central common stock.

Sales by directors were as follows:

1. William L. Day* sold 450 of his 1,000 shares in 1968 and 1969, but purchased 450 shares in Nov. 1969, leaving him with the same balance of 1,000 shares at his resignation from the board on June 21, 1970, as at the time of the merger.

2. R. W. Graham* sold 3,568 of 83,708 shares owned by him in Nov. 1969, repurchasing 3,860 shares in March 1970. Graham maintained his investment in this large amount of Penn Central stock until after the bankruptcy.

3. Edward J. Hanley,* who owned 200 shares during this period, reported that his wife sold 300 of 800 shares which she owned in Dec. 1969. Hanley, who was the chairman of the Conflict of Interest Committee, stated through his attorneys that the 300 shares had been sold "in order to establish a tax loss to off-set taxable gain on other securities which Mr. Hanley had sold."

*Day and Graham, directors of Penn Central Transportation Co., were both elected to the board of Penn Central Co., on June 18, 1970. Hanley was on the board of Penn Central from its formation.

[41] Not the least of these complications was that in October, 1969, when the Penn Central Co. was formed, the Penn Central Transportation Co. became a wholly owned subsidiary, and only vice presidents of Penn Central Co. reported their purchases and sales to the Commission under section 16 of the 1934 act.

[42] Although, prior to the merger, the New York Central had also had a generous option plan, Penn Cen- [illegible] including options, was far more extensive.

have irrevocably associated them with their stock purchases, using the proceeds from Penn Central stock sales to pay off the loans. Obviously, the presence of these loans, which enabled officers, with no cash outlay of their own and at the most favorable terms possible, to benefit from a price rise in Penn Central stock, also acted to encourage officers to sell in a down market to protect their investments.

A stunning example of such a bail-out is that conducted by David Bevan, who was at the vortex of Penn Central's machinations, and who sold 15,000 shares of Penn Central stock in the first half of 1969 at prices ranging between $50 and $66, paying off a $650,000 stock option loan and managing to keep his personal fortune virtually intact. In contrast to this was the trading, or lack thereof, of Stuart Saunders, who has made no sales since 1967, even though his 45,000-share block of stock represented almost his whole fortune, and large loans he had made to purchase the stock remian outstanding. Of course, Saunders was virtually locked in to his no-sale position both because of the potential liability which his insider knowledge would have caused for him, and the possible harm to the fortunes of the company which such a vote of no-confidence by him could have engendered.[43]

The heaviest concentrations of officer selling occurred in June and July 1969, a time when the accumulation of Penn Central's major problems in the areas of operations, earnings, and finance culminated with a discussion at the June 25 meeting of the board of directors as to whether Penn Central should withhold its time-honored quarterly dividend from its shareholders.[44] Between June and July 1969, Bevan chose to make the last sale (2,300 shares) of his program of sales which halved his ownership of Penn Central stock; three other officers sold over 50 percent of their holdings—Roberts (2,000 shares), Haslett (3,000 shares), and Smucker (3,600 shares); and two more officers virtually liquidated their Penn Central investment—Flannery (236 shares—100 percent) and Knight (3,950 of 3,957 shares). The circumstances surrounding these sales, including each officer's reasons for them, are discussed below as part of the summary of each officer's trading.

All officers who were questioned denied that any of their sales had been made on the basis of material inside information. It appears that few officers were concerned that the public might be deluded about corporate affairs, and that the possibility that there might be inadequate disclosure had figured very little, or not at all, in their trading. Thus could a high fincancial officer try to explain his sale in February 1970, by stating blandly that he had merely waited until after the 1969 financial figures had been disseminated.[45]

Many of the explanations most commonly given by officers concerning their postmerger trading in Penn Central stock appear, under examination, to lack the sense of urgency reasonably required to cause an officer to make a forced sale. The most obvious example of this was the claim that some sales were made to pay off loans, when in fact the idea to pay off the loan had originated with the officer, and not the bank, or when the officer made a choice to sell Penn Central

[43] It is interesting to note, however, that neither of these reasons stopped Bevan. (See below for a full discussion of Bevan's sales).

[44] This discussion concerned the third quarter of 1969 dividend, which was ultimately declared. The fourth quarter dividend was the first one not declared.

stock over other liquid assets. Likewise, the claims of some officers that they sold because they sought to diversify their assets, either for general purposes or in contemplation of retirement, lose credence when the officer is at a loss to explain how his interest in diversification happened to come to him at a specific time, particularly when such officer's financial situation and dependence on Penn Central stock had remained stable for a number of years preceding his sale. Trading based on a well-established window pattern of purchases and sales does serve to show a lessened reliance on inside information, although it cannot be assumed that such patterns excuse all insider sales.

The company and the board of directors had seen to it that all officers had been clearly informed of the prohibitions against insider trading. In October 1969 a "Penn Central Manual on Insider Securities Trading" was widely circulated at and below the top management level, and in December 1968, and March 1970, memoranda sent out discussing the company's disclosure policy emphasized the duty of insiders to refrain from trading prior to full public disclosure of important corporate news.

Penn Central did a very poor job of watching over the trading of its officers. Saunders claimed that he had turned over all corporate responsibilities in this area to the Conflict of Interest Committee when it was formed in 1968. The Conflicts Committee considered that it had discharged its duties in this area with the publication of various reports, memoranda and manuals prepared by the law firm it had hired.[46] Although the 1969 Insider Trading Manual and the 1970 disclosure memo refer to procedures to be carried out through the office of general counsel in connection with undisclosed material information, no one, including the Conflicts Committee, the president and office of general counsel, paid the slightest attention to implementing the proposed procedures.

Over the years, many officers had been in the habit of consulting D. L. Wilson of the office of general counsel concerning the propriety of their trading under the short-swing trading prohibitions of the 1934 act. As the company drew closer to bankruptcy, a few prospective traders also broached the subject of insider trading. Without, apparently, a deep analysis of the subject, Wilson raised no major objections to these sales, with the exception of discussions he held with Saunders concerning the possibility of his selling at this time.

The secretary's office, under the direction of Secretary Bayard Roberts, prepared and relayed to the Commission the form 4 reports of officer and director trading. According to Roberts, preparation of these reports was a purely bookkeeping function, and the reports were not subjected to any sort of review. When Penn Central Transportation Co. officers stopped filing form 4 reports in October 1969, no one at any level of the company had any thoughts concerning monitoring

[46] The 1969 manual and the 1970 memo had been prepared by an outside law firm at the direction of the Conflict of Interest Committee. Although sent out with the knowledge of this committee, the 1968 memo had been prepared by the legal department at Saunders' instigation. The Conflict of Interest Committee, which had been set up in September 1968, sent, in early 1969, an extensive questionnaire to officers and directors of the company and its subsidiaries seeking information concerning officers' trading and possible conflicts of interest. The committee's report on the questionnaires noted that officers had made substantial sales in 1968, but found no evidence of improper motives. The questionnaires also uncovered some potential short-swing trading violations which were referred to the company for action. The committee delved no further into the subject of officers' trading in general following the questionnaires, and although it did entertain the idea of urging that further questionnaires be sent out on a periodic basis, this suggestion was shelved within the committee and had not been acted on by the time of the bankruptcy.

the further trading of even those officers whose trading was no longer the subject of public scrutiny.[47]

One caveat must be given concerning the individual trading reports: Although the numbers have been checked and rechecked for accuracy, many times the purchases and sales discussed will not balance out to the numbers given. This is because, for reasons of clarity, only major transactions have been signaled. Gifts and charitable donations have, in general, been omitted.[48] Most officers were members of Penn Central's thrift plan, contributing up to 5 percent of their income to make regular purchases of stock at half-price. The major distribution of these shares came after bankruptcy (or after prebankruptcy retirement), but some small distributions were made on an annual basis and have been figured into an officer's total holdings, although not recorded as separate purchases.

OFFICERS—FINANCE

The finance department, run very much as a separate entity by David Bevan, dealt on a daily basis with the company's problems in obtaining cash and the enormous demands for cash made by the subsidiaries as well as the parent company.

It should be noted that the sales of the four men discussed in this section, all top finance department officers, pursue a remarkably similar pattern in that each of the four stated that his sales had been made to pay off bank loans whose need to be paid off at the time was questionable, to say the least. Three of these officers, Bevan, Gerstnecker, and Haslett, who all took part in the Penphil venture, all made their major sales during the beginning of 1969.

DAVID C. BEVAN

	Purchases	Sales	Balance
Feb. 1, 1968			30,404
Mar. 11, 1968	3,600		33,904
Jan. 6, 1969		3,000	30,718
Mar. 11, 1969		3,000	27,546
Apr. 9, 1969		3,000	24,546
May 6, 1969		3,000	21,546
May 27, 1969		700	20,846
June 25, 1969		2,300	18,546
June 19, 1970		4,900	13,246
June 24, 1970		5,100	8,146
July 3, 1970		8,146	

There is no doubt that David Bevan was the key financial officer at Penn Central, responsible for initiating or effecting all financial machinations of the postmerger period. He held the title of chairman of the finance committee throughout this period, and also served on the board of directors except for the period between February 1968 and the fall of 1969. He was one of the three top officers abruptly severed from the company following the dramatic June 8, 1970 meeting of the board of directors.

[47] In October 1969, Saunders asked Cole for a list of officers' stock sales. Cole had the secretary's office prepare the list, and forwarded it to Saunders. When shown a copy of the list, Cole, Roberts, and Saunders all claimed they had forgotten about it, and could not remember why Saunders had asked for it or what he did with it.

[48] Family gifts which remained under the control of the donating officer are counted as part of his Penn Central holdings.

Bevan liquidated his substantial holdings of Penn Central stock in two separate series of transactions. The first occurred between December 1968 and June 1969 when he ceased his program of buying Penn Central shares and sold almost half his holdings of Penn Central stock.[49] The final sell-out occurred between June and August 1970. Between 1964 and 1968, Bevan had acquired a sizable amount of shares by exercising options at 21 and 24½.

By the end of 1968, he had acquired 34,400 shares of stock pursuant to these options, and he had outstanding with Mellon National Bank and Trust Co. an unsecured loan in excess of $650,000 which he had used to purchase these shares. Between January and June 1969 Bevan sold 15,000 shares of Penn Central stock in six separate transactions.[50] The explanation that Bevan presented concerning the 1969 sales was that he had liquidated his $650,000 loan at the insistence of Mellon Bank, and that in any case he had planned as early as 1965 to sell Penn Central stock to liquidate his outstanding loans by 1970. As complete evidence of this, Bevan pointed to a December 1968 letter from Spencer R. Hackett, Mellon Bank vice-president, suggesting that Bevan consider making gradual periodic reductions on his loan, and Bevan's January response agreeing with the suggestion.[51] Bevan claimed that in 1965 he had notified both the Mellon Bank and the Chemical Bank that he intended to pay off his loans within 5 years from the sale of Penn Central stock.[52]

Whatever Bevan's reasons for the 1969 sales, they were not caused by any pressure from Mellon Bank. According to Hackett's sworn statement, Bevan called Hackett in December, 1968, to ask for the letter from Mellon Bank requesting a pay-down. The only reason Hackett wrote the December, 1968, letter was to comply with this request; prior to Bevan's phone call, Hackett had had no thought of asking Bevan to reduce the loan.[53] Bevan, however, denied categorically under oath that he had initiated the Mellon pay-down request.[54]

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[49] Bevan left unexercised 3,600 option shares available to him at 24½.

[50] A reasonable guess as to why Bevan held on to the balance of his stock would be that Bevan, as chief financial officer of the company, was reluctant to make such a public show of no-confidence in the company, since he reported his stock transactions to the Commission on form 4's. It also appears that the company was very conscious of sales by officers and directors during this period. In its April 1970 proxy statement it listed, as required by proxy rules, sales of option shares made between 1965 and 1970 by Saunders (4,000) Perlman (9,200), Bevan (16,000) and eight other officers (29,411). Then it added a footnote to this breakdown which stated: "The sales by Messrs. Saunders and Perlman were made prior to February 1, 1968, the effective date of the Pennsylvania New York Central merger. Prior to the same date, Mr. Bevan sold 1,000 shares and other officers as a group sold 17,752 shares."

[51] Bevan's letter to Hackett, dated January 8, 1969, reads in part, as follows: Thank you very much for your letter of December 24, and I understand perfectly the spirit in which it was written. You are quite right that my loan has been on the books for quite a period of time. Do not feel guilty about this. As I explained to you and John Mayer, I do not think anyone in top management should be a quick-buck artist. There is a limit to everything and the bank has been very good to me.

Your letter also made me stop and reassess my whole position. I have been so busy that I had not really stopped and considered what I had in the way of stock options. In December, I completed earning an additional 3,600 and on February 1 I will have earned an additional 10,000 and as of February 1, 1970, there will be another 10,000 for a total of 23,600 shares that has to be financed. Therefore, I agree with you that it behooves me to gradually reduce my outstanding loan.

[52] A letter to Chemical Bank indicating this was submitted as an exhibit. No such letter to Mellon Bank has been located.

[53] Hackett stated that Bevan gave no reason for the request, and Hackett did not ask for one, as "I did not consider this my affair or that of the Bank." In a further letter, dated January 9, 1969, Hackett took pains to assure Bevan that he was prepared to authorize further loans on his behalf.

[54] Q. Did you ask Mr. Hackett to write the letter to you?

A. No.

Mr. GERMAN (attorney for Bevan). I didn't hear the question.

Q. The question was, Did you ask Mr. Hackett to write the letter to you?

A. No. I don't like the implication. The answer is no.

Q. Do you remember making a phone call to Mr. Hackett at any time in December of 1968 concerning your personal loan?

A. Concerning my personal loan, no.

Q. Information has been given to us that such a phone call was made and such a request was made. Do you remember anything about a phone call of that kind?

A. No. I don't recall any unless you indicated before maybe he said he was writing such a letter or that I should do it. He may have warned me that it was coming or something of that sort, but my answer still

The proceeds of Bevan's 1969 sales came to about $835,000, most of which was used in liquidating the Mellon loan (which exceeded $661,000 in December, 1968) and to reduce the Chemical loan by about $114,000, leaving an outstanding loan balance at Chemical of about $16,000.[55] Both of these loans had been outstanding in significant amounts since 1965.[56] Bevan's considerable reduction of his debts during this period appears, however, not to have been the cause of his 1969 sales, but simply the end result of a decision he made independently that the first half of 1969 was a propitious time to reduce his substantial financial reliance on Penn Central stock.[57]

Bevan made no further sales of Penn Central stock until after his June 8, 1970, dismissal. Between June and August 1970, Bevan sold all of his remaining shares of Penn Central stock, including 3,370 shares from the thrift plan which were distributed to him on August 3, 1970. His first sale was made on June 19, 1970, the last trading day prior to the Penn Central bankruptcy. On this day, pursuant to an order entered with his broker at Yarnall, Biddle & Co., on June 18, Bevan sold 4,900 shares at 11½ in a limit order transaction.[58] On June 24, Bevan's broker entered and executed a further limit order to sell 5,100 shares at 8.[59] At that time, Bevan still maintained his office at company headquarters "trying to get things straightened out for the railroad. * * *" He had decided on June 8, the day of his dismissal by the board of directors, to sell all of his Penn Central shares.[60]

stands that I would have no recollection of it. I did say he may have called me to tell me it was coming or called me afterwards and expressed a hope that it didn't annoy me or anything, but I haven't any recollection of it.

Q. Are you certain then that you yourself did not initiate a call to Mr. Hackett in connection with your loan?

A. I have no recollection of it. If anything had happened, if there was such a phone call, he may have called me, and I may have said, well, then put it in writing.

Q. No; but I am asking you if you are reasonably certain that you never initiated any such call?

A. I am as certain as I can be.

Q. So I take it that means that you are virtually certain?

A. I am virtually certain.

Q. So that you did not about that time initiate a call to Mr. Hackett or to anybody else at the Mellon Bank indicating to them that you would like them to write you a letter requesting that the loan be reduced?

A. I can't even—well, a bank of the quality and character of Mellon, they wouldn't connive with anybody anyway. I don't understand it really at all. This ties in with the whole record. It does tie in completely. I don't recall, but the most I could say is that if they asked me verbally to do it I may have asked them to put it in writing, but I don't recall that.

Now, I may have called Hackett to say, "Merry Christmas." I call a lot of our banks. It is a matter of custom, where we had relations, and maybe he brought it up at that time, I don't know. I don't recall. I am trying to reconcile with you, but, no, this would be always true when Pixley was there. I didn't know Hackett as well. Either he would call me or I would call him either before Christmas or New Years just as a matter of courtesy between us, and that happened with a whole number of banks.

Q. But it is your testimony that at this time late in 1968 the suggestion that you did not suggest in any was——

A. I didn't initiate reduction of the loan.

[55] Bevan claimed the proceeds were used to pay the Mellon Bank loan and capital gains taxes.

[56] During this time, Bevan had a third significant loan outstanding, with Provident National Bank, which was increased rather than paid down between 1968 and 1969.

[57] As of December, 1967 Penn Central stock, at its market value at the time, comprised about two-thirds of Bevan's total assets. By the end of 1969, Penn Central stock, selling at less than half of its 1967 price, equaled about one-fourth of his total assets. Bevan's net worth both in December, 1967, and December, 1969 hovered around $2 million.

[58] This was also the last day the thrift plan made its regular daily purchase. On this day Goldman, Sachs purchased 2,800 shares for the thrift plan at 11½, the market high of the day.

[59] On June 22 and 23, trading in Penn Central stock had been suspended, except for one large trade each day which took place at the closing bell.

[60] Q. When did you decide to sell at this time?

A. As fast as I thought that I was allowed to after June 8th.

Q. When did you reach that decision?

A. June 8. I wanted to make a complete severance.

Q. Can you tell us why you waited until June 18 to send in the first order, or why you decided on June 18 to send in the first order?

A. I suppose it was to allow a reasonable length of time after I got out. I think—I am not sure of this—I think that I waited until it was announced that the Government was going to make the guaratneed loan. I didn't know about whether it was going to be made or not when I left. I thought it was going to be made, but that might have been interpreted [as] insider information, but I wasn't sure. I was optimistic about it. I think I waited until they announced they were going to make it, and then it was changed when they reversed themselves. But that is again recollection.

WILLIAM R. GERSTNECKER

	Purchases	Sales	Balance
Feb. 1, 1968			6,206
Jan. 8, 1969		1,000	5,275
Jan. 9, 1969		1,000	4,275
Jan. 29, 1969		1,000	3,275
Jan. 30, 1969		1,000	2,275
May 26, 1969		1,000	1,275
Nov. 28, 1969	1,400		2,675

Gerstnecker was vice president—corporate (finance) from the time of the merger until August 1969 when he retired to become the vice chairman of Provident National Bank. In this capacity, he functioned primarily as right-hand man to Bevan and was privy to all information on the company's finance problems.

Gerstnecker owned 6,206 shares in February 1968, including 100 shares held in his wife's name. The bulk of these shares had been acquired through an option purchase in 1964, and though he had made some purchases and sales between 1964 and the time of the merger, he had maintained an ownership of between 4,700 and 6,900 shares during that period. In January 1969, Gerstnecker sold 4,000 shares in four 1,000-share transactions, and he sold an additional 1,000 shares in May 1969, leaving him with a balance of 1,275 shares. On November 28, 1969, he made his final option exercise, purchasing 1,400 Penn Central shares at 24½.

Gerstnecker determined at the end of 1968 to resign from Penn Central after July 1969, and go with the Provident National Bank. He testified that his four January sales were for the purpose of liquidating a large loan outstanding at Provident, so that it would not be outstanding when he moved over to Provident, and to purchase 1,000 shares of Provident stock. The Provident loan had been outstanding since March 1964, and totaled during most of that time approximately $155,000. Although Gerstnecker had made the sales in January, he did not pay off the loan immediately, but reduced it between February and July 1969. He purchased the 1,000 Provident shares in August 1969 at a price of $24,750. The price of these shares plus the loan total about $175,000. Even though this amount was less than the $272,000 proceeds of the January sales, Gerstnecker could not recall what uses he made of the balance of the proceeds. Gerstnecker claimed that his May 26 sale, which grossed $55,500, was to finance his planned final option exercise 6 months later, which in fact did take place just 6 months later, commanding a total purchase price of $34,300. Again, Gerstnecker could not recall the uses to which he put the balance of the proceeds.

After further questioning, Gerstnecker also stated that the January sales may have been made due to a desire for diversification of his assets, since he was contemplating changing jobs. He did not elaborate, however, on why a prospective job change would necessarily prompt such diversification. Neither could he point to any reason for having decided to make the sales in January—even after it was called to his attention that his claimed uses of the proceeds, paying off the loan and purchasing the Provident stock, occurred between February and August, Gerstnecker simply indicated that he decided to make the sales following his decision to join Provident.

Two other factors should be noted in connection with Gerstnecker's January sales. First, David Bevan began reducing his holdings in January 1969, and, although Gerstnecker disclaimed knowledge of these sales at the time they were being made, his position as Bevan's assistant makes the timing of these sales appear to be more than coincidental. Second, all of Gerstnecker's transactions were reported on form 4 as of the trade date, as required by form 4, with the exception of two trades, which were reported as of settlement date rather than trade date. These were the last two of his four January 1969 sales, in which he sold 1,000 shares each on January 29 and 30. On those 2 days the Penn Central market price peaked—the Penn Central market price had been rising for about 2 weeks—and Gerstnecker sold his shares at 71–71½. The next day, January 31, the market fell 2 points, and the price of the stock resumed its steady decline which had begun in the last half of 1968.[61] Although Gerstnecker claimed he did not remember directing the reporting of these trades as of settlement date, it is clear that it was a conscious departure from his reporting practice,[62] and his representation to the Commission that the trades occurred on February 5 and 6 rather than at the end of January also made it appear in the published trading summary that his trading had taken place after the publication of Penn Central's financial report.

ROBERT HASLETT

Purchases	Sales	Balance
Feb. 1, 1968		5,425
July 15, 1969	3,000	2,402

From the time of the merger until after the bankruptcy, Haslett served as vice president—investments of Penn Central. As such he reported directly to and worked closely with David Bevan. Haslett owned 5,425 shares at the time of the merger. Five thousand of these shares had been purchased pursuant to options in 1964 and 1967; the balance was acquired from the thrift plan.

Haslett had made no sales of Penn Central stock since he began acquiring it in 1964. On July 15, 1969, he made his only prebankruptcy sale, selling 3,000 shares, and thereby reducing his Penn Central holdings to 2,402 shares. Haslett had no other transactions in Penn Central stock prior to the bankruptcy, and he allowed the substantial number of options at 24½ which had been available to him since December 1967 to expire.

When Haslett had exercised his options in 1964 and 1967, he had taken out unsecured loans for the full amount of the exercise price from Girard Bank, amounting to $63,000 in 1964, and $50,000 in 1967. From 1964 on, Haslett consistently maintained the loan at its original balance, and paid only the interest as it became due in quarterly installments. The balance of $113,000, therefore, was

[61] The market rise had been in response to Saunders' January 10 announcement of the proposed formation of the holding company. On January 30 Penn Central published preliminary figures for 1968, which, although registering an increase on a consolidated basis, indicated that the parent company had lost $2 million, down from a profit of $11 million in 1967.

[62] Gerstnecker's secretary apparently coordinated the filing of Gerstnecker's reports with the secretary's office at Penn Central. (Gerstnecker, of course, signed the form 4's which were submitted to the Commission). The documents submitted by Gerstnecker in connection with his trading contain a copy of the letter transmitting the certificate for the 2,000 shares to his broker. Handwritten on the bottom of this copy, in what appears to be his secretary's writing, is the notation. "Use settlement dates Feb. 5 and 6 in report

maintained from December 1967, until July 1969, when Haslett paid off the loan in full. Haslett stated that his July 1969 sale of 3,000 Penn Central shares, which grossed him about $130,000, was for the purpose of paying off the $113,000 loan, which was in fact paid off July 23.[63] The bank had not requested that the loan be paid off or reduced, and Haslett could not pinpoint why he chose July 15, 1969, as the time to sell stock to pay off a loan which had been outstanding, in part, since 1964: "I sold the stock because it was acting poorly. I had a large bank loan, and I sold enough stock to pay off my bank loan, and sold no more stock, kept the balance."

JONATHAN O'HERRON

	Purchases	Sales	Balance
Feb. 1, 1968			5,833
Apr. 23, 1968		100	5,733
Apr. 26, 1968		1,000	4,733
Apr. 29, 1968		1,000	3,733
May 27, 1968	1,842		5,575
Nov. 7, 1968		2,000	3,575
Nov. 8, 1968		1,000	2,575
Feb. 9, 1970		500	2,075

O'Herron, who had worked for Penn Central's Buckeye subsidiary for a number of years before he was brought to Penn Central to be groomed as Bevan's successor, became Penn Central's vice-president—finance in September 1969, following a 2-month stint in charge of accounting. He replaced Bevan upon his departure in June 1970. At the time he joined Penn Central in July 1969, O'Herron reported an ownership in Penn Central stock of 2,575 shares (including shares held in the names of his wife and children). Prior to joining Penn Central he had received, through his employment at Buckeye, Penn Central option grants of about 9,000 shares, all of which had been exercised and most of which had been sold by 1968. After joining Penn Central O'Herron's only sale prior to bankruptcy was the sale of 500 shares on February 9, 1970.

O'Herron stated that he made this sale, which grossed about $13,000, to liquidate an outstanding (unsecured) bank loan of $12,000 which he had taken out for income tax purposes in April 1969, and which he had told the banker granting it that he would liquidate prior to the end of 1969. Although at the time of the sale O'Herron had a number of other equity securities he could have sold to obtain funds for the loan, O'Herron could only answer, when asked why it was Penn Central stock he chose to see, that it had stopped paying dividends. O'Herron stated that the February sale was purposely timed to follow the dissemination of the 1969 preliminary financial figures by a number of days. By February 1970, O'Herron was deeply involved in the preparation of both United States and foreign public offerings, and he was taking part in the negotiations for private Swiss franc financings and for stand-by bank loans to tide Penn Central over prior to the $100 million Pennco offering. On February 5, 1970, a few days before his sale, he had been informed by a representative of Goldman, Sachs that they would no longer "roll-over" the Penn Central commercial paper as it became due.

[63] From about 1964 to 1970 Haslett had another, secured, loan outstanding at Girard Bank in the amount of $35,000.

OFFICERS—REAL ESTATE AND TAXES

Both of the officers discussed in this section are tax specialists, although one looked after the postmerger real estate transactions and one for a time was also titular head of the accounting department. Both of them attended the budget committee meetings, Saunders' monthly policy meetings.

S. H. HELLENBRAND

	Purchases	Sales	Balance
Feb. 1, 1968			2,844
Feb. 14, 1968	1,023		3,867
Sept. 3, 1968		1,000	2,867
Sept. 4, 1968		1,000	1,867
Sept. 5, 1968		500	1,367
Sept. 16, 1968		700	667
Sept. 17, 1968		300	367

Originally a New York Central officer, Hellenbrand became a Penn Central vice president, taking charge of industrial development and real estate following the merger. In March 1970, with the retirement of T. K. Warner, Hellenbrand also headed the tax department. In February 1968, following the exercise of all available options, Hellenbrand owned 3,867 Penn Central shares. In September 1968, Hellenbrand sold 3,500 shares, reducing his holdings to only 367 shares. Although further options became available to him at attractive prices at the end of 1968, Hellenbrand effected no further Penn Central stock transactions, aside from his thrift plan participation, until after the bankruptcy.

Hellenbrand claimed that his buying and selling followed no specifically laid out program, even though in 1965 and 1966 he had exercised options and 6 months later each time sold at least as many shares as he had acquired. In his testimony, Hellenbrand could point to no specific reasons for his 1968 sales:

> As I said, I recall among the reasons was a desire to pay down the loan which I had outstanding in the bank, and of all the reasons which go into the operation of the human mind to buy or sell something * * *. I do not know that there was anything more specific than the conclusion that I felt it was a wise thing for me to do at the time.[64]

It is likely that Hellenbrand knew at the time of his 1968 sales of the dubious tax-oriented transactions management was then planning for the Great Southwest-Macco subsidiaries to conceal the disastrous condition of the railroad. Hellenbrand also was aware at that time that the so-called Park Avenue properties were not, as they had been advertised to be, a liquid investment which the railroad could sell for cash, due to the formidable obstacles raised by heavy mortgages and minority interests.

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[64] The loans to which Hellenbrand referred were loans obtained in connection with the exercise of the stock options. In September 1968 however, Hellenbrand had only $33,000 outstanding on his loans, while the proceeds from his September sales equaled $228,000.

T. K. WARNER, JR.

	Purchases	Sales	Balance
Feb. 1, 1968			4,888
Mar. 20, 1968		100	4,788
Mar. 25, 1968		100	4,688
Mar. 29, 1968		100	4,588
Apr. 2, 1968		500	4,088
Apr. 5, 1968		300	3,788
May 9, 1968		200	3,588
May 21, 1968		200	3,388
July 9, 1968		100	3,288
Mar. 6, 1969	1,200		4,480
Sept. 8, 1969		2,000	2,380
Sept. 11, 1969		2,000	380
Dec. 19, 1969		100	240
June 12, 1970		200	96

From the time of the merger until July 1969, Warner served as vice president in charge of tax matters (from November 1968 to July 1969 his title was vice president—accounting and taxes). In this capacity he functioned independently of the finance department.[65] In July 1969 when Jonathan O'Herron was brought in, the accounting department was moved from the control of Warner and given to O'Herron. At that time Warner was made vice president—corporate administration, and he kept this title until his official retirement in May 1970. Warner looked upon this job change as being kicked upstairs to make room for O'Herron and as early as June 1969, he began to consider retirement.[66] Nonetheless, between July 1969 and his retirement in May 1970, Warner was in charge of the department of corporate analysis and cost and profit analysis as well as taxes.

Between 1964 and 1969, Warner had made purchases and sales of significant amounts of shares each year (in 1967 and 1968, he sold a significant number of shares but made no purchases). From 1965 on, however, the amount of shares he owned was never less than 3,000 shares. On March 6, 1969, he made his final option exercise, purchasing 1,200 shares at $24.50 per share. At this time he borrowed $50,000 from a bank, using $29,400 of the borrowed money to exercise his option. Following the exercise of this option, he owned 4,480 shares. On September 8 and 11, 1969 he sold 2,000 shares of stock each day, and and on December 19, 1969, he sold an additional 100 shares. These sales, along with gifts he made during 1969, reduced his ownership to to a total of 240 shares at the end of 1969.

On May 1, 1970, Warner officially retired from the company. It should be noted, however, that he sold 200 of the 296 shares he owned at the time of his retirement on June 12, 1970, just prior to the bankruptcy.

Warner's reasons for the 4,000 share sale he made in September 1969 were very unclear. First he mentioned that by selling in September, he would have been able (under the 6-month rule) to buy further option shares in March.[67] The only options available to Warner

[65] He was, however, close enough to Bevan to be the only nonfinance officer chosen to participate in the Penphil venture.

[66] Warner claimed that the reason his retirement was delayed some months was that Saunders had asked him to remain.

[67] Warner's testimony reads as follows:

"There were several factors, one of which is that under the stock option plan, when you terminate service you can continue to exercise your stock option for 3 months thereafter. I had also already planned to leave, therefore, when the 6 months expired on the 1969 exercise, sometime in February, by selling in September I can buy 6 months later.

"I was then planning to leave December 31, so I could purchase stock through March 31 under the terms of the plan."

were at 57⅜, and by September 1969, Penn Central had sold down below 41. Reminded of this, and asked if he had expected the stock to have climbed above 57⅜ by March, Warner stated that diversification in anticipation of retirement [68] rather than a prospective option purchase had been the major reason for his sales.[69] According to his recollection, Penn Central stock represented over 25 percent of his investment portfolio in 1969. Warner did not elaborate on why he chose to diversify by virtually eliminating Penn Central stock from his investment portfolio nor did he indicate why he decided to pursue this diversification policy in September 1969. Warner invested the proceeds of the sales in other securities.

Warner's involvement in tax matters exposed him to much of the covered-over activities of the Great Southwest-Macco group. By late 1969, he was deeply involved in the program of maximizing earnings through tax aspects and through exploration of the subsidiaries for possible opportunities to bring up earnings to the parent company. Indeed, at the very time he was selling on September 9 and 11, 1969, he was involved in a tax accounting change for Macco that would increase Macco's 1968 earnings. Warner knew that such actions were important to continuing the Macco-Great Southwest facade for the public offering of Great Southwest stock then being readied.[70] In a followup of earlier discussions Warner wrote to Saunders on September 10, 1969:

> This relates to the 1968 tax elections of the Macco group which will be included in the Penn Central consolidated Federal income tax return which must be filed on Monday, September 15. Last evening I was informed by Peat Marwick & Mitchell (Philadelphia) that the Macco people were sending us tax return material for their group in which they were increasing taxable income from $1 million to $27 million. We have not yet received the Macco papers, but a letter on a related subject confirms the P.M. & M. statement. The public accountants report that the new elections will result in a change in Macco's (but not our consolidated) book net income eliminating $13 million of deferred taxes and increasing its book net income by that $13 million. This is important in preparing the SEC financial statements for the sale of Great Southwest stock.

The next day (on which Warner was selling a second 2,000 shares) Warner met with others to review the matter. Bevan reported to Saunders in a memo on that day:

> Messrs. Warner, Hill, Wilson and myself met this afternoon and are unanimously of the opinion that we should go along with the Macco management's recommendation. This will add almost 50 cents a share to the reported earnings for last year, and merely on a basis of 10 times earnings will add $5 a share to the value of any stock sold, and if it goes to 20 times earnings it would add $10 a share. Our capital gains would be enhanced by this amount.

It should be noted the overwhelming portion of Macco's profit that year was in the Bryant Ranch transaction which produced little cash but obligated Macco to heavy expenditure commitments.

Officers—Operations and Labor

All of the top operating people dealt with Penn Central's major service problems, which peaked at the beginning of 1969. They also

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[68] At no time, however, had Warner planned to retire without seeking other employment, and by December 1969 he was discussing employment with a law firm.

[69] Q. Did you expect the price of the stock to go beyond $57 within the 6 months before your retirement, or up to your retirement, in the 3 months after?

A. I just never knew that much, understanding why stocks went up and down, so that I think one ought to try remain flexible. But I want to add, I am not sure that was any more than another straw. I wouldn't be surprised that my leaving was not the main thing.

[70] See Great Southwest section of this report.

experienced first-hand the crippling budget restrictions which the finance department placed on the operating departments beginning in mid-1969, and which magnified the operating problems which increased again during the 1969–70 winter.

With the exception of Messrs. Funkhouser and Sullivan, all of these operating officers attended the budget committee meetings, and must have been fully aware from those meetings of the company's "profit maximization" policies, and of the contrast between Saunders' private dissatisfaction with the company's performance and his soothing public pronouncements on the subject.[71] Further, dealing on a day-to-day basis with budget restrictions and endless pressure to produce more revenues brought home to these officers the realities of the company's cash lag, and of the workings of "profit maximization". Apart from company rumors, however, the operating people may have had only the same knowledge as the public concerning the dealings between Penn Central and its subsidiaries, since these nonrailroad activities were dealt with only in summary fashion at the budget committee meetings.

ROBERT G. FLANNERY

	Purchases	Sales	Balance
Feb. 1, 1968			511
June 12, 1968	325		836
Mar. 17, 1969		300	536
May 12, 1969		100	436
May 13, 1969		200	236
July 2, 1969		200	36
July 3, 1969		36	

A former New York Central officer, Flannery served as vice president—systems development from the time of the merger until February 1969, when he was named vice president—operations. He remained with the company until after the bankruptcy.

In June 1968, following a purchase of 325 option shares, Flannery owned 836 Penn Central shares.[72] In 1969, he totally liquidated his holdings in a series of five transactions between March and August. Named to replace Smucker due to the winter 1969 operating crisis, Flannery began liquidating his shares about 1 month after he took charge of the operations department. Flannery claimed the proceeds were used to purchase a house, on which he placed a down payment on April 19, 1969, and which was completed in 1970. According to Flannery's reckoning, he had invested a total of $143,000 in the house by the time it was completed, including a $65,000 mortgage, and also (it appears) approximately $47,000 in cash netted from the sale of his previous house. The total gross proceeds of Flannery's Penn Central sales, $44,000, would have more than made up the cash difference needed to reach $143,000, but Flannery claimed that, along with his Penn Central shares, he liquidated his stock holdings in other companies in May and September, 1969, to raise money for his house. Flannery did not sell his house in New York until August 1969. He claimed that

[71] It should be noted that after problems arising from possible leaks of information to the brokerage firm of Butcher & Sherrerd in mid-1968, Penn Central attempted to restrict the internal dissemination of financial information by sending the various officers only that information of particular interest to them prior to the budget meetings. However, the full scope of the information was discussed during the meeting and so the various officers would emerge with a fairly complete, general picture of what was occurring within the company.

[72] Under a New York Central stock purchase plan, Flannery had contracted to buy an additional 130 shares in 1967. As allowed by the contract provisions, however, Flannery rescinded the sale within a

at the time he committed himself to buy the house in Philadelphia, he did not know what price he would get for his New York property. He had paid $63,500 for the New York house "And was quite fortunate for selling same for $89,000 which was far more than I expected." Except for the first Penn Central sale in March 1969, the proceeds of which were used as the down payment on the house in April, Flannery was unable to relate the timing of any Penn Central sales to a specific need for cash:

> You also asked me to clarify my purchase of a house in Philadelphia as related to my savings account bank statement for the year 1969. You will note that on February 18, 1969, my account was down to $968.88. I sold 300 shares of Penn Central stock March 17, 1969, and deposited same in the account. A large part of this was withdrawn in April in order to make the downpayment on the purchase of my new home, copy of purchase agreement you have in your file. You are also aware of the fact that I had made quite a commitment in purchasing this home prior to disposing of my home in Hartsdale, N.Y. Also, the committed amount of $120,000-plus was just for the bare minimum of a house. As stated to you, I eventually ended up with $143,000 invested and the difference between the original commitment and the final amount was for drapes, carpeting, landscaping, and so on. In fact, we paid several contractors direct for the installation of better fixtures such as kitchen appliances, bathroom fixtures, electrical outlets, and so on, which was over and above the committed price to the contractor. With this commitment, you will note I also sold Penn Central stock in May and July and other stock in September in order that I could properly plan and know definitely how many commitments to make in further improving the house.

A. PAUL FUNKHOUSER

	Purchases	Sales	Balance
Feb. 1, 1968			5,001
June 24, 1968		1,900	3,101
Dec. 26, 1968	1,900		5,001
Jan. 26, 1970		100	4,949
May 27, 1970		4,500	504

Funkhouser was a close associate of Saunders, having worked for him at Norfolk & Western. From the time of the merger until March 1970, he was vice president in charge of coal and ore traffic. In March 1970, in response to the gravity of Penn Central's passenger service problems, he was made senior vice president—passenger service.

Funkhouser's last option exercise was in December 1968, giving him ownership at that time of a total of 4,900 shares, all acquired through options, plus 101 shares held by his family. Prior to the merger, Funkhouser had acquired his stockholdings between 1964 and 1968 by exercising options using borrowed funds, and selling a portion of the purchased shares after 6 months to pay off the loan. The December 1968, purchase was not made with loaned funds, and it marked the beginning of a holding period unbroken until 1970. On January 26, 1970, there was a sale of 100 shares he had given to his wife in 1967. On May 27, 1970, Funkhouser sold 4,500 shares, representing the major portion of his Penn Central holdings.

Funkhouser testified that the January 1970 sale of 100 shares was pursuant to his wife's decision to sell since she did not want to hold the stock because they passed the dividend. The public announcement that the fourth quarter dividend would not be declared had been made in November 1969. Funkhouser could not recall why she did not reach this decision until January.

The May 27 trade had its origin in an April 28, 1970, limit order to sell 4,000 shares at 20¼ which Funkhouser changed on the morning of May 27 to a market order to sell 4,500 shares. Funkhouser explained that he decided to sell his shares after the April 22 publication of Penn Central's first quarter earnings, which made him decide that the company would not be able to resume paying dividends in the foreseeable future. Based on this decision, he placed his 20¼ limit order on April 28, anticipating that the market in Penn Central stock (which had closed at 17⅞ on April 27) would recover sufficiently to allow execution of the order. The limit of 20¼ had been chosen because Funkhouser had arbitrarily set himself the goal at that time of realizing $80,000 in liquidating his Penn Central investment. The price of the stock did not recover, however, and Funkhouser explained his decision to change his order to a sale of 4,500 shares at market as follows:

> * * * there was an announcement on May 15 that the credit rating of the Pennsylvania Co. had been downgraded. And I determined that the stock, after that, probably wouldn't get back up into the 20's—and I executed a market order on May 27. Now my reason for selling was basically because I wanted some return on my investment. I did not not know the company was going bankrupt nor did I—and I full[y] expected it to be turned around at that time. But I knew that we were having tremendous earnings problems—that is, in brief, my reason for selling.

Funkhouser decided to sell his shares at market on the afternoon of May 26. That afternoon he consulted both Wilson and Roberts concerning his proposed trade, specifically asking each one if he knew of any inside information why I should not sell my shares. Both men told him that they knew of no reason why such a sale should not be made. Funkhouser entered the market order the next morning, prior to the opening of exchange trading.

Funkhouser claimed that by 1969 he was counting on the substantial cash dividends which his sizable Penn Central holdings had been yielding.[73]

When he sold, he deposited the proceeds in a savings bank until August, when he reinvested the money in bonds:

Q. The question is, "When you made the sale in May, did you do it with any specific investment in mind, or was it simply because you were dissatisfied with the Penn Central's dividend policy at this point?"

A. I did not sell with any specific investment in mind. My motivating force was to obtain some return on that investment. Normally I would have invested probably in some security soon after that on the advice of my wife, but I don't know particularly why I didn't; but we went into reorganization and I had the money in savings. I

[73] At that time, these shares represented about one-third of his equity investments, the other two-thirds of which had been chosen for appreciation rather than dividend return:

Q. Did you contemplate, when you discovered that this investment was not going to bring in dividends, making any changes in any of the other investments which you were holding which were not bringing in dividends so that that money would give you a return on your money?

A. I don't recall doing that. The securities other than my Norfolk & Western for the most part were being handled by Bonsal White, and it was, for the most part, an effort to seek appreciation rather than income. And I had at that time, I think, substantial gains which, had I sold, would have resulted in considerable tax, although I suppose it could have been offset against the Penn Central loss. But these secutities were under—well, as a matter of fact I think I did take some gains that offset that loss. In hindsight I may have made some changes.

But I would say this to you: The securities that Bonsal White was handling for me, the goals were more appreciation than income. And I don't recall selling those stocks to seek more income. If I did sell—and I think I may have sold some—it would have been to offset by taking the loss, and probably they went back into the area of seeking appreciation under his guidance.

Q. Well would you say then that you did not have appreciation in mind when you invested in Penn Central stock?

A. I did not have appreciation in mind?

Q. Well did you, or did you not?

A. Yes; I would say that appreciation was a factor. I was hoping to acquire as much of the stock as

was drawing interest on the savings account, and then I decided to put the money in tax-free bonds. My return on the tax-free bonds would have been, I think, somewhere around 5 percent and 6 percent, taking into consideration the taxes.

HENRY W. LARGE

	Purchases	Sales	Balance
Feb. 1, 1968			4,604
July 8, 1968		1,000	3,554
Feb. 18, 1969		300	3,254
June 10, 1969		200	3,054
Sept. 17, 1969		200	2,854

Large served as executive vice president—sales and marketing from February 1968 until his retirement on June 1, 1970. A career employee, he reported directly to the president. At the time of the merger, Large owned 4,604 shares, most of which had been acquired from options. Following the merger, he exercised no further options, even though by December 1968, he was eligible to purchase 1,600 further option shares at 24½.

Large explained that his July 1968 sale, the proceeds of which were $85,000, was made in order to pay off a stock option loan of $58,400 and an income tax loan of $15,000, and to provide cash for anticipated capital gains taxes. Bank records show the two loans paid off as of July 17, 1968. Large claimed that each of his three 1969 sales were made to meet income tax payments; the proceeds of the sales, which were $18,336, $10,450, and $8,053, respectively, were used for tax payments of $18,000, $7,000, and $7,000.

Large insisted that he only sold what he felt he had to sell of his shares, although he did not indicate whether this involved a choice between Penn Central shares and any other liquid assets he may have had.

A. E. PERLMAN

	Purchases	Sales	Balance
Feb. 1, 1968			2,860
Apr. 1, 1970		500	1,400

Note: Between 1968 and 1969, 960 shares had been donated as gifts.

Perlman was the president of Penn Central from the time of the merger until December 1969, when Saunders brought in Paul Gorman to be president. Insisting that the conditions of his employment contract be adhered to, Perlman became vice-chairman of the board at that time, retaining this position until his June 8, 1970, removal by the board.

Prior to the February 1968 merger, Perlman had exercised options for 34,000 shares which were the total number of options granted to him (these grants had been made before 1964) and had sold 32,890 of these shares. As of February 1968, Perlman reported his ownership of stock at 2,860 shares. His only transactions in 1968 and 1969 were disposing of 960 shares as gifts. On April 1, 1970, he sold 500 shares and held the remaining balance of 1,400 shares until after the bankruptcy.

Perlman claimed that his 500 share sale resulted from turning over his portfolio to Lionel D. Edie & Co., Inc. (an investment adviser). Edie made its first appraisal of Perlman's portfolio in January 1970. As a general policy, Edie was against buying railroad stocks at that time, and favored the sale of its customers' current railroad stock holdings. Although Perlman had given Edie complete discretion over his account, Edie checked with Perlman as a matter of practice before making a trade. When told of Edie's plans to dispose of all of his Penn Central stock, Perlman stated he vetoed the idea because he believed that as a director of Penn Central he should remain a substantial holder of the company's stock. He said he told Edie it could only sell up to 500 shares which in his view would still leave him a substantial holder of Penn Central stock. Perlman claimed he characteristically followed Edie's recommendations concerning his holdings, and noted within 2 years of acquiring Perlman's portfolio, Edie had replaced all stock originally held. Perlman stated that at no time did he discuss the merits of Penn Central with Edie representatives, and insisted the 500 shares trade was made solely on the basis of the general Edie recommendation.

Perlman's sale is included in this report because it came so close to bankruptcy that he obviously had adverse information which was not available to the public at the time of his sale. He knew, to an extent that the public did not, that Penn Central was a sick company. He had complained about money being diverted to real estate operations, and of lack of funds for the railroad. He was unhappy with the way the company was being managed and knew of all the operating difficulties. He knew of the internal pressures to generate additional earnings and sitting through budget meetings must have had a good idea of some of the artificial techniques being used to accomplish this purpose. On the other hand, for at least 6 months prior to his sale, since the decision was made to replace him as president, he had been effectively isolated from regular sources of information within the company. His awareness, if any, of the critical new problems which were then developing would most likely have come from secondary sources.

DAVID E. SMUCKER

	Purchases	Sales	Balance
Feb. 1, 1968			12,600
July 8, 1968		9,000	3,600
Feb. 21, 1969	2,200		5,800
July 2, 1969		2,200	3,600
July 3, 1969		1,400	2,200
Feb. 25, 1970		1,600	40
Apr. 10, 1970	2,067		[1] 2,107
Apr. 20, 1970		2,000	107

[1] Thrift plan distribution following Smucker's retirement.

Smucker was executive vice president in charge of operations until February 1969. At that time, with Penn Central's operations in a disastrous state, he was replaced by Flannery at the insistence of Perlman, and made executive vice president—office of the chairman until his March 1970 retirement. At the time of the merger, Smucker held 12,600 shares, which he had acquired through options. He sold

9,000 shares in July 1968, hitting the market near its all time high at about 85. In February 1969, he made his final option exercise of 2,200 shares. He sold 3,600 shares in July 1969, and 1,600 in February 1970, and made gifts to his family, leaving him with a balance of 40 shares at his retirement on March 1, 1970. Following his retirement, he sold 2,000 of the 2,067 thrift plan shares distributed to him immediately upon receiving them in April 1970.

It appears that about $83,000 of the proceeds of the July 1968, sale was used to pay off loans Smucker had taken out in connection with the exercise of his options in 1967. Smucker stated that the sale had been planned at that time to obtain funds to exercise options when they vested in December 1968, and for capital gains taxes. At this time, according to Smucker, he was expecting to exercise in December not only his remaining options at 24½, but also up to half of his recently granted option to purchase 12,000 shares at 57⅜.[74] When Smucker exercised his options in early 1969, however, Penn Central stock was down to selling in the low 60's and the options at 57⅜ had lost their attractiveness to him, so he exercised only the options remaining to him at 24½.

The only reason Smucker gave for his 1969 and 1970 sales was that he had decided to retire. Smucker's official termination date was in March 1970, and he claims that he actually left the company in December 1969. By July 1969, however, he had been relieved of responsibility for operations and was contemplating retirement:

> Yeah, by July of 1969 I had decided to retire. Mr. Saunders' 90 days had elapsed and I decided to retire. And I was sitting there holding 3,600 shares of stock, and we had been told by the legal department and by the financial department that if we've got any questions relative to purchases or sales of the company's stock to talk to Dave Wilson or Ted Warner or both. So I got Dave Wilson up to my office, and I said, here I'm sitting, oh, buddy with 3,600 shares of stock that I have owned since December of 1967; and I unfortunately exercised an option to buy 2,200 shares last February. How long do I have to hold this.

According to Smucker's testimony, he decided following the consultation to sell his stock, even though it was less than 6 months since he had made his last purchase in reliance on Wilson's advice that recovery of profits would not be possible under section 16 of the 1934 act.

The gifts of 560 shares to Smucker's daughter and her family were also prompted by Smucker's review of his financial affairs in contemplation of his retirement.[75] Smucker explained that the balance of 1,600 shares was not sold until February 25, 1970, because he had placed a limit order to sell them at 45 on August 27 which he remained hopeful of executing until February, when the stock had slid to 25.

Although Smucker's 1969 sales were made following his removal from operating responsibility, he had continued to work for Penn Central in Saunders' office and, as evidenced by various memoranda he wrote, he was very much aware that the operating situation was still critical. As an operating officer he recalled being "bumped over the head to get the expenses down and see if you can't find or sell some scrap or do something to get the income up."

[74] The June 1968, sale grossed about $765,000. Figuring the cost of these options at about $400,000 leaves a balance of proceeds, after payment of the loans, of about $280,000.

[75] These shares were subsequently sold, but Smucker claimed that he had refused to advise the donees as to when they should sell and in fact did not know when the sales occurred.

JAMES R. SULLIVAN

	Purchases	Sales	Balance
Feb. 1, 1968			2,730
Feb. 29, 1968	260		2,990
June 4, 1968	325		3,315
Jan. 20, 1969		500	2,815
Mar. 13, 1970		2,300	515

A former New York Central operating official, Sullivan served as vice president (marketing) of Penn Central from the time of the merger until after the bankruptcy. Sullivan, who was subordinate to Large (later replaced by E.G. Kreyling) and who did not attend the budget committee meetings, would have learned only indirectly of Penn Central's financial and diversification problems. He was, however, clearly aware of all of the problems in the railroad end of the business. He had been in favor of a slower approach toward integration of the two roads, feeling that the acceleration plan was a mistake. When operating problems developed, as head of marketing he was very familiar with the barrage of customer complaints which arose. He knew Penn Central was losing business because of these problems, and from his testimony it is clear that he was acutely aware of the conflicts between former New York Central and former Pennsylvania Railroad employees, and the impact this was having on the orderly functioning of the department.

Sullivan claimed that his 1969 and 1970 sales were made on the basis of his broker's advice to diversify his portfolio. In 1965, he had opened an account at Merrill Lynch, Pierce, Fenner & Smith, and from his testimony, it appears that from the time of opening the account his broker, Edward W. Kann, had discussed with Sullivan the advantages of diversification. Ignoring his advice, however, Sullivan had steadily increased his investment in Penn Central shares (which were, of course, New York Central shares prior to February 1968) by exercising his options, so that by December 1968, Penn Central represented about 75 percent of the value of his equity holdings. Sullivan emphasized that his broker's recommendation was not merely diversifying away from reliance on one stock, but also diversifying from equity into debt investments, due to the general stock market decline. Although he did make substantial bond purchases with the proceeds of his Penn Central stock sales, Sullivan also made substantial equity purchases in 1969 and 1970, and sold few or none of the other equity stocks he owned, indicating that his "diversification program" was, in fact, solely away from Penn Central, and not from equity stocks in general.

Sullivan's January 1969 sale was made to buy $30,000 worth of 1-year municipal bonds. ("* * * I am a little hard to convince sometimes, it takes a little while, and when we made this move, we went with a relatively small excursions [sic] in the city of Goshen bonds.") Apparently, Sullivan's broker had called in January to recommend the Goshen purchase, but Sullivan could not recall why he chose January 1969 as the first time to take his broker's diversification advice seriously.

Later in 1969, Sullivan made further equity purchases and listened to periodic suggestions from his broker to diversify into more bonds, but he sold no Penn Central (and bought no debt securities) until

March 1970. Sullivan could give absolutely no reason why it was March of 1970 when the diversification urge hit him again.[76]

This time, at the time of the sale Sullivan and his broker did not have a crystal clear idea of what they would do with the proceeds:

We had discussions, I had had discussions with Kann about a number of things that he had suggested in the way of diversification and we concluded that this activity would require approximately that much money, so we proceeded accordingly.

Sullivan's March 13 sale of 2,300 shares (reducing his Penn Central holdings to 515 shares) grossed about $56,000. About $40,500 of this was invested immediately in long-term bonds, and $7,000 went to purchase shares (equity) in Maui Land & Pineapple Co. In August, a further $10,000 was invested in more bonds. (Sullivan stated that at the time of his sale his broker had indicated "That he would probably have something else at hand within a very short time," and that he was surprised, but not disturbed, by the 5-month delay.) [77]

When questioned concerning the amount of shares he chose to sell in March 1970, Sullivan responded as follows:

Question. Can you tell us in March of 1970 whether you considered selling that remaining 500 shares or why did you decide to keep it?

Answer. No, I thought it was all right to leave it where it was and if I had been disturbed about the thing, I would have throttled the thrift plan, but the idea never occurred to me so we just let it go right along.

Question. Did it occur to you that in March of 1970, you were liquidating the major part of your holdings in the stock for the first time in a number of years?

Answer. I don't know that it occurred to me in that context, what I was [thinking] about was the advice of my counselor on the business of debt securities and the outlook as he saw it and as I seemed to feel it was of the market, that stocks were going to, in general—the stock outlook was not promising.

Sullivan knew of and dealt with the operating problems the company experienced during the 1969–70 winter. Claiming that the appointments of Flannery and Kreyling to key operating posts had made him optimistic about the future of Penn Central, Sullivan discounted the idea that his trading was in anticipation of the tremendous first-quarter loss which those operating problems had caused. He also claimed that in making his sales he didn't even think about "the results of the first quarter or anything like that:"

Question. Was there any particular price consideration in March of 1970 when you decided to actually follow Mr. Kann's advice apart from the 500 shares you sold in 1970 and sold the bulk of your Penn Central holdings? Was there any consideration that you gave to the price that Penn Central was selling at that time?

Answer. Not especially, of course we were anticipating, with the things that we talked about at some length here, that the Penn Central might very well regain its position, so it was a question to stay with that or to diversify as Kann had recommended, so we decided to diversify rather than sell it all. If I had any real serious concern about the thing, the sensible thing would have been to just eliminate it all, but I stayed with the thrift plan or 600 whatever shares that are there.

Question. Can you say that at the time you sold, you did expect the price of the stock to turn around eventually?

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[76] Q. Can you recall for us what went on to generate your decision to sell 2,300 shares of stock on March 13, 1970?

A. Yes; as I have indicated to you, I had these continuing discussions with Kann and our experience with the Goshen bond thing seemed to go all right so it seemed to me that in the light of Kann's continued reminders on this subject and my feeling that his judgment was sound, that this was the thing to do.

Q. Why was it the thing to do so on March 13, 1970?

A. That just happened to be the date that we decided to move off with it, just as January 20, 1969, was the date we decided to move off with the sale of the 500 originally.

[77] In the month prior to Mr. Sullivan's 1970 sale, his 1969 investment of municipal bonds matured. About 80 percent of the funds from the maturing bonds plus the 1970 Penn Central stock sale was invested in debt securities and about 20 percent was invested in equity securities.

Answer. Yes; I thought it might very well do so.

Question. Was that in the near future or distant future?

Answer. I would think in the longer haul because of the problems we have just been talking about.

Question. As far as the shorter haul, at that time as I understand it, well, the first quarter earnings had not been calculated because the first quarter had not been closed.

Answer. That's true.

Question. Did you expect the stock was going to decline significantly before it possibly turned around?

Answer. To be perfectly candid, I didn't give any special consideration to that at all, as to what it was liable to do in the near future or the results of the first quarter or anything like that. I didn't even think about it. I was concerned with finally moving in the direction that Kann suggested that we ought to move and we would still retain a quite substantial position in Penn Central, so as the turn around occurred, we still have a fairly substantial equity and of course, we had these other options.

Question. When you say finally, this is over a year after Mr. Kann had first suggested it.

Answer. Yes.

Question. And I would simply like to ask you one more time why you chose this particular period of time to put this program into effect in a major way.

Answer. Well, simply because I became convinced that this was the right thing to do.

GUY W. KNIGHT

	Purchases	Sales	Balance
Feb. 1, 1968			4,281
June 20, 1968		1,750	2,531
July 15, 1968		73	[1] 2,458
Dec. 20, 1968	1,600		4,047
July 3, 1969		3,950	97
Sept. 4, 1969		90	[1] 7

[1] Sales made for account of children.

Knight was a senior vice-president in charge of personnel and labor relations from the time of the merger until his October 1969 retirement. While not directly connected with the operations of the company, and not a participant in the budget committee meetings, Knight's position in charge of labor relations brought him into close working contact with Penn Central's operating people. He sold virtually every Penn Central share he owned at the beginning of July, the same time numerous operating officials had chosen to liquidate their holdings.

At the time of the merger, Knight owned 4,281 Penn Central shares. In June 1968, he sold 1,750 shares. In December 1968, he exercised an option for 1,600 shares. On July 3, 1969, along with a number of other officers selling at this time, Knight liquidated his Penn Central holdings, selling 3,950 of his balance at that time of 3,957 shares.[78]

Since 1965, Knight had an established "window" pattern of exercising options and making substantial sales at 6-month intervals, and his 1968 and 1969 transactions fall within this 6-month pattern. Even with these sales, however, he had maintained a balance of at least 1,000 shares from August 1965 until the time of the July 1969 liquidation.

Asserting his rights under the fifth amendment, Knight refused to supply any information relative to his Penn Central trading or any other Penn Central related activities.

[78] In July 1968 and September 1969 Knight made sales on behalf of his children of 73 and 90 shares, respectively.

General Corporate Officers

The two officers discussed in this section, although possessing no expertise concerning the operational and financial aspects of the company, had constant, day-to-day access to top management in pursuing their duties as head of public relations and corporate secretary.

WILLIAM A. LASHLEY

	Purchases	Sales	Balance
Feb. 1, 1968			3 000
Mar. 30, 1970		500	2,507
Apr. 15, 1970		500	2,007
May 22, 1970		1,000	1,007

Lashley was vice-president in charge of public relations and advertising until after the bankruptcy. Reporting directly to Saunders, he had virtually complete access to all company officers, and his office was responsible for drafting almost every public statement issued by the company. Having worked for Saunders for many years,[79] Lashley knew almost reflexively that the public relations department was expected to stress—or manufacture—something hopeful out of the bleakest announcement. It is likely he knew of every significant development in the company, and it appears that he knowingly and actively participated in management's attempts to conceal adverse information about the company.

Lashley steadily exercised his 1964 option to purchase Penn Central shares at $28 per share until the end of 1967, so that, by the time of the merger, he owned 3,000 shares. Sixteen hundred of these shares were owned jointly with his wife, who had put up the purchase price for some of them. Lashley made a 500-share sale of Penn Central stock on March 30, and again on April 15, 1970, in response to bank pressure to pay down the loan for which these shares were collateral. Although Lashley claims that his Penn Central sales were made solely because of the bank's demands, it is significant to note that at the same time he was making Penn Central sales to reduce this outstanding debt he was resisting pressure from another bank to sell out 300 shares of Norfolk and Western stock securing another loan which was also undercollateralized.[80]

The sales point up the difference in regard which Mr. Lashley had for Penn Central stock as opposed to Norfolk and Western stock at the time, because the proceeds of the sale of Penn Central shares went to reduce an 8-percent loan with a bank with which Lashley felt he had a good relationship,[81] while, in contrast, Lashley was simultaneously maneuvering to avoid selling his Norfolk and Western stock to pay off an 8¾-percent loan with another bank (Lincoln Bank) with which

[79] Lashley had previously worked for Saunders at Norfolk and Western.

[80] Lashley claimed that he had no inside information at the time of his sales, but that "I had hesitation to sell because I was a corporate officer and might be accused of having inside information." Prior to his sales, Lashley consulted with Wilson and Saunders about his sales. Saunders was consulted because, "I felt badly about it, about the situation, and told him that my personal finances were such that I was going to have to sell some of the stock. I knew he wasn't selling any of his". According to Saunders, he advised against the sale and told Lashley to consult the legal department. Lashley claimed he consulted with Wilson because he believed the circulated guidelines had advised him to. "Dave Wilson, as I recall, said, 'Well, if you have to you have to, but make sure you report the sales to the SEC.' "

[81] The Penn Central stock-secured loan had always been maintained at prime rate and, aware of this beneficial rate, Lashley has to date maintained the loan in its reduced form.

he felt his relationship had become acrimonious. As Lashley's relationship with this second bank deteriorated, Lashley, "pretty upset and angry at the Lincoln Bank for their constant harangues," transferred the loan to the Provident National Bank. When Lashley was asked why he did not feel compelled to sell his Norfolk and Western stock to reduce that loan at the same time he sold his Penn Central stock, Lashley responded, "Because I wanted to hold on to it. I regarded Norfolk and Western stock as a good investment, particularly from the standpoint of dividend. They were paying, I think, about $6 a share."

At the time of his sales on March 30, and April 15, 1970, Lashley knew that the first quarter results would be much worse than expected. Before the March 25, 1970 announcement of the filing of the debenture application with the Interstate Commerce Commission, Lashley was involved in Penn Central discussions about disclosing the fact that Penn Central's first quarter results would be worse than expected.[82] Ultimately, Penn Central decided not to make such a disclosure.[83]

At the same time that Lashley was arranging the loan with Provident to retain his Norfolk & Western stock, he made a further major sale of Penn Central stock, selling 1,000 shares on May 22, 1970. This was part of the 1,600 shares purchased with his wife's funds and held in their joint names.[84] Lashley regarded this stock as belonging to his wife, and it had not been pledged in connection with any of his loans. Lashley claimed that the May sale was made at the insistence of his wife, who was "terribly worried about the loss of, the complete loss of her investment, and I sold at her request in order to salvage what we could of her investment."

Although Lashley claimed his wife did not seriously request him to sell stock "before about April or May," he could not recall precisely when the request began:

> . . . she started making the request when I was telling her about my difficulties with the banks and more loans. And she said "Why don't we just get rid of all of it and sell out of Penn Central completely?" And I said "I didn't want to do that, that I was hoping the stock would come back and hold on as much as I could." But she was very concerned about it so at her request I made those two sales.

When asked why he chose May 22 as the day finally to comply in part with his wife's directives Lashley answered as follows:

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[82] Penn Central officials believed that Chrysler Corp. had disclosed its anticipated bad first quarter while announcing a securities offering. Lashley contacted Chrysler and reported as follows:

"Attached are copies of the news releases which Chrysler Corp. issued in connection with their public offering of sinking fund debentures in February.

"You will note that neither the preliminary announcement on January 27 nor the release of February 20, which was on Friday and therefore did not appear in the Wall Street Journal until Monday, February 23, mentions the prospects for the first quarter in the release itself. However, a prospectus was attached to each of the releases.

"Also, I suspect that Chrysler deliberately selected a Friday to put out the release in hopes that it would not attract any great attention. I am certain they were somewhat upset by the full story in the Wall Street Journal on February 23." (Memo from Lashley to O'Herron & Hill Mar. 20, 1970.)

[83] But Lashley realized disclosure would come sometime:

"Although we have not yet received clippings, I am enclosing accounts of the Pennsylvania Co. application to the ICC to authorize $100 million of securities as they appeared in the Wall Street Journal, New York Times and Washington Star today.

"Because of the heavy amount of financial news resulting from the lower interest rate and spurt in the stock market, neither the Wall Street Journal or New York Times had much space to go into details about the securities involved, although they called us for information and we had to give it to them because it was in the application filed with the ICC.

"Our friend Steve Aug of the Washington Star, however, went into more details.

"I expect that many more details of the transaction, together with the statements we will have to make about the first quarter, will come out much more prominently when we offer the debentures for sale." (Memo from Lashley to Bevan Mar. 26, 1970.)

[84] The remaining 600 shares were sold on June 29. Lashley turned the proceeds of the sale of all 1,600 shares over to his wife.

I think it was shortly—I think we talked it over the previous night and I came in and made the decision during the morning to—I think it was in the morning—to sell the stock.

Lashley must have been well aware by the last half of May 1970 that the debenture offer had been canceled and that senior management was meeting with Government officials about a guarantee. As head of the public relations department, Lashley admitted receiving queries concerning the financing during the month of May, but claimed he referred the calls to Jonathan O'Herron. Although disclaiming knowledge of inside information at the time of the sale, he did admit in response to repeated questioning that he had spoken with O'Herron concerning the status of the financing at some time during this period.

BAYARD ROBERTS

	Purchases	Sales	Balance
Feb. 1, 1968			5,731
Mar. 21, 1968		1,800	3,931
June 11, 1969		1,000	2,957
June 29, 1969		700	2,257
July 3, 1969		300	1,957
Jan. 8, 1970		200	1,757

Between merger and bankruptcy, Roberts served as secretary of the company. This position afforded him access to vital corporate information, as he took minutes of the board of directors meetings, and the meetings of the board's finance committee. He did not, however, attend the budget committee meetings on a regular basis, and it does not appear that he worked closely with the finance department. At the time of the merger, Roberts owned 5,731 shares, acquired through the exercise of options. His only post-merger acquisition of shares was the inheritance of 59 shares from his father's estate. In March 1968, he sold 1,800 shares, applying most of the proceeds to liquidate a loan incurred in exercising his options in 1966. By mid-1969 he owned over 3,900 shares, with no large loans left outstanding. In June and July 1969, he sold 2,000 shares, and he sold an additional 200 shares in January 1970, leaving him with a balance, through the time of the bankruptcy, of 1,757 shares.

Roberts stated that he had opened an account with Drexel Harriman Ripley in early 1969 at the time of the settlement of his father's estate, and looked to that firm for investment guidance from that time on. He claimed that Drexel was recommending in general the sale of Penn Central stock at that time and that Roberts, determining that his financial position was too heavily reliant on Penn Central, decided to sell half of his Penn Central holdings, retaining half his shares out of an "obligation to hold on" based on his status as a Penn Central officer.[85] Roberts also testified that he had been contemplating diversifying his assets since prior to 1964, when he began exercising his options. As to why he chose June 1969, as the time to put his 5-year-old diversification plan into effect, Roberts offered the following explanation:

Well, the decision to sell was made before I even opened up the account actually. Just a question of when. Actually, I didn't want to sell before I had the account with Drexel because I didn't know what I would do with the proceeds and I wanted some advice on that. So after the account was opened then I gave some

serious thought as to the timing of the sale. And we were then coming in toward the annual meeting and proxy material was going out and the annual meeting was coming along and so I said, well, let us wait until that is all over and then I will sell my stock. And that is about the way it worked out. The annual meeting was the Tuesday before the second Wednesday of May and I sold it about a month later.

On June 10 or 11 Roberts placed an order with Drexel to sell 2,000 shares. Drexel sold 1,000 shares at 51¾–52 on June 11 and on June 24, 700 shares were sold at 49¾. Noticing that his whole order had not been executed, Roberts got in touch with Drexel at the end of June, requesting that the final 300 shares be sold. Roberts claimed he called because he was anxious to complete the sale in order to enable him to exercise his options 6 months hence—he had outstanding an unexercised option of 1,000 shares at 24½.[86]

Pursuant to his diversification program, Roberts reinvested all of the proceeds of the 2,000-share sale at Bruce's direction in various equity securities. His January 1970, 200-share sale was made to pay part of the capital gains tax on the major sale:

As you can see from the record I had a substantial capital gain on the sale of the 2,000 shares of Penn Central stock which I was able to offset by the sale of other securities where I took a loss but I couldn't offset it all and I therefore had to raise some more money to cover the tax on the capital gain. I was about to go away on vacation toward the end of January. The entire market was sliding off at that point and I wanted to go away with a free mind so I decided to sell some more stock, Penn Central stock, to raise the cash so I'd have it available at the time of the April tax return.

According to the testimony of D. L. Wilson of the office of general counsel, Roberts had learned in the first 2 weeks of June 1969, that Saunders was thinking of taking the unusual step of proposing that the board of directors delay consideration of the third quarter dividend until a special August board meeting, bypassing the traditional June board meeting. Roberts consulted Wilson on Saunders' behalf about this in mid-June.[87]

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[86] A letter dated June 30, 1969, to Roberts from Richard Bruce, his investment adviser at Drexel, appears to confirm Roberts' statement. The second paragraph states:

"As you directed, I have entered orders to sell 200 Penn Central at 50¼ and 100 at 50½. I expect these orders will be executed in the next few days which will complete the program to sell your 2,000 shares and will leave you free to exercise your option on additional Penn Central shares 6 months hence."

The 300 shares were sold on July 3.

[87] Saunders eventually decided against this course of action, probably at least partly due to Wilson's recommendation that it be announced publicly.

CHRONOLOGY OF OFFICER SALES DISCUSSED IN REPORT

	Sales	Balance
1968:		
February		
March	Roberts, 1,800	3,931
	Warner, 300	4,588
April	Warner, 800	3,788
May	Warner, 400	3,388
June	Funkhouser, 1,900	3,101
	Knight, 1,750	2,531
July	Knight, 73	2,458
	Large, 1,000	3,554
	Smucker, 9,000	3,600
	Warner, 100	3,288
August		
September	Hellenbrand, 3,500	367
October		
November		
December		
1969:		
January	Bevan, 3,000	30,718
	Gerstnecker, 4,000	2,275
	Sullivan, 500	2,815
February	Large, 300	3,254
March	Bevan, 3,000	27,546
	Flannery, 300	536
April	Bevan, 3,000	24,546
May	Bevan, 3,700	20,846
	Flannery, 300	236
	Gerstnecker, 1,000	1,275
June	Bevan, 2,300	18,546
	Large, 200	3,054
	Roberts, 1,700	2,257
July	Flannery, 236	0
	Haslett, 3,000	2,402
	Knight, 3,950	97
	Roberts, 300	1,957
	Smucker, 3,600	2,200
August		
September	Knight, 90	7
	Large, 200	2,854
	Warner, 4,000	380
October		
November		
December	Warner, 100	240
1970:		
January	Funkhouser, 100	4,949
	Roberts, 200	1,757
February	O'Herron, 500	2,075
	Smucker, 1,600	40
March	Lashley, 500	2,507
	Sullivan, 2,300	515
April	Lashley, 500	2,007
	Perlman, 500	1,400
	Smucker, 2,000	107
May	Funkhouser, 4,500	504
	Lashley, 1,000	1,007
June	Bevan, 4,900	13,245
(Prior to June 21, 1970)	Warner, 200	96

PART III

III-A. THE SALE OF PENN CENTRAL TRANSPORTATION CO.'S COMMERCIAL PAPER BY GOLDMAN, SACHS & CO.

INTRODUCTION

On July 22, 1968, the Interstate Commerce Commission authorized Penn Central Transportation Co. (the Transportation Co. or the company) to commence selling commercial paper. By late 1969 the Transportation Co. had $200 million in commercial paper outstanding. All sales were effected by Goldman, Sachs & Co. acting as dealer.

During the first half of 1970, the amount of the Transportation Co.'s commercial paper outstanding dropped from $200 million to approximately $82 million. This $82 million in commercial paper was held by 72 customers who had purchased between November of 1969 and May of 1970. As commercial paper is universally believed to be a very low-risk security, these customers were shocked to learn, prior to the maturity date of their paper, that the Transportation Co. had filed a petition in bankruptcy. Penn Central has repaid none of this indebtedness, and there is little likelihood of repayment.[1]

While in this section the focus will be on the role of Goldman, Sachs in selling commercial paper, it should be noted that while the company's paper was being sold, the company and certain of its executives were making false and misleading statements to the public concerning the company's financial condition. These activities are being covered in other portions of the staff report.

Goldman, Sachs continued to sell the Transportation Co.'s commercial paper after they had received information about the financial condition of the Transportation Co. which should have raised serious questions as to the safety of an investment in the company's commercial paper, and Goldman, Sachs did not disclose such information to its customers. The information which Goldman, Sachs received should have put them on notice that a thorough examination of the financial condition of the Transportation Co. would seem appropriate in order that they, and through them, their customers would be apprised of the current position of the Transportation Co. Despite these warning signs, Goldman, Sachs made no meaningful investigation. Such an examination would have disclosed that the financial condition of the company was more serious than had been revealed to the public.

COMMERCIAL PAPER

CHARACTERISTICS OF COMMERCIAL PAPER

Commercial paper is a corporate, short-term promissory note. It is sold either directly by the issuer (borrower) to the purchaser (lender), or by the issuer to a dealer who resells to the purchaser.

[1] There are suits pending against Goldman, Sachs by almost all of the holders. Of these, $20 million in claims have been settled for $0.20 on the dollar.

The most noteworthy factor in the commercial paper market (at least until the Transportation Co. bankruptcy) was the common belief held by purchasers, to a degree not even found among those who invest only in the bluest of blue chip securities, that commercial paper was designed to be entirely riskproof. Because safety of principal so far and away transcended rate considerations, a very large number of purchasers of commercial paper did not shop for rates at all. Most looked upon commercial paper as the equal of U.S. Treasury notes or bank certificates of deposit (CD's) in terms of safety. Because of the short-term nature of the investment (average term is 90 days) it is extremely important that the notes are repaid at maturity and thus the liquidity of the company becomes a matter of vital concern to the customer.

The importance of safety to those who invest in commercial paper becomes apparent in a crisis. In the 30-day period following the Transportation Co. bankruptcy, the runoff in commercial paper is estimated to have reached $3 billion. Only quick action by the Federal Reserve, which had been alerted to the approaching bankruptcy a day or two before, appears to have saved the day. On June 19, 1970, in anticipation of trouble, the Federal Reserve had agreed to let commercial banks borrow freely at its discount window. And on June 23, it voted to change its regulation Q, which limits what banks can pay for deposits, thus allowing them to buy money freely. And the banks borrowed heavily from the Federal Reserve in the weeks that followed—$1.7 billion in just 1 week in mid-July. More than $2 billion in bank money went to aid corporations in paying off maturing commercial paper. This rescue operation not only took some companies out of trouble, it also restored lender confidence in the commercial paper market. What could have blown into a major liquidity crisis vanished almost before it began.

A second most noteworthy factor is that those who purchase commercial paper are loaning funds to corporations which most often they know little about. Furthermore, the purchasers have no control over the use of the proceeds or any other of the borrowers' activities, as a lender normally does.

It is impossible to secure restrictive convenants limiting the commercial paper borrowers' freedom to raise additional debt or governing the use of proceeds. In addition, the purchaser who becomes dissatisfied with the issuer usually has no readily available market to which he can resell his paper before its maturity.[2]

The only information the purchaser can get, and in almost all cases does get, is either through the public media or through the dealer who is selling him the paper. In addition to their dealers' recommendations, most purchasers relied on the ratings given various commercial paper by the National Credit Office (NCO) as a basis for making an investment decision.

The problems of making informed investment decisions about commercial paper were aggravated by the rapid growth of the commercial paper market just prior to the company's bankruptcy on June 21, 1970. Witness the following:

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[2] Paper which is purchased directly from the issuer, however, will usually be repurchased by the issuer at the purchaser's request. Some dealers also, subject to market conditions, maintain a limited secondary market in paper they handle.

A. In 1960 there was $4.5 billion in commercial paper outstanding:
On December 31, 1965, $9 billion outstanding;
On December 31, 1967, $16 billion outstanding;
On December 31, 1969, $31.6 billion outstanding; and
On June 30, 1970, $39.9 billion outstanding.

B. In December 1967, NCO was keeping tabs on 227 commercial paper issuers. By April 1, 1970, its list had increased to 615.

Much of the growth was directly related to the monetary squeeze in which U.S. industry found itself at the end of the 1960's. In December 1968, the Federal Reserve Bank imposed a ceiling on CD interest rates. The banks, expectedly, strenuously objected to regulation Q, as it is known, which had the effect of diverting funds from the banking system and into commercial paper and other money market instruments, but the banks themselves were contributing to the increase in commercial paper outstanding. Bank holding companies began to issue commercial paper, and the banks put hundreds of disappointed loan customers in the direction of commercial paper as a cure to corporate liquidity problems.

It appears that commercial paper will remain an important money market instrument. Some of the advantages are that the seller raises short-term cash at less cost than bank borrowings, the investor receives a higher rate of return than is otherwise possible through purchases of other short-term money market instruments, and commercial paper is also relatively easy to sell, as it requires no registration with the SEC. To make it possible for more institutions to issue commercial paper, legislation has been passed in Massachusetts and New York to enable savings banks to put their cash into commercial paper. Like Ohio, several other States have been authorized to purchase commercial paper. Recent legislative moves have authorized the New York State Teacher Pension Fund and the California General Funds to acquire commercial paper. On the other side of the coin, dealers are engaging in promotional activities to show small- and medium-sized companies the advantages of selling commercial paper.

APPLICABILITY OF FEDERAL SECURITIES LAWS TO COMMERCIAL PAPER

The rapid growth of the market for commercial paper has involved its increased use as a substitute for long-term financing. This has made it more important than ever to reconsider the adequacy of Federal securities law with respect to commercial paper. Almost all commercial paper is exempt from registration pursuant to section 3(a)(3) of the Securities Act of 1933.[3] Thus, commercial paper customers have not been furnished with all the current material information that would be required by a registration statement.

In the absence of registration requirements, there are no customary standards requiring dislosure of material information, to the extent the same is disclosed in a statutory prospectus, to purchasers. In many cases the information available to purchasers is limited and out of date. Furthermore, there is no investigation undertaken by the dealer which would even approximate that which is required of an

[3] Under Section 3(a)(3) of the Securities Act of 1933 commercial paper, if used for "current transactions" and having a maturity "not exceeding nine months," is an exempt security. In the case of the Transportation Company's paper, the Section 3(a)(6) exemption would apply to "Any security issued by a common or contract carrier, the issuance of which is subject to the provisions of Section 20a of the Interstate Commerce Act, as amended," without regard to whether it was used for current transactions or whether its maturity was more than nine months.

underwriter of a security offering registered with the Commission pursuant to the 1933 act.

In addition to the exemption from registration under the Securities Act of 1933, commercial paper maturing within 270 days also is exempt from all of the provisions of the Securities Exchange Act of 1934.[4] The sale of commercial paper is covered by the antifraud provisions of the Securities Act of 1933, sections 12 and 17.[5] Moreover, the Investment Advisers Act of 1940, is applicable to commercial paper.

THE MARKET FOR COMMERCIAL PAPER

COMMERCIAL PAPER DEALERS

Commercial paper sold through dealers—referred to as dealer paper as opposed to direct paper sold directly from borrower to lender—as of late has constituted approximately 40 percent of the commercial paper market—estimated to be $40 billion. The seven major dealers are: Goldman, Sachs; A. G. Becker & Co.; Lehman Commercial Paper, Inc.; Salomon Brothers; the First Boston Corp.; Merrill, Lynch, Pierce, Fenner & Smith, Inc. and Eastman Dillon, Union Securities.

ESTABLISHING THE COMMERCIAL PAPER RELATIONSHIP

Usually a commercial paper relationship will grow out of one of the aspects of the investment banking relationship that a dealer has with an issuer. Once the issuer decides that it wants to issue commercial paper, the dealer will want to determine whether the issuer is creditworthy, i.e., able to repay the additional debt. The dealer will usually have a credit department or a credit analyst who is charged with the responsibility for making this determination.[6] With some dealers the recommendation of the credit department or analyst can be overridden by a partner or by the head of the commercial paper department. With others, the recommendation is final.

The dealer, having decided that the issuer is creditworthy, will usually then confer with the issuer to determine how much paper to issue based upon how much the issuer wishes to borrow and how much the dealer estimates can be marketed.

Next, the dealer and the issuer enter into an oral agreement whereby the dealer is to be the exclusive dealer to market a specific amount of commercial paper for a specific time. Normally, the dealer will buy from the issuer as principal and reoffer it to the public at a markup of from one-eighth to one-quarter of 1 percent. The dealer agrees to

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[4] Under the Securities Exchange Act of 1934 commercial paper is not an "exempted security" as that term is defined in Section 3(a)(12), but is excluded from the definition of a security found in Section 3(a)(10):

"The term "security" means . . . but shall not include currency or any note, draft, bill of exchange, or bankers acceptance which has maturity at the time of issuance of not exceeding nine months. . . ."

Section 3(a)(10) of the '34 Act does not specifically require that in order to be excluded from the definition of what is a security, commercial paper must be used for "current transactions," as does Section 3(a)(3) of the '33 Act. However, see *Sanders* v. *John Nuveen & Co.*, CCH Fed. Sec. L. Rep. paragraph 93,517 (7th Cir. 1972), which used the "current transaction standard" in making its determination that paper of less than 270 day maturity was not exempt from the definition of a security under the '34 Act.

[5] The anti-fraud protection afforded by Sections 12(2) and 17 of the Securities Act of 1933 is expressly made applicable to securities exempted by Section 3. Section 12(a) provides a civil remedy to purchasers where securities are offered or sold by means of an untrue or misleading statemets or omissions "(whether or not exempted by the provisions of Section 3 . . .)." Section 17(c) provides that:

"The exemptions provided in Section 3 shall not apply to the provisions of this section."

[6] The credit analyst considers various factors such as the potential issuer's net worth, its current debt structure, its position in its industry, etc., which affect the issuer's ability to repay the additional debt. Ordinarily this information is obtained primarily from public documents such as registration statements [illegible] and annual reports

assist in the technical tasks involved.[7] The issuer agrees to provide certain information at certain intervals and access to information of the nature provided to banks for line credit.

Since the dealer's compensation rarely varies from the one-eighth to one-quarter of 1 percent per annum spread, the primary sales points for a dealer are its financial capacity to purchase the paper and its marketing ability to sell the paper at a favorable rate.

THE PURCHASERS

Those who invest in commercial paper are predominantly institutions of various types. A small percentage in terms of dollar amount are purchased by individuals. In addition, banks will often purchase in the bank's name for individuals who each may own less than $100,000. Most investors have only one thing in common: funds to invest for a short period of time with the smallest possible risk and the maximum return. Since treasury bills may not fit purchaser's maturity needs and both bank CD's and treasury bills have a lower interest rate, purchasers turn to commercial paper.

DIRECT PAPER V. DEALER PAPER

But why not direct paper instead of dealer paper? Direct paper has many advantages:

A. usually the direct issuer is larger and more established;

B. usually the direct issuer will repurchase the paper if the purchaser so requests prior to maturity; and

C. usually it is easier to obtain the desired denominations and maturities.

However, direct paper typically offers a lower interest rate—by one-quarter percent—and most direct issuers do not have the same ability to reach purchasers as do the large commercial paper dealers, who more actively solicit purchasers.

A purchaser will usually select a particular dealer based upon one or more of the following factors: Prestige and reputation of the dealer; past relationships with the dealer; solicitation by the dealer; variety of paper offered by the dealer both as to type and maturity dates; and the quality of the paper offered by the dealer. Frequently, the purchaser will tell the dealer that it is only interested in NCO prime-rated paper.

REPURCHASES

Until recently, none of the dealers had a standing policy of repurchasing commercial paper prior to its maturity. Currently, a few dealers will under certain conditions repurchase the commercial paper of issuers which they handle. But a repurchase facility usually is not a condition of the original sale and is completely discretionary with the

[7] Those will usually include the following:

A. A determination by the issuer's counsel with assistance from dealer's counsel, if necessary, of the availability of the Section 3(a)(3) exemption which may require the granting of a no-action letter from the Division of Corporation Finance.

B. The selection of a New York City bank to act as the issuing and paying agent and an agreement reached with the bank to function as such.

C. Formal authorization from the board of directors of the issuer specifying the total amount to be issued and designating the officer(s) to execute the notes.

D. Selection of a format for the notes, printing, delivery of a minimum number of notes properly signed by the authorized officers to the bank. These notes have a provision for the issuing bank to complete such items as amount, maturity and payee.

E. The issuer [illegible]

dealer. Infrequently, dealers will repurchase to preserve a good customer's relationship, although not as a condition of the original sale.

INFORMATION PROVIDED TO PURCHASERS AT THE TIME OF SALE

Because of the short-term nature of commercial paper and the way in which investments in commercial paper are made—there is a continuous turnover and a customer usually must choose from whatever commercial paper the dealer has available at the time which will meet the customer's maturity requirements—the usual purchaser does very little investigation or analysis of the investment merits of commercial paper. He is not in a position to acquire information directly and must rely on what he can get from the dealer selling the paper, rating services and the public media.

The profit margin on commercial paper is very thin for dealers—⅛ to ¼ percent spread—who must meet the expenses involved in soliciting and selling plus the cost of inventory. A major reason for dealers to bother with commercial paper is the hope that it will lead customers to use more profitable facilities such as stock or bond underwriting. The low-profit margin would act to discourage dealers from voluntarily undertaking the expense of a thorough examination of issuers' creditworthiness and/or a thorough gathering of information for purchasers.

Since the holder of commercial paper has the status of an unsecured general creditor, there is an additional necessity to have access to reliable and current information, for in the event of bankruptcy the chance to recoup an investment is relatively small.

The dealers frequently prepare a dealer memorandum which is a short descriptive analysis of the issuer.[8] These are provided either to all potential purchasers or to those purchasers whom the dealer feels might be specifically interested. Dealers update the memorandum at least annually, and more frequently if significant events or circumstances should require.

Most customers assume that once they have told a dealer about the type of issuer they are interested in investing in, the dealer will provide only paper that meets the customers' standards. Without regard as to whether they have any basis, a number of other presumptions are held by purchasers: that the dealer will only offer the paper of an issuer which it considers to be credit-worthy and without any substantial risk; that the dealer will inform the purchaser of any adverse information concerning the issuers; and that the dealer will repurchase the paper before maturity.

Although most customers are institutions, they range from highly sophisticated investment oriented institutions to unsophisticated institutions such as many college trust funds, small town banks, and small manufacturing companies. However, as we indicated above,

[8] The typical dealer memorandum consists of the following:
1. A description of the company: Its history and the nature and type of its business;
2. The latest year-end balance sheet;
3. Income statements for the preceding 5 years;
4. Bank credit arrangements including a list of the company's primary banks;
5. The company's NCO or S. & P. commercial paper rating; and
6. Interim earnings.

Additional data which may also be provided about the issuer includes the following:
1. Ratio of current assets to current liabilities;
2. Ratio of funded debt to net worth;
3. Market value of common stock;

even the sophisticated institutions are not given all the information as would be required by the Securities Act of 1933. Also because of the short-term nature of the investment and the speed and the manner in which it is made, investors do very little investigation on their own either into the issuer or the investment merits of the security.

ACTIVITIES OF DEALERS SUBSEQUENT TO INITIAL OFFERING

Most dealers provide one form or another of continuing review of their issuers, although it is very limited. This usually involved checking with banks to see if adequate back-up lines are being maintained in addition to the status of any other relationships between the issuers and the banks.

Most firms which act as dealers in commercial paper have a trading department staffed by individuals whose primary, if not sole, responsibility is marketing commercial paper. Ordinarily this trading department is separate and distinct from other marketing activities of the firm. Commercial paper traders at most firms are responsible not only for marketing the paper but also for maintaining relationships with customers. The investors which the dealers solicit are a relatively small group of institutions who apparently utilize the services of all the dealers.

Most dealers maintain an inventory of commercial paper which is made up of unsold portions of issuer's commercial paper. Dealers are under substantial pressure to turn over their inventory as quickly as possible for the inventory, which can run as high as $300 million, is financed through bank loans. Such financing may be expensive and difficult to find.

PENN CENTRAL TRANSPORTATION CO.'S COMMERCIAL PAPER

ESTABLISHMENT OF COMMERCIAL PAPER RELATIONSHIP WITH GOLDMAN, SACHS & CO.

The first serious discussions between the company and Goldman, Sachs concerning the issuance of commercial paper took place in early 1968. David C. Bevan, chief financial officer of the company at that time, had met Gustave Levy, managing partner of Goldman, Sachs, while the former was with New York Life in 1946. The acquaintance was continued throughout the time Bevan was with New York Life and during the time, from 1951 on, that Bevan was with the company. At a meeting in March 1968, and after subsequent discussions between Bevan, Levy and Wilson, the decision was made to issue commercial paper and utilize Goldman, Sachs. At this point, according to Robert G. Wilson, a partner in Goldman, Sachs and head of its commercial paper department, Goldman, Sachs followed its usual precedures for taking on a new issuer.[9]

Wilson could not, however, recall whether anyone other than Jack Vogel, head of the commercial paper department's credit department, was involved in determining the credit-worthiness of the company, nor could he or Vogel recall if there were any reports prepared relating to the company's credit-worthiness at this time,

[9] This included obtaining the necessary borrowing resolutions, signature cards, annual reports, a copy of the ICC order approving the sale, and financial data

although Vogel stated that he personally did not prepare a written report.

While neither witness could recall the specific steps taken in the case of Penn Central, they did testify as to the normal procedures followed within the firm. The credit department, headed by Vogel, would have made, in the ordinary course of business, a preliminary decision on credit-worthiness,[10] and it would have been up to Wilson to make the final decision. The recommendation by Vogel is usually not made in writing, but a checklist is made as to information received. Usually no memorandum or written record is made of Wilson's conversations with Vogel or of Wilson's decision. Wilson stated that he has no particular standards or guidelines for making this decision but draws upon his own experience and looks at each company individually. Wilson noted that the credit department has informally established certain minimum standards or guidelines. However, he did add that there are some standards in this area:

> You look for a history of earnings, you look for a ratio that shows a relatively strong working capital position. You want to know about the management of the company, its reputation, where the company stands in its field, this type of thing.

Wilson also stated that there was no particular ratio or standard applied to the level of outstandings but that he only relates borrowings in commercial paper to current assets and receivables and the level of inventories since the proceeds from the paper are to be used for current purposes.

Vogel's testimony fairly much paralleled Wilson's in terms of the absence of any standards or ratios that are applied to the factors which are considered. He did, however, expand somewhat on the role of the analyst:

> * * * He would review the company's financial statements, determine whether or not the company is, or has, an ongoing nature to it, whether its product line is of the type that would do more in the next few years, or 10 years, whether the company has a record of profitability, whether it has a reasonable chance to have a record of profitability in the future, whether other lenders, or other suppliers of funds have a favorable opinion of the company in its past, and in its present, and of its future * * *.

As was mentioned earlier, Vogel could not recall having made a written report on the company prior to its being approved by Goldman, Sachs as an issuer, nor could he recall other than in a general way, what factors were considered at the time (summer of 1968). Wilson's testimony was the same.[11]

The Interstate Commerce Commission on July 22, 1968, gave the company authorization to issue $100 million in commercial paper, and by August 5, 1968, sales were well underway.

Once the decision to carry a particular issuer has been made, the credit department normally undertakes to review the public media for information about the issuer. Once a year the issuer is asked for confirmation of existing lines of credit. As will be shown, if the standards described above had been applied in late 1969 or early 1970, Goldman, Sachs would not have continued to offer the company's paper for sale.

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[10] According to Wilson and Vogel the determination of credit-worthiness involves looking into the prospective issuer's borrowing practices, its access to credit, the opinions of banks with whom the issuer maintains lines of credit, and reviewing its financial statements as found in the annual reports. At no time did Wilson or Vogel indicate that it was normal procedure for Goldman, Sachs to investigate the issuer as an underwriter would be in a typical registered public offering.

[11] Vogel testified that Goldman, Sachs takes on about one new issuer a week. These issuers must be in-[illegible] staff of four. In addition, this staff is also responsible for maintainaing an on-going review

THE FLOW OF INFORMATION TO GOLDMAN, SACHS & CO. WHICH INDICATED THE DETERIORATING FINANCIAL CONDITION OF THE COMPANY

From September of 1969 through May of 1970, Goldman, Sachs was very actively engaged in selling the company's commercial paper. In fact, the amount outstanding was increased from $150 million to $200 million during late 1969. During this period Goldman, Sachs gained possession of material adverse information, some from public sources and some from nonpublic sources indicating a continuing deterioration of the financial condition of the transportation company. Goldman, Sachs did not communicate this information to its commercial paper customers, nor did it undertake a thorough investigation of the company. If Goldman, Sachs had heeded these warnings and undertaken a reevaluation of the company, it would have learned that its condition was substantially worse than had been publicly reported.

Public information

Based on information publicly available by November of 1969, a thorough reevaluation of the transportation company's financial condition would seem to have been appropriate. For example, the reported loss of the transportation company for the first 9 months of 1969 was $40.2 million, or $26.4 million more than in 1968. In late November an announcement was made that Penn Central was passing the dividend. In testimony before the ICC, outside counsel representing the company told the ICC that Penn Central was having a very difficult time effecting the merger (management was very upset by this statement). This matter, as well as a reference to the same effect by an independent expert a few days later, was reported in the news media.

The above information was available to Goldman, Sachs through the public media. However, this did not cause Goldman, Sachs to reexamine the financial condition of the company whose paper Goldman, Sachs was selling as prime rated commercial paper. In addition, thereafter, other public information came to their attention which indicated a serious worsening of the company's financial condition.

Other information available to Goldman, Sachs concerning the general financial condition of Penn Central Transportation Co.

Whether it was for these or other reasons, a memo written by Robert Wilson on September 3, 1969, indicates that there was some concern at this time about the company's financial situation. In the memo Wilson states that as "* * * it has been a long time since we had gotten together to talk about the company," he had requested a meeting with the top officials in the company's finance division since, "We have a lot of questions to ask about the merger, cash flow, and their long term financing plans."

On September 19, 1969, Wilson and others in Goldman, Sachs met with Jonathan O'Herron, vice president-finance of the company. Among other things, O'Herron stated that the company would be in a very tight cash position in the first quarter of 1970. Because of this, he asked if Goldman, Sachs would sell as much commerical paper as possible through April or longer, and disclosed that the company had applied to the ICC for authorization to increase its outstanding commercial paper from $150 million to $200 million.

On October 22, O'Herron told Wilson that Penn Central would show a small loss in the third quarter, but he anticipated that the fourth quarter would be in the black with a good improvement.

On October 29, the ICC approved an increase in the amount of the company's commercial paper outstanding from $150 to $200 million. There were, however, a number of important disclosures in the ICC's order. In discussing approval of the issuance of this increased amount, the ICC stated:

> Applicant feels that long-term financing at the present time is not feasible due to the tight-money situation. Although we are sympathetic to applicant's problem, short-term financing has traditionally been relied upon to finance short-term needs and is not normally regarded as a proper source for long-term financing of capital expenditures or for refinancing of maturing long-term debt. As of June 30, 1969, applicant had a deficit working capital situation which can be expected to worsen if reliance on short-term financing is increased. The exhaustion of short-term credit to refinance maturing long-term debt or to finance long-term capital expenditures could expose a carrier to a serious crisis in the event of an economic squeeze, at which time a carrier may require short-term financing for traditional use. We are, therefore, concerned about the use of short-term financing for long-term purposes and feel that where necessary it should be resorted to cautiously.

The order went on to state that on the whole the company was in a strong financial condition, and in view of the tight money market at that time and the fact that the company had indicated its intent to negotiate long-term financing as soon as possible, the ICC would approve the request for an increase in the outstanding commercial paper. In approving the increase, the ICC order noted:

> According to the investment banking firm which usually handles applicants' commercial paper, unless market conditions change, there is a market for an additional $50 million of applicant's notes.

Goldman, Sachs, however, never did explore in any depth the areas of inquiry which they indicated would be the subject of the September meeting. All of the information described above raised serious questions about the soundness of the Transportation Co. and the safety of investing in its commercial paper. The information indicated that the company was experiencing a liquidity crisis and that it might find it extremely difficult in the future to meet its cash needs, thus jeopardizing commercial paper holders. A thorough study of the subject would have disclosed how much more damaging the information about liquidity of the company and its ability to pay off commercial paper holders was. Although such a study would appear to have been in order at this time, Goldman, Sachs did not conduct any further investigation, and made no disclosure of the above information while continuing to actively promote the company's commercial paper. Customers were not told that the company expected to be in a tight cash position in the near future; were not told about the ICC order or the information about the deficit working capital situation or the fact that the company's commercial paper proceeds were being used for long-term financing.

Requests by Goldman, Sachs that Penn Central increase the lines of credit backing up its commercial paper

There was other information Goldman, Sachs was receiving in the latter part of 1969 and in early 1970 which indicated a deteriorating financial condition and raised questions concerning the liquidity of the company.

As early as September of 1969, Goldman, Sachs initiated a request that the company increase its back-up lines of credit [12] for its commercial paper. At the September 19, 1969, meeting described above, O'Herron had described how the railroad was currently borrowing $250 million out of a total $300 million revolving credit. He went on to state that the company intended to use the remaining $50 million of the revolving credit lines plus $50 million of outside lines of credit as back-up for the $200 million in commercial paper. Wilson then asked O'Herron if it were possible to get an additional $50 million in back-up lines. According to Wilson, O'Herron replied that it was, but he would prefer not to do so. O'Herron's account is: "I can't remember specifically whether I said I preferred not to, or said I didn't think I could." When asked why the company could not have increased its lines, O'Herron replied:

> Because I think the Penn Central had already had a line of credit, some of which was used at that time, of $300 million, and which was a pretty sizable amount of credit availability, for even a company of that size. So, the probability of increasing that was not very great in my opinion. So, I can't recall if I said "preferred not to," or "couldn't," I think they are both the same.

Wilson testified that Goldman, Sachs' concern was to convey to the company their feeling that customers were considering back-up line coverage as being more important because of the tight money market which prevailed in late 1969 and early 1970. Although it is his opinion that back-up lines were not a firm commitment to lend money, Wilson did state that back-up lines are important to customers as an indication of some willingness on the part of the banks to supply credit to back up their paper, especially in times of tight money. In fact, when asked what the average commercial paper investor looks to in determining whether an issuer will be able to make repayment, Wilson replied:

> I think they look at all these things, I think they look at cash flow; I think they look at back-up lines; I think they would look at capacity to get lines, capacity to do financing, all these things.

There is conflicting evidence as to whether or not it was unusual for Goldman, Sachs to have been requesting more than 50 percent line coverage of the company at this time. In any case, Goldman, Sachs was to ask the company repeatedly for an increase in line coverage on into the first quarter of 1970 without success (eventually Goldman, Sachs even began asking for 100 percent coverage). The management of the company was very reluctant to ask the banks for more line credit. Although Goldman, Sachs never inquired too deeply into the reasons for the company's reluctance, it should have been apparent that the company had exhausted all credit.

According to Wilson's testimony cited above, the fact that the company only had 50 percent line coverage and the fact that it was unable to obtain more was information that investors would have considered important. The unwillingness and inability of the company to raise more than 50 percent of the coverage was never disclosed to customers. Furthermore, this information, just as the other available information described in the previous section, was a further indication of the financial problems of the company and should have caused Goldman, Sachs to investigate further. During the period in question,

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[12] Back-up lines of credit represented varying degrees of commitments by banks to loan money to the company in the event that it should need it.

when a tight-money market existed, access to credit was even more important. Goldman, Sachs kept a close watch on the banks participating in credit lines to the company. By their own actions, Goldman, Sachs acknowledged the importance of the inability of the company to raise 100 percent coverage at this time. In fact, on February 5, 1970, O'Herron had told Wilson that the company could not raise any additional lines of credit. The inability of the company to obtain 100 percent backup lines, as with other relevant information, was not disclosed to customers.

Publication of 1969 year-end earnings by Penn Central Transportation Company

On February 5, 1970, the transportation company announced a $56 million operating loss for 1969, which indicated a loss of $16 million for the fourth quarter. This was contrary to the company's recent assurances that the fourth quarter would be in the black. In addition to this loss the company wrote off $125 million in passenger equipment and facilities as an extraordinary item. On the same day Wilson called O'Herron to set up a meeting on the next day to discuss the loss. At the meeting, at which Levy and Wilson of Goldman, Sachs, and Bevan, O'Herron, and Robert Loder of the company were in attendance, Bevan attempted to explain the 1969 loss and the company's projected budget—another $56 million loss—for 1970.

Bevan explained that they all had anticipated that the railroad would break even in the fourth quarter but that at the last moment their accountants had suggested certain writeoffs which changed the results. The 1970 official budget, according to him showed an estimated loss of $56 million, and the railroad needed an additional $170 million for capital improvements and equipment, causing the total cash requirement for 1970 to be $226 million. Bevan then explained that this would be raised by trust certificates—$70 million—a long-term financing through Pennsylvania Company—$100 million—and a Euro-dollar loan—$50 to $75 million. Although the timing on these was uncertain, they intended to set up a $50 million bridge loan in the near future. Bevan added that although the official budget showed a $56million loss, the management target for the railroad shows a loss of zero to $23 million for 1970.

This explanation of the manner in which the company was to continue operating appears to have completely answered whatever questions Goldman, Sachs had at this time about the financial situations of the railroad. Levy and Wilson asked no questions about any of the methods mentioned above, by which Bevan intended to raise the necessary funds for 1970. According to Levy no questions were asked because "as I said, I had complete confidence in Mr. Bevan's integrity; that he could do what he said he could do." Furthermore, Levy did not confer with anyone at Goldman, Sachs about Bevan's plans, or direct anyone at Goldman, Sachs to contact the company personnel to inquire into Bevan's statements or to request the railroad to supply Goldman, Sachs with any statements or figures about their budget situation or cash forecast because Levy had "complete confidence in Bevan and O'Herron."

In spite of the fact that the railroad had suffered a loss for 1969 and the fact that it was now having great difficulty raising additional lines of credit, Wilson stated, concerning Bevan's explanation of the

1969 loss and the 1970 projections, that, "We had no reason to doubt him at that time, and we were satisfied with the answers to the questions we asked in these areas." It appears, however, that very few questions were asked. According to Wilson's testimony, the elements which he considered as affecting the company's creditworthiness on February 6, were the fact that the Pennsylvania Company had over $900 million in securities, the fact the railroad had large real estate holdings, and the magnitude of the railroad itself. All these assets, however, had never been evaluated by Goldman, Sachs to determine their actual worth, how encumbered or pledged they were, or whether those that were held by subsidiaries could be liquidated for the company's purposes. Vogel, head of the credit department, who was also at the meeting testified that at this time no reexamination of the company took place as a result of these events:

> As a result of information obtained through these meetings we were reassured by the management—at least in our opinion—of the railroad—that the situation was one that was explainable, normal, and not of any problem. To that extent we accepted that reassurance.

So, as a result of the announcement of a $56 million loss for 1969, Goldman, Sachs had sought the assurance of management that all was well, got that assurance and was apparently satisfied with same.

The National Credit Office (NCO) continues prime rating after 1969 results announced

On February 5, 1970, Allen Rogers of NCO called Jack Vogel of Goldman, Sachs to express concern over the sharply reduced earnings announced in the newspapers that day. Vogel told Rogers that Goldman, Sachs was continuing to sell the company's paper in spite of the sharply reduced earnings. Vogel also suggested that the company had a number of valuable properties and securities, and he was certain that something could be worked out should it ever become necessary. According to a memo written by Vogel, Rogers stated, "that as a result of my comments, he would continue to carry Penn Central Transportation Company as a prime name." According to a memorandum written by Wilson of a conversation with Levy, "I also explained Allen Rogers' conversation with Jack Vogel and that Allen's feeling was that as long as Goldman, Sachs was going to continue to handle the company's c/p (commercial paper) he would keep the prime rating." In fact, NCO continued the prime rating until June 1, 1970.

As will be more fully described below, customers relied heavily on the NCO prime rating as an independent opinion of the creditworthiness of commercial paper issuers. Goldman, Sachs also utilized the availability of the NCO ratings as a selling point to assure customers of the low risk involved in purchasing commercial paper. Specifically with regard to the company's commercial paper, Goldman, Sachs was aware that customers relied on the prime rating of the company's commercial paper, and Goldman, Sachs used the company's commercial rating of "prime" in selling it.

As a result of this conversation with Rogers, Goldman, Sachs became aware of facts which undermined the value of the prime rating given by NCO to the company's paper and the independent nature of that determination. Thus, from this point on it appears that NCO was not the thorough, independent rating service that Goldman, Sachs had represented to customers that it was. In addition

from this point on, Goldman, Sachs was aware that the "prime" rating was based to a great extent on the fact that Goldman, Sachs was continuing to offer it. They also believed that the "prime" rating was based in part on Vogel's opinion that the company had sufficient properties and valuables—which fact Goldman, Sachs had never investigated—to liquidate if necessary. Furthermore, if they were looking to liquidation as a means of determining creditworthiness, the railroad clearly was no candidate for the "prime" rating.

Certainly investors involved in such short-term investments as commercial paper where liquidity is so vital would want to rely on liquidation of corporate assets as a means of payment. Also Rogers' apparent reliance on the simple statement of Vogel would indicate that NCO was not engaged in the kind of analysis required to make an independent determination to continue the prime rating. Nor had Goldman, Sachs done any kind of analysis which would substantiate these statements. In addition, Goldman, Sachs never disclosed to any customers any of these matters.

Goldman, Sachs reduces its inventory of Penn Central paper

Goldman, Sachs' analysis about the significance of the year-end results may be ascertained with greater reliability from the actions they took rather than from their statements. Thus, on the very same day they learned of the first quarter losses, they contacted the company and got a commitment from the company to buy back $10 million of its commercial paper from Goldman, Sachs' inventory. Furthermore, Goldman, Sachs insisted that from then on, the company's paper be sold under a tap issue arrangement whereby Goldman, Sachs would no longer buy any paper from the company, but would ask the company to issue certain paper only after it had found a customer for the paper, an arrangement involving no risk for Goldman, Sachs. At the time the company went into bankruptcy, Goldman, Sachs held none of the company's paper.

The coincidence of the timing of the reduction of inventory and the tap issue arrangement with the announcement of year-end results would appear to indicate that Goldman, Sachs' concern with the company made them more unwilling to risk their assets. In their testimony, Goldman, Sachs' people have admitted that one of the primary reasons for this action was the feeling that the yearend results would make the company's commercial paper much less marketable. Accordingly, they wanted to reduce their inventory. Most customers believed that Goldman, Sachs maintained an inventory in all commercial paper which they offered for sale. Many who purchased the company's paper after February 5, 1970, looked to the fact that Goldman, Sachs had an inventory of the company's paper as assurance that Goldman, Sachs felt the paper to be credit worthy. Goldman, Sachs never informed its customers of its decision to reduce and eventually eliminate its inventory.

Receipt of adverse information as to first quarter results

On March 23, 1970, in a conversation with Wilson, O'Herron stated the first quarter's figures would look terrible.

Goldman, Sachs made no further inquiry as to how adverse the first quarter results would be or how this would affect commercial paper holders. They did not seek to examine records of the company

have discovered that internal documents of the company indicated a loss of $60 million for the first quarter.

Goldman, Sachs continued to actively promote the sale of the company's commercial paper for the period of March 23 to April 14, when another discussion was held with the company's management concerning first quarter results. A total of $17.3 million in commercial paper was sold to 18 customers during this time. None of these customers were told about these expected terrible results for the first quarter.

On April 14, 1970, Goldman, Sachs learns that there will definitely be a loss for first quarter; public learns on April 22, 1970

On April 14, 1970, O'Herron told Wilson that the losses for the first quarter would be "lousy," and, in fact, "staggering." O'Herron added that he did not see the turnaround in the railroad yet, and that the cash position is in very serious shape.

Based on these comments Wilson recommended to Levy that they stop offering the company's paper until the current situation could be clarified. A meeting with Bevan and O'Herron was scheduled for later in the day for that purpose.

At that meeting O'Herron apologized to Wilson for the casual nature of his remarks made earlier in the day. Bevan indicated that he could not tell exactly what the first quarter losses would be, but they would be substantially in excess of the $12 to $13 million lost in the first quarter of 1969. The losses, he explained, had resulted from a $20 million reduction in anticipated revenues and larger expenses due to the most severe winter in the history of the railroad. Bevan stated that he did not anticipate that the losses for 1970 would be worse than those sustained in 1969. He further stated that the entire system had been put on a severe cost-cutting program by Gorman, the new president.

There was more discussion about what measures were being taken to improve conditions. Bevan stated that they expected to announce the final loss figure next Wednesday (April 22) and at the same time would file for the upcoming $100 million public debt offering. Bevan then outlined the ways in which he intended to meet the forthcoming cash needs of the company. He described specific steps that could be taken should it become necessary. Included in these was a plan to sell some of the real estate. Wilson asked whether these properties had several layers of mortgages and Bevan answered affirmatively. Bevan added that their cash position has been the subject of an intensive hearing in the past 30 days before the full ICC and Transportation Secretary Volpe. Bevan and O'Herron asked them to continue to offer the company's commercial paper until they effected their $100 million bond offering in early May.

Again based on a brief explanation by Bevan, Goldman, Sachs was assured that "there was no emergency at the Penn Central Transportation Co." At this meeting Bevan stated that the losses for all of 1970 would not be more than $56 million. Eight days later, the company announced that it lost $62.7 million in just the first quarter of 1970. Bevan outlined new contingency plans for liquidation of real estate, equipment, and securities. As in the past, few questions were asked (Wilson did ask if the real estate was encumbered and Bevan replied that it did have several layers of mortgages), and no steps were taken

to investigate Bevan's reassurances. The next day, Levy told O'Herron that Goldman, Sachs would continue to offer the company's paper.

Bevan's statements at this meeting bore no resemblance to the reality of the situation. The situation was much worse at this time for in addition to the magnitude of the anticipated losses, O'Herron indicated that a substantial part ($51 million) of the income to be reported on a consolidated basis was to come from extraordinary and nonrecurring sources. The actual consolidated losses were, therefore, actually greater than was reported for the first quarter.

During the time between this meeting and the time that the first quarter losses were announed to the public, Goldman, Sachs made one sale of $300,000 of the company's commercial paper. This customer was told nothing of the first quarter results.

Sales of Penn Central Transportation Co.'s commercial paper after announcement of first quarter results

On April 22, 1970, the company announced the results of the first quarter. The parent, Penn Central Co., reported first-quarter consolidated losses of $17.2 million (compared with net income of $4.6 million for same period in previous year). The results included extraordinay income of $51 million. Penn Central Transportation Co. reported a loss of $62.7 million for the first quarter.

Goldman, Sachs continued to offer commercial paper to its customers and in the period April 22 to May 15 sold $5 million to one customer, the American Express Co., on May 1, 1970. Goldman, Sachs witnesses have testified that on April 30, their salesmen were required henceforth to read from press releases announcing first quarter results.

There is some dispute as to what American Express was told. The Goldman, Sachs salesmen stated that they were told about the first quarter results. American Express testified that this was not the case. It had been reluctant to purchase the company's paper, but Jack Vogel, head of the credit department, told it that there were adequate assets to back up commercial paper in order to persuade it to change its mind about buying the company's paper. The paper purchased by American Express resulted from a buy-back by Goldman, Sachs from Mobil Oil and then a resissue to American Express. American Express claims that at this time Goldman, Sachs told it that there was no reason to be concerned about the ability of the company to meet the maturity of the paper.

By mid-May it was clearly impossible to sell any more of the company's paper and all further effort was terminated by mutual agreement between Goldman, Sachs and the company. One of the reasons for the company's bankruptcy was its inability to roll over its commercial paper, for the amount of redemptions which could not be rolled over totaled $117 million for the first half of 1970.

OTHER FINANCIAL RELATIONSHIPS BETWEEN GOLDMAN, SACHS AND THE TRANSPORTATION CO.

In addition to the compensation received for the sale of commercial paper, there were many other areas of financial relationship with the company which were being developed around the time in question, which could have and did produce additional sources of revenue for Goldman, Sachs. On November 4, 1969, representatives of Goldman

Sachs and the company met to discuss a $350 million pension fund and a high performance contingent compensation fund in which Goldman, Sachs was "hopeful that we will be able to make a contribution."

On November 17, 1969, Goldman, Sachs was invited to participate as a syndicate member in the underwriting of a $50 million Pennsylvania Co. debenture offering.

On December 9, 1969, in discussions with the company, Goldman, Sachs uncovered "some possible lease finance business."

On January 2, 1970, Canada Southern Railway Co., a subsidiary of the company, purchased commercial paper of another issuer from Goldman, Sachs ($1.5 million). Also Mahoning Coal Railroad Co., a company subsidiary, purchased commercial paper of another issuer from Goldman, Sachs ($1,300,000). On January 8, 1970, the Peoria and Eastern Railroad Co., a subsidiary of the company, purchased another issuer's commercial paper from Goldman, Sachs ($250,000). This was the first time these subsidiaries had ever purchased commercial paper.

By February 12, 1970, the company and its subsidiaries had purchased over $60 million of commercial paper from Goldman, Sachs in the last 7 weeks.[13]

On February 26, 1970, Robert Haslett of the company called Goldman, Sachs and stated that he would like Goldman, Sachs to start working with him on the company's thrift plan (they invest about $250,000 each month). George Ross of Goldman, Sachs stated that he had every reason to believe that they can do substantial securities business with the company and that Levy should mention Goldman, Sachs' investment management services to Bevan. Goldman, Sachs did eventually handle the thrift plan for the company.

Around this time Levy indicated to Wilson that he should get in contact with Bevan, who stated that the company may have a blanket mortgage from which Goldman, Sachs may benefit, and that this could amount to as much as a billion dollar underwriting.

Methods Employed by Goldman, Sachs To Sell the Company's Commercial Paper to Customers

General Representations Made About Commercial Paper

Since Goldman, Sachs is the oldest and largest dealer in commercial paper, most customers believed that Goldman, Sachs would offer them only commercial paper which met their requirements and which Goldman, Sachs felt was credit-worthy. This impression was created in large part by oral representations made by Goldman, Sachs personnel and by written materials (pamphlets and brochures) distributed by them which extolled Goldman, Sachs as the "largest," and "most important," commercial paper dealer. Further enhancing this image were representations made by Goldman, Sachs that commercial paper is the equivalent of Government securities in terms of safety, that Goldman, Sachs only offered the paper of the top companies; that it maintained a credit department to review commercial paper issuers, that it offered investment advice to purchasers; that it purchased the paper of "outstanding" companies for resale to investors; that it would provide financial information on issuers whose paper

[13] Most of these funds came from the proceeds of the $50 million Pennco debenture offering in December 1969.

it was offering for sale; and that it only offered paper rated "prime" by NCO, an independent credit rating service.

Most customers had sufficient contact with Goldman, Sachs for the latter to become familiar with the nature of the customers' businesses. Furthermore, this familiarity enabled Goldman, Sachs to learn that most customers contemplated that there would be a minimum risk involved as the funds were almost always earmarked for some purpose in the near future. In almost all cases Goldman would assure the customer, when asked, that the purchase was suitable for his situation.

Initially Goldman, Sachs would often provide a customer with a book which contained the latest financial statements of the companies whose paper they offered for sale. After a customer had made a purchase, Goldman, Sachs would send a copy of the issuer's latest available financial figures which would update the information about the issuer which was contained in the book. The information Goldman, Sachs was sending customers about the company, even as late as the end of March of 1970, was the year-end financial statement for 1968.

Rarely would a customer investigate an issuer on its own. Most customers either just stated to Goldman, Sachs that they were relying on Goldman, Sachs to provide them with the "very best paper" or "NCO prime paper" or in a very few cases, gave Goldman, Sachs an "approved list."

Most customers would call Goldman, Sachs and ask what was available which would fit their maturity requirements, and the salesman would describe what was available. In a few cases a customer would ask questions about the financial or general condition of the issuer and would be given answers. The customer would then select a particular paper for purchase.

HOW THESE CUSTOMERS INVESTED IN THE COMPANY'S COMMERCIAL PAPER

In the sales of the Penn Central Transportation Co.'s commercial paper, most customers asked no questions and when some did, they were reassured that everything was fine. When questions were raised by customers concerning the company's increased losses, the salesmen usually replied that merger or other temporary problems were the cause, and with $6.5 billion in assets there was nothing to be worried about. Frequently, the salesmen, through the beginning of April 1970, would cite to customers the company's 1968 results in answer to these questions. Some customers who still resisted were persuaded only after arguments by salesmen that, additionally, the high rate of return (in 1970 the company was offering the highest commercial paper paper rates), and the fact that the company's paper could be tailored to their needs, made it the best for their purposes. Furthermore, most customers at the time of purchase did not have any current financial information about Penn Central Transportation Co., or any of the information described in sections above which was in the possession of Goldman, Sachs, and Goldman, Sachs did not offer any of it prior to the sales. If the customer indicated to the salesman that he had heard something adverse about the company, the salesman would often firmly reply that the company was still "NCO prime" and there was no risk at all involved.

An example of the type of situation in which the customer placed complete reliance on Goldman, Sachs' recommendations is that of a textile manufacturer in Clinton, S.C. The relationship between the customer and Goldman, Sachs originated in 1960 at the time the customer was considering a merger. Goldman, Sachs was consulted to help prepare the rate of the exchange. Although this merger fell through, a subsequent merger attempt in 1964 in which Goldman, Sachs worked out the details (and for which they were paid a fee) was a success.

The two had intermittent contact through the sixties. Goldman, Sachs set up a revolving credit agreement for the customer to enable it to build another plant.[14]

In the fall of 1968, Goldman, Sachs assisted the customer in another merger. In the course of this merger, Goldman, Sachs was furnished with complete financial information on the customer.

In August of 1969, the customer had accumulated $1 million in cash in anticipation of another merger (although it had drawn down $4 million from the revolving line of credit). Since it would be months before the merger took place, the customer contacted the individual at Goldman, Sachs with whom it had been dealing and explained the situation. The individual recommended commercial paper. The customer reminded him of the limitation on commercial paper placed by the revolving credit agreement and stated that it would be relying on the recommendation of Goldman, Sachs and no one else. In fact, the customer's president gave instructions that the company was to buy whatever was recommended by Goldman, Sachs. In September of 1969, Goldman, Sachs by letter recommended certain commercial paper. The customer purchased it. When this paper matured in December, Goldman, Sachs recommended the company's paper. The customer bought it. When this matured in March of 1970, Goldman, Sachs recommended repurchasing the company's paper, which the customer did. This paper and an additional amount, which Goldman, Sachs had at the same time recommended to be placed in the company's paper, were not repaid because of the company's bankruptcy.

The treasurer of a small college in Pennsylvania described, in an affidavit, the circumstances surrounding the college's purchase of the company's paper on March 30, 1970, as follows:

> At this point the availability of Penn Central was mentioned. I hesitated because the college already held $400,000 in Penn Central. On asking for pertinent information from the latest financial report, I was informed the company reported consolidated revenues of $2,251,716,000 compared with $2,102,770,000 the previous year and preliminary earnings of $4,388,000 versus $86,961,000. At this point the problems of consolidation as a result of the merger were pointed out. I next questioned the current asset to current liability ratio, which was indicated at approximately one to one. When I indicated my concern over this, the representative reassured there was no need for concern since total assets exceeded 6½ billion. With some hesitancy I agreed to the purchase of 300M of Penn Central paper.
>
> On April 3, 1970, I received the letter of confirmation and a copy of the financial data on Penn Central. I was dismayed to learn the information conveyed over the phone was as of December 31, 1968, and not December 31, 1969. This, coupled with reports in the newspapers of the increased financial plight of the company, prompted me to call our representative to attempt to sell the paper held by the college. I was informed our representative accepted another job and the college had been assigned a new representative. I do not know what efforts were taken by Goldman, Sachs & Co. to resell the paper, but in any event they were unsuccessful.

[14] A clause of this agreement limited the customer to investing "in securities issued by the United States, CD's of banks and prime commercial paper as determined by generally accepted banking practice."

KINDS OF CUSTOMERS WHO PURCHASED THE COMPANY'S COMMERCIAL PAPER

The customers who purchased the company's paper during this period fall into diverse categories: Institutions sophisticated in securities analysis; companies primarily engaged in manufacturing; colleges and universities; small banks; and individuals purchasing through banks. The vast majority of the customers were institutions or corporations.

Almost all the customers did no investigation of the company before or after purchasing its paper from Goldman, Sachs for a number of reasons. First of all, most of the institutions and corporations were not sophisticated in terms of their ability to gather and analyze the necessary information. Secondly, they did not have access to the kind of information necessary to make a meaningful investment decision on Penn Central's commercial paper. In addition, the quickness with which the decision had to be made would have prevented them from undertaking such an analysis. And last, almost all of the customers were relying on Goldman, Sachs' recommendation, and on the NCO rating and on the general reputation of the company.

SUMMARY

Between November of 1969 and May of 1970 Goldman, Sachs sold $83 million of Penn Central Transportation Co.'s commercial paper which was not repaid because of the latter's bankruptcy. During this time they became aware of information which cast doubt on the safety of this commercial paper. Most of the nonpublic information described above was not disclosed to customers. The information they did disseminate was out of date.

Despite repeated warning signals, Goldman, Sachs initiated no in-depth analysis. If they had, they would have found matters to be much worse.

In addition, Coldman, Sachs failed to disclose that they had reduced and were eliminating their inventory of the company's paper, that NCO had been induced to maintain the prime rating and that the company's paper was meeting strong resistance from customers.

GOLDMAN, SACHS' POSITION ON THE SALES OF THE COMPANY'S COMMERCIAL PAPER

Goldman, Sachs' views concerning its sales of the company's commercial paper may be summarized in the following way. First of all according to Goldman, Sachs, its commercial paper operations were not lucrative when compared to its other activities. (For example in 1969 Goldman, Sachs had outstanding an average of $4.7 billion in commercial paper, but their net profits from these sales was only $435,000.)

According to Goldman, Sachs, the customers were sophisticated investors who purchased commercial paper in $100,000 denominations. Goldman, Sachs felt that these customers were capable of making their own investment decisions and did not have to rely on Goldman, Sachs' opinion. Goldman, Sachs viewed itself as merely a conduit of commercial paper which made no recommendations as to the quality of the paper or the credit worthiness of the issuers. Goldman, Sachs

would merely inform the customers as to what paper was available, and the customer would decide which paper it wished to purchase.

Goldman, Sachs also maintained that in the company, which was the country's fourth largest corporation, there were always sufficient assets which could be liquidated should the need arise, which provided sufficient protection for commercial paper holders.

Goldman, Sachs did take certain steps to disseminate information to customers and at least on two occasions did call in the company's top management for an explanation of what was happening. In addition, customers, if they so desired, could have obtained some information on the company since as a publicly held corporation it was required to make public its financial condition.

III–B. Role of National Credit Office in Rating the Commercial Paper of Penn Central

The concealment of Penn Central's condition was aided by Goldman, Sachs as described in the preceding section. Another entity, the National Credit Office (NCO), also contributed to the misleading of investors. This section is concerned with the activities of NCO prior to June 21, 1970, the date of bankruptcy, with respect to the commercial paper issued by the Transportation Co. and sold by Goldman, Sachs.

National Credit Office is a wholly owned subsidiary of Dun & Bradstreet, Inc. (D. & B.) which until on or about August 23, 1971, functioned as a rating agency for commercial paper. On August 23, 1971, the commercial paper rating service of NCO was transferred to Moody's Investors Services, Inc., another wholly owned subsidiary of D. & B. which is a registered investment adviser.

NCO had been rating commercial paper since 1920 and prior to 1970 it was essentially the only national commercial paper rating service. NCO was never registered with the Commission as an investment adviser.

As a standard method of operation, NCO would enter into a subscription agreement with the prospective issuer of commercial paper wherein the issuer would agree to pay an annual fee to NCO for appraising commercial peper and pursuant to which NCO agreed to evaluate and assign one of the following classifications to subscriber's (i.e., the issuer's) commercial paper:

Prime.—Companies with a net worth or capital funds (net worth plus long-term subordinated loans) in excess of $50 million, which also meet NCO requirements and credit judgment in all other respects.

In the cases of "captive" finance companies, net worth or capital funds in excess of $15 million are required in addition to meeting NCO requirements and credit judgment in all other respects.

Desirable.—Companies with net worth or capital funds (net worth plus long-term subordinated loans) of $25 million to $50 million, which also meet NCO requirements and credit judgment in all other respects.

Satisfactory.—Companies with net worth or capital funds (net worth plus long-term subordinated loans) ranging from approximately $10 million to $25 million, which also meet NCO requirements and credit judgment in all other respects.

Fair.—Companies which do not meet a sufficient number of NCO's requirements for the three preceding classifications.

No Rating.—Companies which do not meet any NCO requirements for inclusion in the commercial paper market.

Additionally, the issuer agreed to "furnish promptly to NCO pertinent financial reports and other data normally provided line banks, in order that NCO may accurately appraise the commercial paper."

From the foregoing it would appear that NCO's function was to rate the desirability of specific commercial paper. It would also seem apparent that as Mr. Eugene Schenk, the president of NCO, has stated:

NCO is the agency on which virtually all prospective buyers rely for ratings in the commercial paper field. Through the years our authoritative appraisals have been of material assistance in making a market for these short-term notes.

The commercial paper market which NCO had been engaged in as the sole national rating agency had experienced phenomenal growth in the late 1960's, primarily due to the severely tight money markets of that period and the relative ease and privacy of raising short-term debt afforded by this market. As the market grew rapidly, NCO's rating responsibilities grew concomitantly as the following data illustrates: NCO rated the following number of issuers in the respective categories at the indicated date.

	Apr. 1, 1970	December 1969	December 1968	December 1967
Industrial	266	236	149	108
Public utilities	163	153	82	25
Finance	118	112	99	92
Banking	47	42		
Insurance	10	9	1	
Transportation	11	9	4	2
Total	615	563	335	227

Thus in a period of 27 months the number of commercial paper issuers rated by NCO had increased by 388 or 271 percent. Further, by June 1, 1970, this number had increased to 647 issuers.

Included in this group of 615 issuers were Penn Central, King Resources Co. and Four Seasons Nursing Centers of America, Inc. all of which received a "prime" or highest possible rating.[1]

The relationship between NCO and the Transportation Co. which began in July 1968 was the customary one, described previously, between an issuer of commercial paper and NCO. After the execution of the subscription agreement and presumably after a customary review by NCO, the Transportation Co. was assigned a "prime" rating. This rating was listed by NCO and disseminated to all subscribers to its rating service.

Additionally, certain subscribers could at their election receive special service from NCO which consisted of a more extensive analysis of the issuer. In the case of Penn Central this would consist of excerpts from the latest annual report and interim financial data, if any, published by the issuer. The only other information contained in this report to subscribers not also contained in the annual report or interim financial statements were the rating classification by NCO, the identity of the dealer handling the paper and condensed information regarding the bank lines of credit available to the issuer, names of the lead banks, and amount of available credit, if any, from such banks.

All of the foregoing information plus, in the case of Goldman, Sachs, more detailed and current financial data was also customarily available to the dealer in the paper who also provided similar information to its customers.

Furthermore, the data contained in these NCO releases, except for the specific items heretofore mentioned, does not differ in any ma-

[1] It is interesting to note that not only was NCO's estimation of the quality of the notes issued by King Resources and Four Seasons deficient, but also that certain of such notes of both entities had a stated maturity of more than 270 days which would not qualify same for the statutory definition of commercial paper and exemption from registration.

terial way from that which Penn Central itself publicly disclosed either in annual or quarterly reports or in press releases which it issued. Moreover, none of these releases contains information as of a date prior to such public release by Penn Central. In fact, most of the data contained in the NCO releases is a mere reprint of Penn Central press releases or excerpts from annual reports.

Preliminary to a specific examination of NCO activities in rating the Transportation Co.'s commercial paper it is necessary to examine the standard or customary operating procedures at NCO during this period.

On September 15, 1969, Rudolph G. Merker was assigned as vice president in charge of NCO's commercial paper rating service. Prior to the assignment of Merker, responsibility for operation of this department had been assigned to Allen Rogers (now deceased.) However, Rogers had only been physically present in NCO's office twice since January 1965, preferring, apparently because of illness, to do his work from his home. The other analysts employed by NCO were located in the Manhattan office and the number of these individuals varied from three to four during this period.

Merker had previously been employed by D & B as manager of the retail and wholesale division of NCO, which apparently is part of the traditional D & B retail credit reporting system. Merker had been employed by NCO for 42 years, primarily in the retail credit reporting area. Merker has no college education and is not a chartered financial analyst. Prior to becoming head of the commercial paper division of NCO, Merker had very limited experience in the commercial paper rating area.

Merker stated that he was to assume Rogers' supervisory responsibilities, but that he did not know why he in particular was selected for this position. The following colloquy is illustrative of the conditions prevalent at NCO during this period:

Question. When you assumed your responsibilities, were you instructed or informed as to what these responsibilities would be specifically, and if so, by whom were you informed?

Answer. No; it was not spelled out.

Question. How were you aware of what your responsibilities and duties would be?

Answer. Well, it was just that being a department head, I knew what the responsibilities of a department head had been at NCO.

Question. At the time you assumed your responsibilities, did you have any conversation or meeting with Mr. Rogers to explain what he expected of you and what you expected of him?

Answer. No; not along these lines; no.

Question. How was it determined what responsibilities you would have and Mr. Rogers would have after you assumed your new position?

Answer. Well, he was a consultant and he was guiding me in my new position as director of commercial paper.

Question. At the time you assumed your responsibilities, were there any written policies or operations manual for the different responsibilities in NCO?

Answer. No; nothing in writing.

Question. How did you become familiar with your duties and the manner of discharging them?

Answer. Just by working with them.

Question. With whom?

Answer. With the problems and the reports and inquiries, and the workload of the day; and guiding and calling Allen Rogers and having his long years of knowledge in the department.

It would seem apparent from the foregoing that NCO's commercial paper department was relatively disorganized and of scant importance

in the D. & B. corporate complex as the person selected to manage same is a veteran functionary of limited skills and experience in this area and as he received no training or ongoing guidance in the performance of these duties.

In any event, Merker was responsible for the daily activities of the commercial paper division subject to the overall supervision of Eugene Schenk, president of NCO. Merker described the daily activities of his department as essentially consisting of supervising the activities of a limited number of analysts—three or four during the period from September 1969 to June 1970—who reviewed files, interviewed prospective issuers and responded to inquiries from subscribers to NCO's rating services.

Merker indicated that the analysts in rating the commercial paper would consider the issuer's annual reports and general operating statements to determine the issuer's liquidity. The analyst would individually review the issuer and assign a rating. However, the same analyst would not necessarily continue to be responsible for the rating of a particular issuer or a specific group of issuers. Thus, this responsibility would be rotated among the various analysts depending upon their availability and workloads. Prior to March 1970 there was no individual responsibility, for as Merker states:

> * * * we didn't have this individual control. It was a case of taking the reports and writing them as they became due to be written but no accounts were assigned to any specific analyst.

It should be noted that the system of rotating responsibility for assigning and/or reviewing the rating of issuers necessarily resulted in varying degrees of familiarity and expertise about such issuers by the NCO analysts.

In the ordinary course of rating commercial paper the issuer would enter into a subscription agreement whereby the issuer would agree to provide NCO with information which would differ in no material way from that information provided by the issuer to its line banks. This information would normally consist of the company's annual fiscal report, quarterly reports, profit-and-loss statements and press releases.

It was normal procedure for NCO to agree with the issuer that a specified officer of the company would provide the aforementioned information to NCO and be available to answer inquiries from NCO.

Normally, NCO, after having had an opportunity to review the aforementioned material might have occasion to personally contact the financial officers of the issuer for purposes of clarification.

However, it should be noted that NCO would not ordinarily consider whether or not the issuer had conformed to any or all applicable regulatory requirements prior to the issuance of the paper. The reason for this was that NCO was concerned primarily, if not exclusively, with the financial condition of the prospective issuer rather than the regulatory environment in which it might operate.

Moreover, the information that NCO would normally obtain in order to issue or continue a rating would not differ in content, detail or timeliness from that which was publicly available except as Merker stated:

> * * * bank information, the individual bank lines from an individual bank for that particular issuing company, the amount outstanding in bank lines, amount owing, and the high and low in bank borrowings for a period of time, either three months or it could be 6 months.

Merker also indicated that this information would be provided in the ordinary course to NCO by the banks without the need for prior authorization by the issuing company. However, this bank checking, if it did occur, would be quite infrequent, not even as often as annually.

Merker summarized the NCO prime rating as follows:

> The NCO prime rating for a commercial paper issuer is giving our opinion of the liquidity of the company in that the commercial paper notes in our opinion would be met at maturity.

The NCO prime rating would be assigned after a review by NCO analysts of the issuer's financial statements. However, in making these determinations NCO did not have any internal guidelines or standard which it required issuers to meet; that is, standards regarding liquidity ratios, asset/liabilities ratios, quick capital ratio, or any other type of objective statistical stanard.

Further, NCO regarded "liquidity," "bank support" and "operating performance" as the most important factors in assigning a rating. While Merker never specifically defined what NCO considered liquidity to be, his understanding of liquidity would appear to be the ability of the issuer to repay any outstanding amount of commercial paper at maturity.

NCO regarded "operating performance" as relating to the profitability of the issuer's operations for a period of time and "bank support" as the lines of bank credit available to "support" commercial paper.

NCO regarded 100 percent bank line coverage as desirable but not required in all instances. The percentage of bank line credit could even be 50 percent depending upon the issuer. Moreover, these lines of credit were not required to be confirmed or revolving, but merely unconfirmed lines would suffice to meet this NCO requirement.

NCO considered other factors also in making its credit determination. In particular, NCO considered the issuer's working capital position indicative of the issuer's ability to repay the commercial paper notes at maturity.

NCO defined "working capital" as current assets less current liabilties, including that portion of long-term debt due within 1 year. A concomitant part of this analysis of "working capital" was an evaluation of the issuer's ability to meet its current debt through cash flow. However, this cash flow was defined by NCO to include not only cash generated through operations but also the ability to raise short-term debt capital. Moreover NCO did not require any minimum dollar amount of working capital.

Further it is important to note that NCO did not require that the issuer's current assets exceed its current liabilities, although commercial paper itself is a current liability. NCO would also consider the availability of other assets which might be utilized to collateralize loans or which might be available for sale, if necessary, to raise capital.

NCO did not, however, require that the issuer have any specific ratio of assets which would be unencumbered by mortgage or lien and available for such use. Moreover, apart from reviewing the balance sheet, NCO would not confirm the amount and types of assets available for collateralization or disposition by sale, either from the issuer or its banks.

NCO also considered the investments of the issuer in securities of subsidiaries, affiliates, and unrelated parties, account or trade receivables, and investments in equipment or inventory.

NCO would not however inquire whether there were any restrictions on such investments (e.g. "letter" stock) or whether such investments had been used as collateral for loans, nor would NCO determine whether such investments were marketable or at what price, if any, these were marketable. As NCO stated, it was concerned solely with "the mere existence" of such investments.

Although NCO did state that it would consider the collectability and terms of payment of receivables, as well as encumbrances on inventory or equipment, its information would be provided by the issuer and would not be confirmed with any other source, for example, equipment trustees.

A further element in the NCO analysis is an "examination" of the corporate complex if an issuer should be part of same, for example, Penn Central Transportation Co. and Penn Central Co. NCO would evaluate the corporate complex, even though in the present market the issuer of the paper is solely responsible for its repayment, and no subsidiary, parent of affiliate guarantees repayment of principal and/or interest.

It should be noted moreover that NCO at this time did not consider any debt ratings of the issuer's securities, by either Standard & Poor's or Moody's, even though Moody's, like NCO, was a subsidiary of Dun & Bradstreet.

While the foregoing discussion of NCO's mode of operation was gleaned from testimony taken from Messrs. Merker and Rogers it is illustrative to consider the following excerpts from a letter written on January 29, 1969 by Louis C. Ward, manager, commercial paper division of NCO to Steven Clarke of the St. Louis Office of Goldman, Sachs & Co.[2]

As mentioned in my telephone conversation with you last week, it is difficult to list each standard we use in evaluating the quality of commercial paper notes, due to the diverse industries on which we report.

Even factors which may appear intangible to others, may be of pertinence in our reaching a rating decision, as per the examples I gave you on the phone.

However, some of the major points we look at are the following:

(*a*) We compare each issuer's various ratios against industry averages.
(*b*) Judge progress at least over the previous 10 years.
(*c*) Evaluate the company and its markets and the market's potential.
(*d*) Make an appraisal of principal officers and their business experience.
(*e*) Analyze the company's potential in future years.
(*f*) Review bank support and periodically contact a sampling of the company's line banks, as deemed necessary.

After reviewing the above, and taking into consideration the company's capital funds position (at least $25 million net worth of capital funds are requisite for "prime", $5 million for "desirable", $1.5 million for "satisfactory"), we then determine the classification.

Another requirement we have is direct contact and discussion with financial management of the company, at least once a year when they are in New York to see the banks.

Occasionally, a nationally known firm seeks to enter the market, but somehow does not measure up to our evaluation of a prime company. Recognizing the questionable acceptance by the market were we to rate it as less than prime, we endeavor to persuade it to delay its plans to issue, until the particular problem we feel it has is alleviated or corrected.

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[2] It should be noted that Clarke attached a photocopy of this letter to a letter he wrote on January 21, 1970 to W. N. Fedderspeel, comptroller of the Granite City Steel Co. of Granite City, Ill., as part of an explanation of what NCO was and what services it performed.

If the company, or dealer, decides to issue, anyway, we either withhold a rating completely or rate it as less than prime.

We feel this approach is equitable to the company and provides a measure of safety for the investor.

NCO had a continuing and extensive relationship with the major commercial paper dealers. This relationship consisted primarily of ongoing contacts between NCO and the dealers relative to information and/or opinions about specific issuers handled by the dealers. The dealers utilized NCO ratings as a marketing tool in offering commercial paper to their customers since many customers, particularly nonfinancial institutions, were required by statute or resolutions of their boards of directors or trustees, to purchase only that commerical paper which was rated prime by NCO, then the only national commercial paper-rating service. Due to the importance of an NCO rating, preferably a prime rating, dealers would require their issuers to obtain (at the expense of the issuer) a rating from NCO.

The largest and most influential commercial paper dealer is Goldman, Sachs & Co., which started as a commercial paper dealer and later expanded into a full-line broker-dealer. Goldman, Sachs was a subscriber to NCO's rating services and its issuers, whenever possible, obtained an NCO rating. Goldman, Sachs, as a customary part of its marketing of commercial paper, would communicate, orally and in writing, the NCO rating of the issuers it handled.

NCO personnel, in particular Merker, were acquainted with and had frequent contacts with Goldman, Sachs.[3] This relationship with Goldman, Sachs did not differ in any material way from those maintained by NCO with other commercial dealers. It apparently consisted primarily of frequent telephone conversations between NCO and Goldman, Sachs and the receipt by NCO of Goldman, Sachs' information sheets about the issuers handled by that firm.

The information sheets referred to were prepared by Goldman, Sachs and distributed to their customers. These were a short precis of the issuer and, according to NCO, did not contain any more extensive information or any more current information than that which was publicly available. Further, Goldman, Sachs did not explicitly make any evaluation on these sheets of the credit-worthiness of their issuers.

During the period from September 15, 1969, to June 1970, Merker was primarily responsible for the rating of Penn Central's commercial paper.[4] He stated that the reason why he became directly responsible for the Transportation Co. rating was: "Well, I had concern, but I was not overly concerned about it, and I was watching it."

When asked to explain the reasons for his concern Merker replied:

The bottom line was on the downgrade, and the railroad company was losing money very definitely, and it was a case that had to be watched very closely.

However, it should be noted that during this period Merker could not recall any other issuers for which NCO had the same concern. While Merker stated that his assumption of responsibility for the Transportation Co. rating was coincident with his becoming head of the NCO rating service on September 15, 1969, the first indication of any activity by him in this area was on October 2, 1969.

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[3] The individuals at Goldman, Sachs were Robert G. Wilson, partner in charge of the commercial paper department of Goldman, Sachs; George Van Cleave, Wilson's assistant; Jack Vogel, the chief credit analyst of the commercial paper department; and Walter Fekula, a credit analyst.

[4] It is significant to note that Merker could not recall any other issuer for which he had the primary responsibility of rating during this period.

Merker's concern was prompted by a telephone conversation with Rogers who discussed an unfavorable item about Penn Central appearing in the Robert Metz column in the New York Times of that day. After receiving this information Merker reviewed the June 30, 1969, data in Moody's Transportation Manual which disclosed declining profits on a consolidated basis and a loss for the Transportation Co. itself for the 6 months ended that day. On October 3, 1969, Merker spoke with Jack Vogel of Goldman, Sachs regarding Penn Central. Vogel stated that he was not concerned about the 6-month results nor the unfavorable items in the New York Times. With respect to this conversation with Vogel, Merker testified as follows:

Question. Did you rely on Mr. Vogel's comments?
Answer. Yes; I did.
Question. Did you have any basis for relying on his comments?
Answer. He is a responsible man and well recognized in the commercial paper market.
Question. You were aware though, I assume, that at the time he was working for the dealer in Penn Central commercial paper and as such it would seem to me that he would tend to be as favorable as possible on the security. Did you take this into consideration?
Answer. I do not think that Jack would have misled me.
Question. Did you see any conflict of interest in his position in that he is handling and his organization is selling this particular issue and you are asking him for his opinion on paper which they are selling on a continuing basis?
Answer. No; I didn't see any conflict of interest, no.

The reason for Vogel's lack of concern was the existence of bank lines of credit of $300 million available to the Transportation Co. Merker, however, did not inquire as to what amounts were then available or what conditions, if any, were applicable to the availability of same.

After speaking with Vogel, Merker wrote to Jonathan O'Herron, Penn Central's vice president (finance) and asked for interim operations figures, a list of banks of Penn Central's and bank credit lines and the high and low borrowings and other short-term debt. Merker received the requested information from O'Herron in October 1969. Merker stated that in reviewing the Transportation Co. file: "* * * I saw no need for action as far as the rating was concerned."

On October 28, 1969, NCO issued a release to its subscribers on the Transportation Co., which gave consolidated earnings and revenues for 9 months of 1969 which indicated a downward trend. NCO however, then stated:

> From this office's point of view the commercial paper standing of this company is not affected because of the readily salable assets of the subject, if the need arose.

On October 29, 1969, NCO issued another release on Penn Central which stated in part:

> Jonathan O'Herron vice president—finance, has advised that the company has available a $100 million line of credit to support its commercial paper position.

At this same time Penn Central had approximately $150 milmillion in commercial paper outstanding.

On November 6, 1969, the ICC authorized Penn Central to issue another $50 million in commercial paper, increasing the authorization to $200 million. The ICC's concern with the use of short-term debt has already been described.[5] However, despite the fact that this

[5] See discussion at page 280.

concern was expressed in a public document, NCO never reviewed it and was unaware of the serious implications of the ICC statement.

On November 26, 1969, Penn Central announced that for the first time in its history it was suspending payment of quarterly dividends. This action was taken by Penn Central "* * * to conserve cash and in keeping with responsible management." Apart from notifying its subscribers of this already public information, NCO did not take any action with respect to the company's rating.

In December 1969, Pennco for the second time in 6 months was used as a financing vehicle to raise money for the Transportation Co.[6] NCO took no action regarding a review of the Transportation Co. rating, even though these facts, evidencing lack of financing capability by the parent Transportation Co., were publicly stated in the offering circular for the debentures issued by Pennco at this time.

On February 4, 1970, Penn Central announced preliminary 1969 results on a consolidated and unconsolidated basis. On a consolidated basis Penn Central had earnings before extraordinary items of $4.4 million in 1969 as compared with $87 million in 1968. The Transportation Co. lost $56.3 million, compared with only $5.1 million a year earlier.

When asked what NCO did upon receipt of this information Merker replied: "We had discussed it among the analysts and decided to wait for the balance sheet of December 31, 1969."

According to Merker, NCO did nothing else about Penn Central at this time. However, on February 5, 1970, Allen Rogers of NCO spoke with Jack Vogel of Goldman, Sachs. According to Vogel their conversation was as follows:

> Alan Rogers of NCO called me today to express concern over the sharply reduced earnings announced in the newspapers today. He asked if we were continuing to sell the company's notes and whether I felt that Penn Central had sufficient resources which could be converted to cash to pay down debt, if necessary. I said that Goldman, Sachs was continuing to sell the commercial paper notes of Penn Central Transportation Co. In answer to question No. 2, I suggested that the company has a number of valuable properties and securities, and that I was certain that something could be worked out should it ever become necessary. Alan said that as a result of my comments, he would continue to carry Penn Central Transportation Co. as a prime name.

In his testimony Rogers stated that he could not recall such a conversation, but he admitted that it was possible that NCO continued rating the Transportation Co. as prime as a result of Goldman, Sachs' confidence in it.

In March 1970 Penn Central released the audited 1969 results and a balance sheet as of December 31, 1969. This report confirmed in detail the preliminary results announced on February 4, 1970.

Upon receipt of this report NCO reviewed same. However, this report was reviewed by a committee of NCO personnel, namely Merker, Rogers, Dan Cahalane (a junior analyst), and Eugene Schenk. NCO did not, however, take any action whatsoever with respect to the Penn Central rating until April 23, 1970. On that day Merker wrote to O'Herron as follows:

> We are presently reviewing our classification. Because of the very substantial losses recorded last year; and it is apparent that the operating performance for the first quarter of the current year was rather disappointing for the parent organization just reported a loss of $17.2 million, we would appreciate your assistance in furnishing some additional information.

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[6] See section on Finances in Part I of this report.

Mr. O'Herron, in the event that additional capital must be raised, what assets would be available for this purpose? Also, please tell us how the funds from the sale of commercial paper notes are being used.

This information, and any other comments that you care to make would be very helpful in our analysis.

Unfortunately for NCO, O'Herron never responded to this inquiry even though Merker sent a followup letter on May 18, 1970.

On April 22, 1970, Penn Central announced a first-quarter loss of $17.229 million compared with consolidated net income of $4.601 million for first quarter 1969. The Transportation Co. had a first quarter loss of $62.7 million compared with a loss of $12.8 million in 1969. And it was obvious that even these substantial losses were not reflective of the underlying situation since they included the impact of large reported profits on two transactions.[7]

During the period from April 23 to May 18, 1970, NCO discussed the Penn Central situation but did not ever consider lowering the company's rating from prime, nor did they take any further action. In fact, the primary topic of discussions during this period was the failure of Penn Central to reply to the letter of April 23.

Moreover, NCO was not aware that the last sale of the Transportation Co.'s commercial paper occurred on May 1, 1970; that Goldman, Sachs ceased to offer the company's commercial paper on May 20, 1970; and that as of April 23, 1970, Goldman, Sachs required its sales personnel to inform prospective customers of the Penn Central earnings announcement of April 22, 1970.

NCO was unaware that the May 12, 1970, offering circular for the Pennco $100 million debenture offering contained the following statement at page 4:

> At May 8, 1970, railroad had outstanding $152.1 million of commercial paper pursuant to orders of the Interstate Commerce Commission authorizing up to $200 million of such paper. To the extent that commercial paper outstanding has been less than $200 million, railroad has borrowed under a $50 million bank line of credit. As additional backing for its commercial paper railroad has available $50 million under the credit agreement referred to under introduction. Between April 21, 1970 (the day preceding the announcement of the operating results of railroad for the 3 months ended March 31, 1970) and May 8, 1970, maturities and payments of commercial paper exceeded sales of commercial paper by $41.3 million. Of the commercial paper outstanding at May 8, 1970, approximately $75 million matures prior to June 30, 1970, and the balance at various dates to December 16, 1970.

Although this was a preliminary offering circular, it should have been available to NCO pursuant to their subscription agreement with Penn Central. NCO, however, did not become aware of the fact that the company's redemptions of commercial paper were exceeding sales until the appearance of a Wall Street Journal acticle on May 27, 1970.

On May 15, 1970, Standard & Poor's downgraded the bond rating of the Pensylvania Company and its proposed $100 million debenture offering. On May 18, 1970, Merker spoke with Jack Vogel of Goldman, Sachs. According to Vogel, Merker asked him if he still felt the same way about Penn Central in view of Standard & Poor's rating change. Volgel replied affirmatively and Merker accepted his explanation for the change.[8]

On May 28, 1970, Merker spoke with Jack Vogel about Penn Central. Vogel after stating that the Transportation Company had bank

[7] See discussion at page 54.

[8] Merker, however was unable to recall that the conversation took place and the content of same.

credit still available to redeem commercial paper, also suggested that Merker check the May 12th offering circular.

Merker did obtain a copy and on June 1, 1970, after internal discussions at NCO between Merker, Schenk & Rogers, Merker called O'Herron asking for more information. O'Herron declined to provide same and this, coupled with the fact that the $100 million offering was aborted, prompted NCO to reserve Penn Central's rating pending further information. Effectively this meant that NCO while not refusing to rate the Transportation Company's commercial paper, was not assigning a rating for a limited period as well as downgrading it from prime.

After discussing this action with Vogel and O'Herron, NCO then issued a press release regarding this action. A mere 3 weeks later, Penn Central filed for reorganization.

PART IV

IV. PENPHIL COMPANY (PENPHIL)

INTRODUCTION

Penphil, a private investment company whose stockholders include David Bevan (D. Bevan), other members of the Pennsylvania Railroad Co.'s (PRR) financial department, and officers of companies in which it made investments, purchased securities at a cost of over $2.2 million between 1962 and 1968. Charles J. Hodge (Hodge) and D. Bevan controlled Penphil.

Penphil was closely related to the PRR. Most of the funds for Penphil's investments came from loans made by Chemical Bank. At the time these loans were made D. Bevan was the chief financial officer of the PRR (and later the Penn Central) which had substantial banking relationships with the Chemical Bank. D. Bevan was also in charge of the investments of the PRR and its employee funds. In nearly all instances, the PRR and its employee funds invested in companies in which Penphil was to make or had made investments.[1] The possible conflicts of interest arising from Penphil's investments were never disclosed to the PRR board of directors.

Penphil also engaged in the practice of inviting officers and directors of companies in which Penphil invested to become members of Penphil. This put Penphil in the position of having an avenue of access to information concerning the day-to-day operations of the companies.

In July 1962, D. Bevan and Hodge, a partner in Glore Forgan—who was to become instrumental in PRR's diversification program of the mid-1960's—organized Penphil for the purpose of buying and selling securities of companies about which Penphil had intimate knowledge because of close business relationships between Penphil shareholders and the companies.[2]

In connection with these purchases D. Bevan, Glore Forgan, and Hodge arranged for the Chemical Bank, New York, to extend a line of credit to Penphil. Because of D. Bevan's position at the PRR, the Chemical Bank was willing to make these loans to Penphil at the prime rate without compensating balances and with the securities purchased as the only collateral. Prior to 1966, the Chemical Bank loaned Penphil more than 95 percent of the cost of its investments in stocks, most of which were traded over-the-counter. Overall, the Chemical Bank, between 1962–1968, loaned Penphil over $1.7 million to buy securities at a cost of more than $2.2 million. The loan balance was at times as much as $1.2 million.[3]

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[1] In the latter parts of this section no distinction is drawn between the investments made by the company and by the employee funds. Both are referred to as PRR or Penn Central investments hereinafter, unless otherwise specified.

[2] A table giving background information on Penphil shareholders has been attached as Exhibit 1.

[3] See discussion *infra* at p. 307 *et seq.*

SUMMARY OF TRANSACTIONS

In July 1962, Penphil made its first purchases of securities when, on the recommendation of Hodge, a Kaneb Pipe Line Co. (Kaneb) director and a member of its executive committee, Penphil bought Kaneb stock at a cost of $115,925. The July purchases were made with knowledge of nonpublic information regarding a substantial increase in Kaneb's earnings during the first third of 1962 and earnings per share estimates for the year. Penphil purchased additional Kaneb stock at a cost of $40,000 in February 1963. At that point Hodge had information about Kaneb's 10-year estimates of favorable revenues, earnings and cash flow. During 1962 and 1963, the PRR and various Penphil stockholders also purchased Kaneb stock. These purchases were made when each had nonpublic information concerning major pipeline expansion plans and significant increased earnings of the company. As of April 20, 1972, Penphil still held its shares and had an unrealized profit of $926,000.

Penphil's next purchase was 10,000 shares of Great Southwest Corp.—GSC—common stock in July 1963. Hodge, a GSC director, had nonpublic information about a dramatic and unexpected improvement in GSC fiscal 1963 earnings which were expected to double 1962 earnings. In March 1964, D. Bevan personally purchased GSC shares while in possession of information not publicly available that the PRR was considering acquiring 80 percent of GSC's outstanding stock. In November and December 1965, Penphil, D. Bevan, and Hodge sold their shares of GSC to the PRR at substantial profits. Penphil's profit was $212,500.

In August 1963, Penphil, on Hodge's recommendation, made purchases of the common stock of Tropical Gas Co., Inc. (Tropical) Hodge, also a Tropical director, was intimately aware of the company's affairs.

In May 1964, Penphil bought Continental Mortgage Investors (CMI) shares for $196,800. Prior to this purchase Penphil had obtained significant confidential information from CMI's investment banker. This information came from a partner of that firm who was also a Penphil stockholder. This information concerned CMI's confidential plans for $10 million of long-term debt financing and its cancellation of plans for further equity financing; both announcements, when publicly made, were expected to have the desired effect of removing the lid on the price of CMI stock. Penphil still holds these shares and as of June 2, 1971, had an unrealized profit of more than $1 million.

From May 29 to June 2, 1967, nine Penphil stockholders and the PRR bought an aggregate of 5,539 shares of Symington Wayne Corp. (Symington Wayne). On June 27, 1967, Penphil bought 1,000 Symington Wayne shares. These purchases were made with knowledge of private merger discussions Symington Wayne was conducting with two competing companies.

The terms being proposed were very favorable to Symington Wayne and its shareholders in that if either offer was accepted it would cause Symington Wayne shares to immediately increase in price. The subsequent public disclosure of these negotiations resulted in the stock selling at an immediate and substantial premium. By the end of January 1968, Penphil, seven of its stockholders and the RPR sold their Symington Wayne shares at substantial profits.

In late 1965, D. Bevan, Hodge, and Benjamin F. Sawin (Sawin) a Penphil stockholder and its bank expert, made plans for Penphil to invest in a chain of Florida banks. They determined to do this through initial investments in two banks in Boca Raton, Fla. controlled by Thomas F. Fleming, Jr. (Fleming). Penphil used personnel and assets of Arvida Corp. (Arvida) a newly acquired subsidiary of the PRR, to meet with and obtain an agreement from Fleming that he would arrange for stockholders of these banks to sell Penphil some of their bank stock which, at the time, was tightly held. At least Penphil's initial purchases of this bank stock were made at a time when some of its members were in possession of nonpublic information concerning significant business developments in the Boca Raton area and private plans of the bank to sell stock to its stockholders at $6 below market. Penphil has an unrealized profit on these purchases of more than $742,000.

Finally, in June 1968, Penphil bought 5,000 shares of National Homes Corp. (National) common stock on the recommendation of Lawrence M. Stevens, a Penphil stockholder who was the manager of the Philadelphia office of Hornblower and Weeks-Hemphill, Noyes. During that same month three Penphil stockholders bought an aggregate of 2,200 National shares. National is the only instance where it appears Penphil invested without having any inside relationship with the target company. It is significant that Hodge opposed this investment, saying that the stock should not be held blindly.

As a result of its investments Penphil has made a profit of $226,895.51 from securities bought and sold, and, as of June 1971, had an unrealized gain of $3,026,476.40 from securities held. Penphil has not had a loss on any of its investments with the single exception of a $40,000 note which it purchased from Holiday International Tours. The latter investment was associated with the EJA situation discussed elsewhere in this report.

Background—Penphil

In the summer of 1962, D. Bevan and Hodge were the principal organizers and promoters of Penphil, a closely held corporation which was designed to engage in the business of purchasing, holding, and selling securities for its own account. On July 19, 1962, the day after its first securities purchase, Penphil was incorporated in Pennsylvania by Thomas Bevan, an attorney who was David Bevan's brother. Prior to Penphil's incorporation, 13 personal friends of David Bevan and Charles Hodge were invited by them to be stockholders. All were substantial businessmen, many being officers or directors of publicly held companies. Immediately upon its incorporation, Penphil issued 3,000 shares of its common stock by selling 200 shares to each of the 13 friends as well as Charles Hodge and David Bevan for a total capitalization of $15,000. It was planned that Penphil's capital structure would be thin with substantially all of the funds needed for its business to come from bank loans.

Between July 1962 and the present, Hodge and Bevan invited and arranged for 15 additional people to become shareholders of Penphil. Ten of these persons purchased their shares either directly from Penphil or from one of the original shareholders. Five persons became shareholders when a corporation of which they were stockholders, Florphil Co., was merged into Penphil. Florphil had been incorporated to give

these five shareholders an opportunity to participate in certain of Penphil's investments. This matter will be discussed subsequently.

The evidence indicates that Penphil's investment objective was to purchase securities of issuers about which it had a great deal of current material information. Although any Penphil stockholder could suggest possible investments, investment decisions were, in fact, made by a small number of Penphil stockholders who dominated the affairs of the company.

From its establishment in July 1962 until October 20, 1970, Penphil made investments in common stocks, notes, warrants, U.S. Treasury bills and commercial paper. The following is a list of all of Penphil's investments other than U.S. Treasury bills and commercial paper:

Trade date	Issuer	Shares purchased and (sold)	Cost or (proceeds)
July 18-23 1962	Kaneb Pipe Line Co	22,633	$115,925.35
Feb. 1, 1963	do	5,000	40,000.00
July 18, 1963	Great Southwest Corp	10,000	165,000.00
Aug. 1-29, 1963	Tropical Gas Co	10,000	191,495.27
May 8, 1964	Continental Mortgage Investors	10,000	196,800.00
Dec. 7, 1965	Great Southwest Corp	(10,000)	(376,949.00)
Sept. 27, 1966-Jan. 6, 1967	First Bank & Trust Co. of Boca Raton, Fla	8,250	249,972.00
Jan. 12-Mar. 27, 1967	University National Bank of Boca Raton, Fla	4,733	62,640.00
June 27, 1967	Symington Wayne Corp	1,000	34,234.38
Nov. 2, 1967	Kaneb Pipe Line Co	[2] $500,000	493,544.90
Do	do	[1] 7,653	7,653.00
Jan. 4, 1968	Symington Wayne Corp	(1,000)	(41,549.16)
Feb. 21, 1968	Holiday International Tours	51,000	25,000.00
June 5, 1968	National Homes Corp	5,000	74,101.53
June 21, 1968	Holiday International Tours	[2] $40,000	40,000.00
July 26, 1968	First Bank & Trust Co. of Boca Raton, Fla	1,815	90,750.00
Aug. 21, 1968	Holiday International Tours	(51,000)	[2] (25,000.00)
Sept. 10, 1968	Kaneb Pipe Line Co	[2] ($500,000)	(516,423.62)
Nov. 18, 1968-Jan. 13, 1970	First National Bank of Deerfield Beach, Fla	(3)	(12,886.11)
Oct. 20, 1970	U. S. Freight [4]	(8,900)	(138,345.74)
Do	National Homes Corp	(5,000)	(82,407.01)

[1] Warrants.
[2] Note.
[3] Advance.
[4] Penphil received 8,900 shares of United States Freight Co., in exchange for its 10,000 shares of Tropical Gas Co., Inc., upon Tropical's acquisition by United States Freight in October 1969.

As the result of purchases, sales, stock dividends and splits, Penphil's investment portfolio as of June 2, 1971, contained the following shares of common stock and warrants to purchase common stock:

Issuer:	*Shares*
Kaneb Services, Inc	[1] 30,488
Continental Mortgage Investors	60,000
First Bancshares of Florida, Inc	[2] 52,096
Kaneb Services, Inc., warrants	7,653

[1] Kaneb Services, Inc. is the successor of Kaneb Pipe Line Company.
[2] Penphil received shares of First Bancshares of Florida, Inc. (First Bancshares) in exchange for its shares of First Bank and Trust Co. of Boca Raton (First Bank) and University National Bank of Boca Raton (UNB). First Bancshares is a registered bank holding company which was formed on or about October 15, 1970 to hold the stock of First Bank, UNB, First Bank of Riviera Beach, and Citizens Bank of Palm Beach County.

Only a small portion of the money which Penphil invested in securities came from Penphil shareholders. Penphil shareholders invested only $389,062, and $209,000 of this amount was not invested until late 1969. Penphil's largest source of funds was a line of credit extended by the Chemical Bank. Such loans were made at the prime rate with no compensating balances required and were secured entirely by the securities which the loans were used to purchase.

CHEMICAL BANK

The PRR had done banking business with the Chemical Bank since 1891 and its account with Chemical was one of the PRR's largest and one of the bank's oldest accounts, As of the latter part of December 1961, the PRR had more than $22,718,000 in outstanding loans from the Chemical Bank and was maintaining a compensating balance of between $4,543,000 and $5,818,000.

The banking relationship between the Chemical Bank and the PRR was a close one, and as vice president—finance, D. Bevan was a key man in the relationship. Bevan had known William S. Renchard, president of the bank since at least 1946, when Bevan was with N.Y. Life Insurance Co. D. Bevan had a personal line of credit with Chemical at the prime rate since at least 1960.[4] Hodge's and Sawin's relationship to the Chemical Bank also appears to have been very close. Glore Forgan had a long standing banking relationship with the Chemical Bank. Since 1961, Hodge had a personal line of credit, which reached a loan balance of nearly $950,000 by November 1968.[5] Sawin was president of an important Philadelphia bank and acquainted with Renchard.

During the week of July 16, 1962, D. Bevan telephoned Renchard to arrange financing for Penphil's purchase of Kaneb. Renchard's memorandum of this conversation is as follows:

To: Messrs. M. P. Chamberlain, C. A. McLeod.
From: Mr. W. S. Renchard.

David Bevan, financial vice president of the Pennsylvania Railroad Co., called me on the telephone today and said that he and a group of friends, totaling about 15, are planning to organize a corporation to purchase a substantial block of common stock of Kaneb Pipe Line Co. The group will include Charlie Hodge of Glore, Forgan & Co., Benjamin F. Sawin, president of Provident Tradesmens Bank & Trust Co., Messrs. Gerstnecker and Haslett of the Pennsylvania Railroad's financial staff and others.

They have in mind the purchase of a block of 25,000 shares of Kaneb stock at a price of somewhere between $5 and $6 a share. Mr. Bevan said he had made a thorough study of the outl * * * company and thought this was a very desirable purchase. App*arently* * * * block is being sold for ta*x* reasons. The *group* * * * equity into * * * ould pay in $7,500 additio*nal* * * * *m*onths' * * * amounts of money borrowed * * * *wou*ld like to set the loan up * * * basis at the prime rate of interest. WSR told Mr. Bevan we would be glad to handle this accommodation for him and suggested that he have whoever is *h*andling the mechanics *get* in touch with Mr. Chamberlain or, in his absence, Andy McLeod.

Frankly, the rate on the proposed loan is too low, but, in view of the size of the deal and the fact that it has such good friends connected with it, WSR felt it was preferable not to quibble with Mr. Bevan over the rate. He indicated that George Bartlett of Glore, Forgan & Co. would probably be the one to negotiate the purchase of the stock and very likely Charlie Hodge would be the one to work out the mechanics of the loan arrangement.[6]

Hodge, a managing partner of Glore Forgan, thereafter contacted C. A. McLeod, a Chemical Bank vice president, regarding the loan on the morning of July 23, 1962, and that day McLeod mailed Warren Bodman, another Penphil member, and a partner in Yarnall, Biddle & Co., a broker-dealer, the necessary corporate papers for the loan account to be opened by Penphil along with a demand note form and loan purpose statement form. Penphil completed its purchase of

[4] Prime rate loans for individuals are highly unusual.

[5] Staff Report of the Committee on Banking and Currency, House of Representatives on *The Penn Central Failure and the Role of Financial Institutions*, 92nd Cong., 1st Session, ("Patman Report"), p. 201.

[6] The memorandum is in poor condition and pieces of it are missing. Letters *italicized* are readings from

22,633 shares of Kaneb stock the next day, and Glore Forgan subsequently delivered the certificates to the Chemical Bank against payment.

Although the purpose of the initial Chemical Bank loan was to purchase shares of Kaneb stock, the effect was that Hodge and D. Bevan established for Penphil a line of credit with the Chemical Bank which was to provide it with a ready source of funds for its purchases of securities. From the time of this first loan through August of 1968, Penphil, when it wished to buy stock, would merely have T. Bevan contact the bank by telephone, advise the bank that stock was being purchased, that a loan of a specified amount would be required and that the certificates would be delivered against payment. The evidence shows that the bank would then mechanically and routinely pay for such stock upon delivery. During the period from July 1962 to at least February 1968, Penphil purchased, among other securities, 27,633 shares of Kaneb, 10,000 shares of GSC, 10,000 shares of Tropical, 10,000 shares of CMI, 10,065 shares of First Bank and 4,733 shares of UNB. All of these securities were traded in the over-the-counter market. In connection with the purchases of the Kaneb, GSC and Tropical stock, Glore Forgan was the executing broker-dealer and Hodge was the salesman. After each purchase Glore Forgan caused the stock to be delivered to the Chemical Bank against payment. As previously noted, Hodge, a partner of Glore Forgan, had participated in the arrangments whereby the Chemical Bank extended the credit for the purchase of these securities.[7] Similarly the CMI shares were purchases on credit extended by the Chemical Bank although the executing broker-dealer delivering the shares to the bank against payment was Hemphill, Noyes. At least the 1,815 shares of the Florida bank stock purchased on July 26, 1968, were delivered to the Chemical Bank as collateral by T. Bevan. Purchases of the rest of the First Bank and UNB shares by Penphil were largely made with proceeds from the sale of securities originally purchased with Chemical Bank loans.

The following chart reflects the dates and amounts of loans made by the Chemical Bank to Penphil to finance the purchase of securities.

[7] Regulation T of the Federal Reserve System establishes margin requirements on loans by a broker-dealer for the purchase of securities, and further prohibits him from arranging for loans by others on a basis more favorable than he himself could provide. It appears that the credit extended was not in accordance with the provisions of regulation T.

Loan Date	Loan Amount	Purchase Amount	Security
August 20, 1962	$102,000.00	$115,925 35	Kaneb common.[1]
February 8, 1963	40,000.00	40,000.00	Do.[1]
July 25, 1963	120,000.00	165,000.00	Great Southwest common.[1]
August 8, 1963	47,450.00	47,450.00	Tropical Gas common.[1]
August 14, 1963	25,012.30	25,012.50	Do.[1]
August 16, 1963	27,187.50	27,187.50	Do.[1]
August 26, 1963	30,026.25	30,026.25	Do.[1]
September 9, 1963	[2] 45,636.75	42,036.75	Do.[1]
September 11, 1963	8,057.52	8,057.52	Do.[1]
September 13, 1963	4,000.00	4,000.00	Do.[1]
September 20, 1963	3,749.95	3,749.95	Do.[1]
March 23, 1964	[3] 1,739.95		
May 25, 1964	196,800.00	196,800.00	CMI shares.[1]
December 29, 1965	[2] 379,000.00	372,433.33	U.S. Treasury Bill [1] [10]
September 15, 1966	[4] 15,000.00		
June 29, 1967	10,000.00	34,234.38	Symington Wayne common.
October 17, 1967	[5] 40,000.00		
November 2, 1968	493,000.00	501,197.90	Kaneb $500.000 debenture and warrants.
June 24, 1968	[6] 50,000.00	74,101.53	National Homes common.
June 25, 1968	40,000.00	40,000.00	International Air Bahamas and Holiday International Tours notes.
August 30, 1968	[7] 60,000.00	90,750.00	First Bank common.[1]
October 4, 1968	[8] 30,000.00		
Total	[9] 1,768,659.92		

[1] Delivered to Chemical Bank against payment and held by Chemical as collateral.
[2] The disposition of the additional funds is unknown.
[3] The purpose of this loan is unknown.
[4] Loan to pay estimated Federal tax.
[5] Funds used to purchase Penphil stock from the estate of Leslie Cassidy.
[6] Purpose of this loan is uncertain but it appears to be for the purpose of purchasing National Homes stock.
[7] With this loan, Penphil's loan balance reached its maximum figure, $1,228,000.
[8] Money borrowed to be deposited in overdrawn bank account to pay interest due and to pay current bills.
[9] As of June 30, 1971, Penphil still had an outstanding loan balance of $280,000
[10] A series of short term investments were made on a "roll over" of these funds.

It was possible for Penphil to buy securities at a cost of more than $2,200,000 because of the highly unusual and enviable relationship between the Chemical Bank and certain Penphil stockholders. This relationship enabled Penphil to borrow, at the prime rate and without compensating balances, 95 percent of the cost of the securities purchased before 1966 and 79.7 percent of Penphil's total investments.

KANEB PIPE LINE CO.

BACKGROUND

Kaneb Pipe Line Co.,[8] a Delaware corporation with its principal office in Houston, Tex., was organized in 1953, for the purpose of transporting petroleum products by pipeline in Kansas and Nebraska. As of December 31, 1961, the company had 885,385 shares of common stock outstanding. The stock traded in the over-the-counter market. As of December 31, 1961, the PRR and the following persons who became Penphil shareholders owned Kaneb stock:

	Shares
Fisher [1]	97,263
Hodge	7,954
D. Bevan	155
T. Bevan	100
Horner [2]	3,082
PRR	15,782

[1] As of December 31, 1961, Fisher was Kaneb's second largest stockholder with 97,263 shares. The Northwestern Mutual Life Insurance Co. was the largest shareholder with 99,189.
[2] Edwin Horner, an investment banker of Lynchburg, Va. was a friend of Hodge.

[8] The name was changed in 1971 to Kaneb Services, Inc.

Herbert Fisher (Fisher) was president of Kaneb and was also president of Pipe Line Technologists (Pipetech), a consulting firm which provided the management of Kaneb under contract and which had been a consultant to the PRR since the 1950's. Hodge had been a d rector of Kaneb and, along with Fisher, a member of its three man executive committee since the mid-1950's. Glore Forgan was Kaneb's investment banker.

KANEB'S BUSINESS OPERATIONS 1961-62

For 1961 Kaneb's net income of $38,547 was down from $505,815 in 1960 due to "generally depressed conditions . . . throughout the Midwest petroleum products market during 1961." However, on March 5, 1962, Fisher wrote the Kaneb directors, including Hodge, and reported that shipments of fuel oils in January and February were at record highs due to severely cold weather in the areas served by Kaneb. He also stated that "As a result revenues are up more than 20 percent and earnings are expected to more than double those for the first 2 months of 1961."

A report to the shareholders included in the 1961 annual report and dated March 15, 1962, and distributed about April 1, briefly mentioned that business during the first 2 months of 1962 was stronger than during the comparable period of 1961, but gave no figures and no indication of the magnitude of the improvement. A detailed report of first quarter earnings was presented at Kaneb's annual shareholders meeting on April 16, 1962, but since only two persons who were not part of management were present and no press release was issued no public dissemination of this information occurred. During the latter part of May 1962, Hodge was informed that Whatley estimated 1962 earnings per share would be 58 percent greater than in 1961. A public announcement of the significant information concerning the improvement in Kaneb's earnings was made during the last week of August 1962, when Kaneb's semi-annual report was mailed to shareholders.

At least by August 1961, and continuing into 1962 Kaneb was also privately considering several proposals for the expansion of the transmission of liquid propane to its main line system. Fisher believed that this expansion would have a significantly favorable effect on Kaneb's earnings.

KANEB STOCK PURCHASES DURING 1962 BY THE PRR AND PENPHIL STOCKHOLDERS

From February 1962 to June 1962, D. Bevan and Robert Haslett, who was director of investments of PRR and also a Penphil member, caused the PRR to buy in 10 transactions 9,642 Kaneb shares at prices ranging from $6 to $7 per share. These purchases increased the PRR's holdings to 25,424 shares, an increase of 61 percent. Each of these transactions was executed by Glore Forgan on an agency basis with Hodge as the saleman.[9]

[9] Included in these ten transactions was a purchase on February 9 and a purchase on April 18, the same days that Horner, a friend of Hodge and subsequently a Penphil stockholder, bought Kaneb stock. Although a great majority of Horner's previous and subsequent transactions were executed through another broker-dealer, the Kaneb shares were purchased through Glore Forgan. Whether Hodge recommended these purchases is presently unknown.

On July 18, 1962, the day before Penphil's incorporation, Hodge and D. Bevan caused Penphil to begin buying Kaneb stock by purchasing 3,000 shares at $5 per share. On July 19, Penphil purchased an additional 19,033 shares and on July 23 another 600 shares at $5 per share for a total of 22,633 shares at a cost of $115,925.35. Of that amount $102,000 was borrowed from the Chemical Bank. Glore Forgan was the executing broker-dealer on these transactions, and Hodge was the salesman. At or about this same time, D. Bevan bought 1,200 shares, T. Bevan purchased 300 shares, and Hodge's secretary, Martha Fonner, purchased 50 shares. As noted above, information concerning the improved earnings did not become a matter of public knowledge until the last week of August 1962.

1963—KANEB STOCK PURCHASED BY THE PRR, PENPHIL AND PENPHIL STOCKHOLDERS AND RELATED EVENTS

On November 15, 1962, Kaneb's board approved an expansion of its business in the transportation of liquid propane. This information was released to the press on January 7, 1963.

On December 10, 1962, in connection with the possible acquisition of Kaneb by another company, James Whatley, vice president of Kaneb, mailed to Hodge a preliminary worksheet outlining estimated earnings and cash flow for Kaneb over the next 10 years. These estimates, which projected substantial growth in revenues and earnings, were never made public.

Shortly thereafter, Glore Forgan, with Hodge as salesman, executed substantial purchases of Kaneb stock for Penphil and Penphil members. On January 2, 1963, 5 days before the press release regarding the propane expansion, D. Bevan purchased 500 shares at 8½ bringing his holdings to approximately 1,855 shares. On January 8, 1963, Fred Billups [10] purchased 1,000 shares at 8¼ per share. On January 31, 1963, D. Bevan met with Fisher, Hodge, and William R. Gerstnecker, treasurer of PRR, for lunch. The stated purpose of the meeting was to discuss pipeline studies being undertaken for the PRR by Pipetech, but the possibility of Fisher joining Penphil was discussed. At this time Fisher strongly indicated his interest in becoming a Penphil stockholder.[11] The next day, February 1, Penphil purchased 5,000 shares of Kaneb at $8 per share, increasing its Kaneb holdings to 27,633 shares. Penphil borrowed the entire purchase price from Chemical Bank.

In late November 1963, Fisher and Glore Forgan arranged for a placement of 17,900 unregistered Kaneb shares for the New York Life Insurance Co. Of these, 4,500 shares were purchased at 10⅛ by Penphil stockholders, as follows: Gerstnecker, 500; D. Bevan, 1,000; Haslett, 500; 500 by Paul Fox, another PRR vice president; and Hodge, 2,000. On December 6, Hodge bought an additional 200 shares.[12]

[10] Billups was president of Tropical Gas, a company of which Hodge was a director. He became a Penphil member on June 30, 1963 and Tropical Gas became another Penphil investment.

[11] On February 5, Fisher wrote to Gerstnecker requesting the names, business connections, et cetera of all members of Penphil. Fisher commented: "It appears that this substantial group of successful businessmen could do much towards putting some good deals together. If I am to join them, it is quite important that we become better acquainted. I am sure that we all have the same interest; namely to get into some good growth situations where we can recoup substantial capital gains."

[12] Other than the purchases by D. Bevan and Billups in early January 1963, there were only two purchases of Kaneb stock by Penphil shareholders prior to November 1963. On June 18, Hodge bought 200 shares and on October 11, bought 100.

As of December 31, 1963, Kaneb had issued and outstanding 972,503 shares of common stock of which Penphil owned 29,462 shares, Penphil shareholders owned 158,597 shares and the PRR owned 56,974 shares. These shares, totaling 244,059 constituted 25.1 percent of the issued and outstanding Kaneb stock.

KANEB STOCKHOLDINGS BY PENPHIL, PENPHIL STOCKHOLDERS AND THE PRR 1964–69

During 1964, Penphil's holdings of Kaneb increased by 2,026 as the result of stock dividends. Penphil stockholders as a group increased their holdings, primarily from stock dividends, by 9,956 shares and the PRR increased by 24,479 as the result of both purchases and stock dividends. As of December 31, 1964, Penphil owned 30,488 Kaneb shares, Penphil stockholders 168,193, and the PRR 81,453 shares. This constituted 26.9 percent of the issued and outstanding shares. From 1964 through 1969 Penphil and its stockholders changed their holdings very little.[13] However, the PRR increased its holdings by purchasing an additional 34,047 shares. As of December 31, 1969, Penphil still owned 30,488 shares; Penphil stockholders owned 167,297 shares and the PRR 115,500 shares, which constituted 23.5 percent of Kaneb's shares. As of the present time Penphil still owns these shares which had been purchased at a cost of $155,925.35. The shares now have a market value of $1,082,324, giving Penphil a $926,398.65 paper profit.[14]

Great Southwest Corp.

BACKGROUND

Great Southwest Corp., whose principal office is in Arlington, Tex., was incorporated in Texas in 1956 for the purpose of owning, leasing, and developing real estate. As of June 30, 1963, GSC had 1,076,501 shares of common stock outstanding, which was traded over the counter. At that time Toddie Wynne (T. Wynne), chairman of the board and a director of GSC, his son, Toddie Wynne, Jr. (T. Wynne, Jr.), a director of GSC, and Angus Wynne, Jr. (A. Wynne), president, a director and chief executive officer of GSC, owned or controlled approximately 45 percent of the outstanding shares. Rockefeller Center, Inc., (RCI) owned 220,851 common shares of GSC or 20.48 percent of the outstanding shares.

From at least January 13, 1960, until October 1970 Hodge was a member of the GSC board of directors, and during the same period was a partner of Glore Forgan, GSC's investment banker.[15]

From its inception in 1956 through September 30, 1961, the end of GSC's fiscal year, the company sustained continued operating losses. For fiscal 1962, however, GSC achieved a consolidated net profit of $565,246 representing earnings of 52 cents per share. This turnaround was due largely to the successful operation of Six Flags Over Texas (Six Flags), a division of GSC.

[13] On Nov. 2, 1967, Penphil purchased a $500,000 face amount Kaneb 6⅞ percent subordinated note and 7,653 warrants for the purchase of an equal number of shares at $30 per share. Penphil paid $493,544.90 for the note and $7,653 for the warrants. Chemical Bank loaned Penphil $493,000 of the total price of $501,197.90 at 5½ percent (later increased to 6 then 6½ percent). Penphil sold the note for $516,423.62, including interest, on September 10, 1968, and as of June 2, 1971, Penphil still held the warrants.

[14] Calculated on the AMEX closing price on Apr. 20, 1972.

PENPHIL'S PURCHASE OF GSC STOCK

On June 4, 1963, GSC held a board of directors meeting attended by Hodge, among others. At this meeting it was reported that GSC was doing better than had previously been estimated and it was expected that net income for fiscal 1963 would double that of fiscal 1962. This dramatic increase in projected net income was due to better than expected net income of Six Flags and to profit from land sales.

On June 14, 1963, 10 days after this board meeting, Hodge wrote A. Wynne inviting him to become a Penphil stockholder. This letter confirmed an earlier oral discussion of the matter. The addition of A. Wynne as a Penphil stockholder gave Penphil direct access to the person who was conducting the day-to-day affairs of GSC. A Wynne accepted the invitation and in September 1963 sent his check in the amount of $9,000 to D. Bevan.

On July 10, 1963, Haslett and Edward D. Meanor (a private investor), both Penphil stockholders, flew to Texas and met with A. Wynne to discuss GSC. On July 15, after returning from Texas, Haslett spoke with Hodge by telephone concerning the purchase of GSC stock by the PRR and on July 17 he went to New York City to meet with Hodge.

A Glore Forgan research report dated July 17, 1963, concluded that GSC's earnings per share for fiscal 1963 would at least double fiscal 1962 earnings. This report and the conclusion therein incorporated in large part the financial and operating information which had been disclosed and discussed at the board meeting on June 4, 1963.[16]

On July 18, 1963, Penphil purchased 10,000 shares of GSC at $16.50 per share from Glore Forgan. Hodge was the registered representative who placed the order. The total cost of this purchase was $165,000; this transaction was financed by a loan from the Chemical Bank in the amount of $120,000 secured by the 10,000 GSC shares. These shares were delivered to the Chemical Bank against payment. On the same day the PRR purchased 4,000 shares of GSC at $16.50 per share from Glore Forgan. Again Hodge was the registered representative. In connection with both of these purchases, the investment decisions were made by D. Bevan, Haslett, and Hodge.

No public release of the improvement in GSC's fiscal 1963 earnings was made until August 5, 1963. On that day the Wall Street Journal published an article based on an interview with A. Wynne in which Wynne stated that earnings for GSC for the fiscal year ending September 30, 1963 (fiscal 1963) were going to be within the range of from $1.35 to $1.50 per share: (actual fiscal 1963 earnings per share, published later, were $1.44). Such earnings would be nearly three times GSC's earnings for fiscal 1963.

THE PRR ACQUIRES GSC

In February 1964, as part of Glore Forgan's efforts to suggest certain areas of diversification for the PRR, Hodge recommended to D Bevan that the PRR acquire 80 percent of GSC's outstanding stock. In his letter Hodge noted that there was "a distinct possibility of acquiring in one fell swoop about 40 percent of the company"

[16] It is unclear whether this report was ever distributed by Glore Forgan to its customers, but it [illegible]

at a price between $20 and $22 per share. Hodge also informed D. Bevan that Glore Forgan owned 28,000 shares of GSC and that Mrs. Hodge was the owner of GSC convertible debentures in the face amount of $84,000.

During the spring of 1964, D. Bevan, Gerstnecker, and other members of PRR's finance department considered the merits of Hodge's recommendation. While it was under consideration, D. Bevan, on March 19, 1964, purchased 150 shares of GSC from Glore Forgan at 18⅝; Hodge was the registered representative.

On June 24, 1964, D. Bevan and Stuart Saunders recommended, and PRR's board of directors approved, the purchase by Pennco of 518,439 shares of GSC (approximately 49 percent of GSC's outstanding stock) from RCI and the T. Wynne family at a price of $22.50 per share. This purchase was closed on July 15, 1964, at a total cost to Pennco of $11,924,097. Glore Forgan, agent for both the buyer and sellers, received a commission of 50 cents per share, totaling $529,219.50. It was the PRR's intention to acquire 80 percent of GSC's outstanding stock.[17]

Almost immediately after the above purchase, Haslett, at D. Bevan's direction, began to purchase additional shares of GSC for Pennco in the open market. Between July 1964 and October 1966 Pennco purchased 320,986 GSC shares in 118 transactions.[18] This series of purchases commenced on or about July 22, 1964, with a purchase of 2,000 shares at $20.75 per share. From that date to November 30, 1965, Pennco bought 280,795 shares of GSC stock. During the period July 1964 to July 1965 the price of GSC stock remained relatively stable, fluctuating between 18¾ to 22⅞ per share. Near the end of July 1965, however, the price began to rise and by November 30, 1965, Pennco was paying $39 per share for GSC stock.

On December 7, 1965, Penphil sold to Glore Forgan a 10,000 share block of GSC stock at $37.75 per share. On that same day Glore Forgan marked up these 10,000 shares $.43 per share and resold them to Pennco at a profit of $4,300. Penphil originally purchased its 10,000 shares of GSC at a total of $165,000. Upon the sale to Glore Forgan Penphil realized total proceeds of $377,500 and a profit of $212,500.

Between November 3 and December 8, 1965, Hodge sold, either through or to Glore Forgan, 1,900 GSC shares at prices ranging from $37.75 to $45 per share for a profit of $30,721.14. Hodge had purchased these shares on April 20, 1965, at 21⅝. On December 21, 1965, D. Bevan sold 107 GSC shares to Glore Forgan at $35 per share. The result of this sale was a profit of $1,752.13 or 87.9 percent. At the time of the initial purchases Hodge and Bevan had material nonpublic information as to PRR's interest in the acquisition of at least 80 percent of GSC's outstanding stock.

Although Penphil's records contain no resolutions, discussions or explanations regarding its purchase and sale of GSC common stock, D. Bevan set forth an explanation of these transactions in a letter dated July 2, 1970, to Mr. Edward J. Hanley, a director of Penn Central and a member of Penn Central's "information, disclosure and conflict of interest committee."

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[17] This intention was not publicly disclosed.

[18] Of the 118 transactions, 54 were executed by Glore Forgan, generally as principal.

DEAR ED: This is to confirm our verbal conversation.

At the time we bought a small amount of Great Southwest stock for our contingent compensation fund, Penphil bought another odd lot offering with the same idea in mind that it was an interesting speculation.

At that point, control of Great Southwest was tightly centered in the Rockefeller and Wynne families. No one had any possible way of knowing that at a later date a rift would occur in the Wynne family. However, this occurred in the following year and as a result Toddy Wynne, Angus Wynne's uncle, thereupon expressed a desire to dispose of the family's interest in Great Southwest. Since the understanding between the Rockefellers and the Wynnes was that they would act in consort, control of the company became available and it was offered to us through Glore Forgan and, of course, as you know we purchased controlling interest.

A few months later I expressed a desire that Penphil sell its Great Southwest stock so that we would be sure to avoid any future possible conflict of interest. My wishes were respected and the stock was sold at a price of $38. All members of Penphil made a sacrific in this connection as the price of $38 compares with even today's very low price of approximately $60 a share since the stock was later split 10 for 1. Actually at its highest the stock sold at $430 a share which was just a little over a year ago.

Sincerely,

DAVID C. BEVAN.

This explanation, written at a time when D. Bevan and his associates were being investigated by the PCC committee for these transactions, inaccurately described the reasons for the transactions in the staff's view. Moreover, it conceals certain significant aspects of these transactions. Specifically, the odd-lot transaction referred to was, in fact, a 10,000-share purchase by Pennco; the "few months later" referred to was, in fact, a 17-month period. Also, the letter fails to disclose that Bevan was responsible for Pennco's open market purchases including a 10,000-share purchase on December 7, 1965; that Penphil purchased its 10,000 shares on December 7, 1965; that Penphil purchased its 10,000 shares of GSC stock at $16.50 per share and received a profit of $212,500 (a 130-percent profit) on the sale of such securities; and that in November and December 1965, at the time D. Bevan was causing Pennco to buy GSC stock on the open market, he and Hodge were selling GSC stock held personally by them to and through Glore Forgan at a substantial profit. It would appear that the actual reason for the sales by Penphil, D. Bevan, and Hodge in December 1965 may not have concerned a conflict of interest as D. Bevan stated, but may have been because they knew that Pennco had virtually completed its program of acquiring at least 80 percent of GSC's outstanding stock. Furthermore, the crucial moment insofar as a conflict of interest was concerned was when the PRR decided to acquire an 80 percent interest in GSC. At that time Penphil had a major investment in GSC stock which was not disclosed to the board of directors of the PRR.

Although Pennco continued to purchase GSC stock from December 1965 to October 1966, it had, by December of 1965, bought 281,000 of the 320,000 shares it was to purchase. At the present time, Pennco owns over 90 percent of GSC's outstanding stock. It has sustained an unrealized loss on its investment as of June 9, 1972, of more than $42 million. This is in sharp contrast to the substantial benefits Penphil, D. Bevan, Hodge, and Glore Forgan gained through their transactions.

Tropical Gas Co., Inc.

BACKGROUND

Tropical Gas Co., Inc., with principal offices in Coral Gables, Fla., was incorporated in Panama on April 14, 1954, for the purpose of selling and distributing liquified petroleum gas (LPG) and gas-consuming appliances. As of May 1962, Tropical and its subsidiaries sold LPG throughout the Caribbean and Central America. Tropical's wholly owned subsidiary, Southeastern Natural Gas Corp. (subsequently known as Tropigas Inc. of Florida), sold LPG and LPG appliances in the southern half of Florida.

During the period from 1962 through 1969 Frederick H. Billups (Billups) was Tropical's president and chairman of the board and Hodge was a director and vice president.[19] Tropical's 10-member board of directors also included Hobart Ramsey (Ramsey) and Alfonso Manero (Manero).[20] Billups, Hodge, and Ramsey were on Tropical's executive committee, of which Billups was chairman and Hodge was vice chairman.[21] Each of these persons became a Penphil stockholder.

During 1962, Tropical realized a net income of $1,689,633 on net sales of $14,146,872. At December 31, 1961, Tropical had approximately 950,000 shares issued and outstanding, which were traded in the over-the-counter market.

PURCHASES OF TROPICAL COMMON STOCK FROM 1962 THROUGH 1964 BY PRR AND PENPHIL

Prior to May of 1962, under the direction of D. Bevan and Haslett, the PRR had purchased 2,300 Tropical shares and between May 1962 and May 1963, the PRR purchased 29,000 additional shares of Tropical stock through Yarnall, Biddle & Co. and Glore Forgan at prices declining from 25 to 20⅞ per share.[22]

By letter dated June 14, 1963, Hodge invited Billups and Ramsey to join Penphil. They accepted and became Penphil stockholders on June 30, 1963. The inclusion of Billups as a stockholder gave Penphil direct access to the person running the day-to-day affairs of Tropical. On July 3, the PRR bought 2,900 Tropical shares through Glore Forgan at $18 per share.

Between August 1 and August 7, 1963, upon Hodge's recommendation, Penphil purchased 5,415 shares of Tropical common stock through Glore Forgan at prices ranging from $18 to $18⅞ per share.

From August 19, 1963, to August 29, 1963, Penphil purchased 4,585 more Tropical shares through Glore Forgan at prices ranging from $19.75 to $20 per share. As a result of these purchases, Penphil held a total of 10,000 shares of Tropical stock.

In January 1964 Tropical management, including Hodge, began considering the listing of Tropical common stock on the American Stock Exchange (ASE). Tropical's board of directors authorized an

[19] Hodge had been a Tropical director since 1954.

[20] Manero was a partner in Glore Forgan; Ramsey was a limited partner in that firm.

[21] On April 26, 1962, Comer J. Kimball was elected to Tropical's board of directors and executive committee. Kimball, who was chairman of the board of the First National Bank of Miami and Arvida Corp., played a role in the PRR acquisition of Arvida and in Penphil's acquisition of the stock of First Bank & Trust Co. of Boca Raton and the University National Bank of Boca Raton.

[22] The 2,300 purchased prior to May 1962 were bought for the compensation plan; the 29,000 were bought for the pension plan as were all shares purchased thereafter.

application for listing on February 21, 1964. This meeting was attended by Hodge, who from February 26 to 28, 1964, bought 1,000 shares of Tropical at $20⅞ to $21 per share. At the time of Hodge's purchases, Tropical's intention to list its stock on the American Stock Exchange was nonpublic. On July 29, 1964, 1,130,298 shares of Tropical common were listed on the ASE.

D. Bevan became a director of Tropical in November 1964, on the invitation of Billups, and subsequently became a member of Tropical's executive committee.[23]

From June 23, 1965, to October 15, 1968, the PRR increased its holdings of Tropical stock by 56,000 shares bringing the PRR holdings to 90,400 shares. Most of the transactions in Tropical stock during this period were made through Glore Forgan.[24]

On October 23, 1969, stockholders of U.S. Freight Co. (U.S. Freight) and Tropical approved an agreement which called for the exchange of 0.89 shares of U.S. Freight stock for each share of Tropical. Tropical became a wholly owned subsidiary of U.S. Freight on January 9, 1970. As a result of this transaction, Penphil received 8,900 shares and the PRR received 79,566 shares of U.S. Freight in place of their Tropical holdings.

Billups died on May 12, 1970, and on May 27, 1970, Hodge was elected to fill Billups' positions as Chairman of Tropical's board of directors and director of U.S. Freight. Hodge continues to hold both of these positions. D. Bevan and Ramsey continue to be Tropical directors and, along with Hodge, are members of Tropical's executive committee.

On October 20, 1970, Penphil sold its 8,900 shares of U.S. Freight through Yarnall, Biddle & Co. at $22.50 per share. The proceeds of $198,345.74 from the trade represented a profit of $6,850.47 for Penphil.

Continental Mortgage Investors

BACKGROUND

Continental Mortgage Investors, a Massachusetts real estate investment trust, was organized on November 29, 1961, for the purpose of investing in first mortgage construction and development loans and in FHA and VA insured mortgages. Its principal offices are located in Boston. Since CMI's inception, Mortgage Consultants, Inc. has administered the day-to-day operations of CMI and serves as the investment adviser and consultant to CMI's board of trustees.[25] As of March 31, 1964, there were 1,710,644 CMI shares of beneficial interest issued and outstanding. CMI shares were traded over the counter until April 14, 1965, when they were listed on the New York Stock Exchange.

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[23] Bevan had been asked to become a Tropical director before but had declined because of alleged possible conflicts of interest while the PRR was looking into possible pipeline acquisitions.

[24] On October 2, 1968, Mapco Inc., an Oklahoma based producer and distributor of oil, natural gas, and liquid plant foods, announced that it planned to make a tender offer for Tropical stock with the objective of acquiring 80% of Tropical's stock. In addition, as of October 2, 1968, Tropical was planning a public offering of 230,000 shares of common stock. (A registration statement covering this offering was filed with the SEC on October 15, 1968). Between October 3, and October 15, 1968 Penn Central purchased 9,800 Tropical shares.

[25] At about the time of CMI's formation, D. Bevan was asked to become a member of CMI's board of trustees. Bevan says that he turned it down after consultation with attorneys in PRR's legal department because of possible conflicts of interest with real estate operations of the PRR and its subsidiaries.

PENPHIL AND THE PRR BUY CMI SECURITIES

In 1963, CMI, with the assistance of Hemphill, Noyes & Co., its investment banker, began developing plans for the private placement of $10 million long-term notes. The proceeds of these notes were to be used to replace part of CMI's outstanding short-term bank loans with lower cost, long-term borrowing. As of March 31, 1964, CMI short-term bank loans were approximately $40 million.

On April 1, 1964, Lawrence M. Stevens (Stevens), the managing partner of the Philadelphia office of Hemphill, Noyes & Co., and a member of Penphil's investment committee, wrote a confidential memorandum to the other members of Penphil's investment committee, recommending that Penphil invest in CMI shares. In his memorandum Stevens wrote that Hemphill, Noyes & Co. was placing $10 million of 4½ percent 20-year notes and 10,000 shares at $15 per share, the proceeds of which would be used to pay off part of CMI's current bank debt. The memorandum stated:

> Incidentally and confidentially, the company has a bank line of approximately $20 million at the prime rate (4½ percent). These loans require a compensating balance, however, whereas present financing will permit 100 percent use of the funds derived. As far as the additional common stock is concerned, it would represent only quite minor dilution and would not, in my opinion, represent a material factor.
>
> Following this financing the company plans to announce, as you may note on one of the enclosed sheets, that no further debt or equity financing is contemplated at the present time. A quite substantial portion of the $10 million of notes and stock has been reserved for one of the large New York City companies. One other institution has indicated that it will take a substantial amount of notes and stock and, in addition to that, two or three other institutions have the proposal under consideration.
>
> Dividend payments for the 1963 fiscal year were $1.10. We expect dividend payments for the 1964 year will amount to $1.35 per share. At a price of $17¾ for the stock this would afford a yield of about 7.6 percent.
>
> May I again reiterate that some portions of the enclosed are confidential in nature.

Attached to Stevens' memorandum were four pages taken from a confidential memorandum prepared by Julius Jensen, III, a partner of Hemphill, Noyes & Co., in the corporate finance department. (Jensen's memorandum). These four pages, on the first of which was written the word "confidential," first stated that CMI shares had been selling at an "artificially depressed" price between $14½ and $16 per share. According to Jensen, "numerous security analysts and investment advisers," believed that the artificially depressed price resulted from the request made to CMI stockholders that they authorize the issuance of up to 1,900,000 additional shares at a minimum price of $15 per share; and that this request, and the stockholder approval, were thought to have created an expectation that a substantial equity offering was imminent and would result in an immediate dilution of stockholder equity.[26]

Jensen's memorandum then stated that to remove the "lid" on the market price of CMI shares, the trustees planned to announce that no further permanent debt or equity financing was contemplated after the proposed $10 million debt financing was completed; that CMI's trustees also planned a broader distribution of information about CMI, since the SEC's limitation on communications during periods

[26] This was in spite of public announcements by CMI that no decision had been made regarding the time

of such financing would not apply;[27] and that these steps would cause CMI's price to rise to $18½ to $20 per share shortly after the proposed financing.

Based on projected earnings for the next 3 fiscal years, Jensen predicted that the market value of CMI stock would rise to $25½ to $30½ per share by the end of the next fiscal year, $31½ to $37 per share by the end of the second succeeding fiscal year, and $36 to $43 per share by the end of the third fiscal year.

On April 2, 1964, after receiving this information as a member of Penphil's investment committee, Francis A. Cannon,[28] purchased 500 CMI shares for his wife's account at $17⅝ per share. By April 9, 1964, three investment committee members had recommended CMI as a proper speculation for Penphil.

By May 6, 1964, the PRR pension plan through D. Bevan and Hastlett, Morgan Guaranty Trust Co. of New York as Trustee for a pension trust, and First National City Bank as trustee for various pension trusts, had agreed to purchase $11 million of CMI 4½ percent notes due May 1, 1984, and an aggregate of 110,000 shares at about $15 per share.

Penphil purchased 10,000 CMI shares on May 8, 1964, from Hemphill, Noyes & Co. at $19.68 per share, at total cost of $196,800, all of which Penphil borrowed from the Chemical Bank. Hemphill, Noyes & Co. bought more than 4,500 of these shares from at least 40 other persons and delivered the 10,000 shares to the Chemical Bank against payment. At the time of these purchases there had been no public disclosure of the information contained in Stevens-Jensen confidential memorandum.

The placement of the CMI notes and shares with the three purchasers was concluded on May 20, 1964. The PRR bought $1 million of the CMI notes and 10,000 of the CMI shares at a price of $15.1648 per share. News of the placement, published in the Wall Street Journal on May 26, 1964, included the announcement the Stevens-Jensen memorandum had revealed, that CMI's management had "Come to the conclusion that the sale of the additional shares authorized, other than the 110,000 shares * * * would be inadvisable under the circumstances and should not be undertaken."

After its purchase in the May 1964 placement, the PRR continued to make investments in CMI. By December 1967, the PRR and its subsidiary, the Buckeye Pipe Line, acquired an additional 27,500 CMI shares and $2,025,000 in CMI notes.

In August 1968, CMI shares were split 3-for-1, giving Penn Central a total of 105,750 CMI shares and Penphil a total of 30,000 shares.[29] In March 1970, CMI shares were further split 2-for-1 with the result that Penn Central held 211,500 CMI shares and Penphil held 60,000 shares. The market price of CMI shares as of June 2, 1971 was $21⅛, and the value of Penphil's CMI holdings was $1,267,500, an unrealized profit of $1,070,700 or more than 540 percent.

[27] Information released by CMI had been limited to quarterly and annual shareholder reports.
[28] Cannon was administrative vice president of First Boston Corp.
[29] On February 17, 1969, the PRR purchased a $1,000,000 CMI 5 percent note due April 1, 1989.

PURCHASE OF FIRST BANK AND UNB STOCK BY PENPHIL AND ARVIDA'S PURCHASE OF FLEMING/BUTTS REAL ESTATE

D. Bevan and Hodge had been instrumental in Pennco's acquisition in mid-1965 of controlling interest in Arvida Corp., which was in the business of purchasing, developing and selling real estate, principally on the east and west coasts of Florida. By the close of 1965, D. Bevan, Hodge, Gerstnecker and A. Wynne Jr., all Penphil shareholders, were on Arvida's board.

As early as the fall of 1965, D. Bevan and Hodge were interested in purchasing on behalf of Penphil a substantial block of stock of banks in the Boca Raton area. They therefore requested Comer J. Kimball, Arvida's chairman,[30] to obtain information on the First Bank and Trust Co. of Boca Raton N.A. (First Bank), University National Bank (UNB), and Boca Raton National Bank, the three banks in Boca Raton. He forwarded information on the deposits, loans, and capitalization of the banks to Bevan and Hodge in late November 1965.[31] Early in 1966 Bevan and Hodge requested Sawin to have Kimball arrange for Sawin to meet Thomas Fleming Jr., chairman of the board and largest shareholder of First Bank and UNB, to discuss the possibility of investing in these banks. Such a meeting was held on February 17 in Boca Raton between Hodge, Sawin, and Fleming. In addition to the availability and price of First Bank and UNB stock, they also discussed the possibility that the group represented by Hodge and Swain would participate with Fleming in building up a chain of banks in appropriate places in Florida. These conversations, without Hodge, were continued on the 18th. On February 21, 1966, Swain wrote Fleming thanking him for the information he had made so readily available and advising him that D. Bevan, Hodge, and he had discussed an investment by the group of $1 million to $1.2 million. Because of the very thin market in UNB and First Bank stock, it was difficult to acquire such stock on the open market.

Shortly after Sawin's discussion with Fleming about the purchase of First Bank and UNB stock, Fleming advised D. Bevan that he and his wife's family owned certain real property in the Boca Raton area (Fleming/Butts property) that he wished to sell. On March 23, D. Bevan advised Arvida's executive committee concerning Fleming's desire to sell the Fleming/Butts property. At a meeting of Arvida's executive committee on May 12, 1966, attended by David Bevan Hodge, and Gerstnecker, Arvida was authorized to negotiate for the Fleming/Butts property. Thereafter, on May 19, 1966, Brown Whatley president of Arvida and of Stockton, Whatley, Davin & Co., a large real estate and mortgage banking company, which provided operating management for Arvida, wrote Fleming a letter of intent proposing that Arvida purchase an option on 3,020 acres for the price of $3 million. Whatley concluded the letter by saying:

> We would appreciate it if you would keep our interest in your property in confidence. In the event you are interested in our proposal, we would probably want to take the option in a nominee so that our identity would not be disclosed unless and until the option is exercised.

[30] He had also been a director of Tropical since 1962. Kimball was at the time chairman of the First National Bank of Miami.

[31] During the same period John Harper of Glore Forgan sent to Bevan, at his request, information on

During the negotiations on the Fleming/Butts property, Fleming openly expressed his desire for more of Arvida's banking business. At an Arvida board meeting the board authorized the transfer of one of Arvida's bank accounts to First Bank. On September 26, 1966, Fleming wrote D. Bevan that he and Whatley had successfully concluded negotiations regarding the sale of the Fleming/Butts property.

Pursuant to arrangements with Penphil, on September 27, the day after the negotiations to purchase the Fleming/Butts property were concluded, Morgan Zook, executive vice president of First Bank, opened a brokerage account at the Boca Raton office of Hayden Stone in Zook's name as nominee for Penphil. On that day, Zook purchased 100 shares of First Bank; on September 28 he purchased 150 shares and on October 3, 100 shares. These 350 shares were all purchased for Penphil at $30 per share. Penphil's objective, to acquire a substantial block of First Bank stock, however, could not be achieved by purchasing stock in the open market because of the thin market.

At least as early as February 1966, Sawin had suggested to Fleming that First Bank and UNB have a new offering of their shares, the proceeds of which could be used to construct a new bank building. In August 1966, after a July bank examination, the Comptroller of the Currency advised First Bank that it needed additional capital because of its recent substantial growth. As a result, Fleming and the other bank directors began to discuss the possibility of a preemptive rights offering. On September 13, 1966, the board of directors of First Bank authorized, subject to stockholder approval, the issuance of 25,000 additional shares at $24 per share. This information was disclosed to Sawin sometime prior to Penphil's purchases in September and October and before other First Bank stockholders were notified on October 5. Existing stockholders as of October 19, 1966, would recieve rights to purchase these shares. As noted above, Penphil purchased 350 shares between September 27 and October 3, 1966. Thereafter, on December 9, Sawin wrote a memorandum to Hodge describing the rights offering and recommending that Penphil buy approximately $200,000 of additional First Bank stock and approximately $100,000 of UNB stock. Sawin asked for authority to proceed with the purchase of this stock. Copies of this memorandum were also sent to D. Bevan and members of Penphil's investment committee. Shortly thereafter, Hodge, on behalf of Penphil, authorized Sawin to purchase $200,000 of First Bank stock. This rights offering was made in late December 1966. First Bank's directors received the lion's share of the rights offered and Fleming arranged for each director to sell a portion of his rights to Penphil at $1.50 per right. Pursuant to this arrangement, Penphil purchased 30,848 rights between December 30, 1966, and January 6, 1967, exercised the rights and purchased 7,712 First Bank shares. The cost to Penphil of the rights and stock was $231,360.[32] As of January 6, 1967, Penphil owned 8,250 First Bank shares (6.3 percent of the outstanding shares) for a total cost of $249,972.

It should also be pointed out that during the spring of 1966, at the same time it was negotiating for the Fleming/Butts property, Arvida was also confidentially granting IBM an option to purchase approximately 500 acres of land located near the Fleming/Butts property

[32] This money came from the proceeds received from Penphil's sale of its [illegible]
Penphil also exercised the 350 [illegible]

and on which IBM proposed to build a research and manufacturing facility. This agreement was known to only a few persons associated with Arvida and IBM. Arvida wanted to keep the agreement with IBM confidential until after IBM purchased the property and Arvida acquired an option to purchase the Fleming/Butts property. When Penphil purchased 350 shares of First Bank stock from September 27 to October 3, IBM had already confidentially exercised the option and planned to build a manufacturing and research facility in Boca Raton. The entrance of IBM into the area with its attendant favorable economic impact was almost certain to generate new banking business. Penphil also had, at the time it made these purchases, the nonpublic information that First Bank had authorized a rights offering to existing shareholders at $6 below the current market price.

FLORPHIL

Florphil Co. was incorporated on January 13, 1967, in order to give Whatley, Joseph Davin, vice president of Arvida,[33] and three others not associated with Arvida,[34] an opportunity to participate in Penphil's investments in First Bank and UNB, Upon its incorporation Florphil issued 1,600 shares at $30 per share to these five individuals. On the same day Florphil issued 8,250 shares to Penphil in exchange for 8,250 First Bank shares.

In early 1967, Penphil and Florphil began to purchase shares of UNB. On January 12, Penphil bought 328 shares and on January 30, bought 200 additional shares at $20 per share and on March 6, 100 shares were purchased at $21 per share. On February 8, 1967, UNB authorized an offering of 10,000 shares. Each UNB shareholder, as of February 8, received the right to purchase, at $16 per share, one new share for each five shares owned. Penphil, the record owner of 528 shares, exercised its rights and bought 105 additional shares. On March 22, Florphil bought 8,500 rights at $1 per right from existing shareholders, exercised the rights, and bought 1,700 shares at $16 per share. On March 27, Penphil purchased 11,500 rights at $1 per right, exercised the rights, and purchased 2,300 shares at $16 per share. The purchase of these rights was arranged in much the same manner as with the First Bank rights in December 1966. By March 27, Penphil and Florphil owned 4,733 UNB shares at a total cost of $98,-340. UNB as of that date only had 60,000 shares issued and outstanding, 7.1 percent of which were owned by Florphil and Penphil.

On February 20, 1968, Penphil and Florphil merged, with each Florphil stockhloder receiving 0.8181 Penphil shares for each Florphil share owned. The following chart reflects the unrealized profit to each individual Florphil shareholder which resulted from this transaction.

Name	Florphil shares	Cost of shares	Penphil shares received	Total net asset value	Unrealized profit
Harry Ortlip	500	$15,000	409	$19,795.60	$4,795.60
Joseph David	200	6,000	163	7,889.20	1,889.20
Alfonso Manero	200	6,000	163	7,889.20	1,889.20
Brown Whatley	500	15,000	409	19,795.40	4,795.60
O. F. Lassiter	200	6,000	163	7,889.20	1,889.20

[33] Kimball, Arvida's chairman died in March 1966.
[34] O. F. Lassiter of Executive Jet Aviation, Alfonso Manero of Glore Forgan, and Harry F. Ortlip.

In August 1968 First Bank had another offering of its securities at which time Penphil bought 1,815 shares at $50 per share for a total consideration of $90,750.

FIRST BANCSHARES

Sometime prior to June of 1968 Fleming had been invited to become a Penphil stockholder and on January 6, 1969 did so by purchasing 2,285 Penphil shares at $35 per share for a total cost of $79,975.

In February 1969, First Bank declared a 100-percent stock dividend and Penphil received an additional 10,690 shares. UNB declared a 10-percent stock dividend and Penphil recieved an additional 135 UNB shares. Penphil, as of February 1969, owned 19,565 shares of First Bank and 4,668 UNB shares.

As already stated, by February 1966, Sawin had been discussing with Fleming a program whereby a substantial interest would be acquired in a number of banks in southern Florida. In addition to Penphil's investments in First Bank and UNB, various Penphil stockholders discussed with Fleming possible investments in other Florida banks during the period of 1966 through 1969. At about this time, a bank holding company became a technique employed to circumvent Florida's prohibition against branch banking. On September 19, 1969, Fleming issued a news release announcing a proposed new bank holding company which would exchange its shares for outstanding shares of First Bank, UNB, First National Bank & Trust Co. of Riviera Beach, and Citizens Bank of Palm Beach County. Fleming was to be chairman of the board of the holding company.

Pursuant to permission granted by the Federal Reserve Board on May 21, 1970, the holding company, First Bancshares, offered its shares of common stock; the exchanges of stock were declared effective as of October 15, 1970. As a result Penphil became the owner of 26,048 shares of First Bancshares stock. Penphil's shares, after a 2-to-1 stock split on March 1, 1971, doubled to 52,096, approximately 7 percent of First Bancshares outstanding stock. According to a summary of financial data prepared by Penphil, the market value of such stock as of June 2, 1971, was $1,181,400 representing an unrealized profit over Penphil's cost ($439,062) of $742,338.[35]

SYMINGTON WAYNE CORP.

BACKGROUND

Symington Wayne Corp. was incorporated in Maryland in 1924 and maintained its principal office in Salisbury, Md. The company was primarily engaged in manufacturing gasoline pumps and other service station equipment, steel castings, and equipment used in the railroad industry and handtools. During the period 1967–68 Symington Wayne's stock was traded on the New York Stock Exchange and as of December 31, 1966, the company had issued and outstanding 1,956,278 shares of common stock. During the period 1958 through 1967, the company's net sales increased from approximately $40 million to

[35] As already noted, Pennco acquired its controlling interest in Arvida for approximately $20,400,000. The last installment fell due in July 1967, and it was necessary for Pennco to borrow $3 million from the First National Bank of Miami to pay the balance owed. First Bank and UNB both participated in the loan in the amount of $200,000 and $50,000 respectively due July 27, 1969. During January 1969, D. Bevan, through

$104 million and net income increased from approximately $1,600,000 to $4,500,000. Retained earnings as of December 31, 1967, were $26,283,105. Hobart Ramsey, a Penphil stockholder and Glore Forgan partner, was also a member of the board of directors of Symington Wayne.

DRESSER'S TENDER OFFER

Sometime prior to April 27, 1967, Dresser Industries, Inc. (Dresser) purchased 140,000 shares of Symington Wayne stock. On April 27, John Lawrence, president and chairman of the board of Dresser, advised the Dresser board that these shares of Symington Wayne had been acquired and recommended that he explore with Symington Wayne an exchange of Dresser cumulative convertible preferred voting for the outstanding common stock of Symington Wayne.

On May 2, 1967, Lawrence contacted William H. Bateman, president and chairman of the executive committee, of Symington Wayne by telephone and a meeting was arranged for May 16, 1967, to discuss in detail Dresser's proposal. By letter to Bateman dated May 15, 1967, Lawrence set forth in some detail the proposal being made. At the meeting on May 16, Lawrence presented a document entitled Opportunities Resulting From a Merger of Symington Wayne Corp. and Dresser Industries, Inc. Bateman requested Paine, Webber, Jackson & Curtis, its investment bankers, to analyze the proposal and also discussed it with various officers and directors of Symington Wayne. Bateman concluded that the Dresser offer would "have to be sweetened considerably before it would be advantageous to our stockholders." Paine, Webber estimated the value of Dresser's offer to be $36 per share or a premium of 6⅞ over the then market price of Symington Wayne common stock. On May 24, 1967, a meeting of Symington Wayne's executive committee was held with Hobart Ramsey, a Penphil member since June 1963, present. The Dresser proposal was discussed. The members of the committee were unfavorably impressed and directed Bateman to communicate this to Dresser, which he did that day. The next day, Lawrence and the vice president, finance of Dresser met with Bateman and an attorney for Symington Wayne. At this meeting Lawrence improved Dresser's offer for Symington Wayne's stock by increasing the amount of the proposed dividend on the convertible preferred. On May 26, Dresser's new offer was communicated to the members of the executive committee, including Ramsey. Ramsey thereafter discussed these meetings with Hodge, whose office was next to Ramsey's at Glore Forgan.

PURCHASE BY PENPHIL STOCKHOLDERS AND THE PRR

On Monday, May 29, at least seven Penphil stockholders purchased 5,300 shares of Symington Wayne. Warren H. Bodman (Bodman), a general partner of Yarnall, Biddle & Co., a broker-dealer in securities, bought 100 shares at 33⅛. Other Penphil stockholders purchasing that day through Yarnall, Biddle & Co. were D. Bevan, 1,000 shares at 30⅞, 31, and 31⅜; T. Bevan, 100 shares at 33⅝ and Vincent G. Kling, 500 shares at 32⅝, 32¾, and 33. Hodge purchased 2,000 shares that day through Glore Forgan at prices ranging from 30⅝ to 33½ per share.

D. Bevan and Haslett caused the PRR to purchase 1,000 shares at 33 and 33¼ per share through Yarnall, Biddle & Co. on May 29. In addition, Gerstnecker bought 100 shares and Haslett bought 500 shares through White, Weld & Co. on that day.

On June 1, 1967, Paul D. Fox purchased 100 shares through DeHaven & Townsend, Crouter, and Bodine, while on June 2, Ramsey bought 139 shares through Glore Forgan at 33⅞ and 34 per share.

Despite the fact that at least seven Penphil stockholders purchased Symington Wayne stock on May 29, and one other bought by the first of June, those questioned have denied discussing the matter with each other and denied knowledge of the Dresser proposal. None, however, has been able to give any substantial reason for purchasing these shares except "I must have thought it was a good investment."

MERGER DISCUSSIONS BETWEEN SYMINGTON WAYNE AND UNIVERSAL AMERICAN

On May 30, 1967, the Symington executive committee met and discussed the new Dresser offer and determined to make a counterproposal. It does not appear that such a counterproposal was made, however merger discussions between Symington Wayne and Universal American Corp. (Universal) were initiated by Bateman during June. On June 21, 1967, Bateman and a Symington Wayne attorney met with officials of Universal in New York City to discuss in detail a possible merger. As a result, Bateman wrote the board of directors on June 22, stating that the Dresser offer would mean approximately $42 to $43 per share to Symington Wayne's stockholders; however, Dresser would not commit itself in writing to continue Symington Wayne as a separate corporate entity. On the other hand, he pointed out that Universal's offer appeared more favorable because it would mean approximately $53 per share to Symington Wayne stockholders and there was a much better chance that Symington Wayne would retain its identity even to the extent of having an equal number of members on the board.

On the morning of June 27, Bateman, the Symington Wayne attorney, Ramsey, and a Glore Forgan analyst, among others, again met with Universal officials to discuss the merger and arrived at an agreement in principle to merge the companies. It was further agreed that letters of intent would be exchanged subject to board approvals on June 28, 1967, and a joint announcement would be made on June 28, after the close of trading on the NYSE.

At 10:42 a.m. on June 27, Penphil purchased 1,000 shares of Symington Wayne at prices ranging from 33½ to 34 per share through Glore Forgan. Hodge was the registered representative on the trade, which was placed by T. Bevan. On the 28th, the boards ratified the merger agreement and a public announcement was made. On June 29, the PRR purchased 4,000 shares at prices ranging form 33½ to 34 per share through Glore Forgan. Hodge was again the registered representative.

DRESSER ACQUIRES SYMINGTON WAYNE

Subsequent to the merger agreement, Dresser countered on July 7 with a tender offer for Symington Wayne stock at $40 per share.

Eventually this tactic was successful and Universal withdrew its merger proposal. In April 1968, Symington Wayne merged with Dresser.

SUMMARY

As previously noted at least seven Penphil stockholders purchased Symington Wayne shares on May 29, and two others purchased the stock on or before June 2, 1967. Penphil itself also purchased 1,000 shares on June 27. The following chart sets forth these purchases, the subsequent sales and the resulting profits:

PURCHASES AND SALES OF SYMINGTON WAYNE

	Hodge	Bodman	Kling	D. Bevan	Haslett	T. Bevan	Gerstnecker	Fox	Ramsey	Penphil
Date of purchase	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	May 29, 1967	June 1, 1967	June 2, 1967	June 27, 1967
Number of shares	2,000	100	500	1,000	500	100	100	100	139	1,000
Total Cost	$55, 203. 03	$3, 312. 50	$16, 614. 69	$31, 596. 27	$16, 916. 19	$3, 398. 31	$3, 385. 75	$3, 147. 26	$4, 767. 70	$33, 875.
Date of sale	Aug. 1, 1967	Oct. 16, 1967	Nov. 30, 1967	Dec. 20, 1967	Dec. 27, 1967	Jan. 4, 1968	(1)	Jan. 5, 1968	(1)	Jan. 4, 1968
Number of shares sold	2,000	1,000	500	1,000	500	100		100		1,000
Proceeds of sale	$78, 496. 55	$4, 000. 00	$20, 774. 58	$42, 046. 65	$20, 774. 58	$4, 154. 91		$4, 167. 15		$42, 000.
Profit	$13, 293. 52	$687. 50	$4, 159. 89	$10, 450. 38	$3, 858. 39	$756. 60		$1, 019. 89		$8, 125.

[1] It is not known at this time whether or not Gerstnecker or Ramsey have sold their shares.

In addition to the above purchases and sales, the PRR purchased and sold Symington Wayne stock during this same period:

Date	Purchases		Sales	
	Shares	Cost	Shares	Proceeds
May 29, 1967	1,000	$33,480.65		
June 29, 1967	4,000	136,640.17		
Dec. 27, 1967			2,000	$83,198.32
Jan. 2, 1968			2,000	83,695.70
Jan. 19, 1968			1,000	43,589.12
Total	5,000	169,940.82	5,000	210,483.14
Less cost				169,940.82
Profit				40,542.32

NATIONAL HOMES CORP.

BACKGROUND

National Homes Corp. is an Indiana corporation organized June 25, 1940, to engage in the manufacture and sale of prefabricated houses. By 1968, National had formed or acquired a number of subsidiaries which engaged in manufacturing prefabricated homes, operating subdivisions, manufacturing mobile homes, making construction loans to builder-dealers, and making mortgage loans to purchasers of homes. National's headquarters and main manufacturing facilities are located in Lafayette, Ind. As of December 31, 1967, National had 4,687,754 shares of common stock issued and outstanding and 1967 sales of $53,900,072. National's common stock and warrants were listed on the Midwest Stock Exchange.

INVESTMENTS BY PENPHIL, PENPHIL MEMBERS, AND THE PRR

Unlike most of Penphil's investments, there does not appear to have been any interlocking relationship between Penphil shareholders and National. Neither the PRR, Penphil nor Penphil stockholders owned shares of the stock of National prior to June 1968. During 1968, prior to August, National apparently did not engage in any unusual or extraordinary business transactions.

During June 1968, Penphil and certain Penphil stockholders purchased shares of National. On June 5, 1968, Penphil, on the recommendation of Stevens, bought 5,000 shares of National through Hornblower & Weeks, Hemphill, Noyes at prices ranging from $14½ to $14⅞ at a total cost of $74,101.52.[36] On the same day, D. Bevan purchased 1,000 shares through Hornblower & Weeks at $14¾ per share.[37] Stevens was the registered representative on the trades through Hornblower & Weeks, Hemphill, Noyes. Due to an apparent oversight, Hodge was not consulted or advised of Penphil's purchase until the morning of June 7th. Although Hodge believed Penphil would

[36] Stevens is deceased. There is no record of the reasons for his recommendation of National Homes stock.
[37] D. Bevan sold his 1,000 shares on December 9 at $34 per share for a profit of $18,671.82.

probably make some money on this investment, he nevertheless disapproved.[38]

Penn Central purchased 9,700 shares of National stock on December 2, 1968, at $28⅞, 5,200 of these shares were sold during September 1969, at prices ranging from $18¾ to $19¾. Penphil sold its 5,000 shares of National on October 20, 1970, at $16¾ for a profit of $9,035.98.

Exhibit IV-1

PENPHIL STOCKHOLDERS

Original Penphil stockholders

David Bevan did not hold any office with Penphil but was one of the persons who controlled its affairs. While a Penphil stockholder, D. Bevan was vice president, finance of the Pennsylvania Railroad Co. (PRR) and chairman of the finance committee of the PRR and its successor the Penn Central Company (PCC). In these positions D. Bevan had overall responsibility for investments in securities by the PRR, PCC and their subsidiaries, including investments for the plan for supplemental pensions (pension plan) and the contingent compensation plan (compensation plan).[39] During this period D. Bevan was a director and member of the executive committee of Great Southwest Corp., Kaneb Pipe Line Co., Arvida Corp., and Tropical Gas Co., Inc.

Charles J. Hodge whose Penphil stock was held in his wife's name, was also one of the persons who controlled Penphil's affairs and was a member of Penphil's investment committee. He was a partner or officer of Glore Forgan & Co. and its successors, a broker-dealer and investment banking firm, during the period 1962–71. While a Penphil stockholder, Hodge was also a director and member of the executive committee of Kaneb Pipe Line Co., the Great Southwest Corp., Tropical Gas Co., Inc., and Arvida Corporation.

Thomas Bevan the brother of David Bevan, was at various times between July 1962 and 1970 president, secretary, treasurer and a director of Penphil. As Penphil's secretary and treasurer until 1971, Bevan maintained all of Penphil's corporate books and records, including Penphil's checkbooks and financial records. Throughout Penphil's existence T. Bevan has been a partner of the Philadelphia law firm of Duane, Morris and Heckscher. Until 1971 he handled all of Penphil's legal work.

Lawrence Stevens, whose Penphil stock was held in his wife's name, was a member of Penphil's investment committee until his death in 1969. As a member of the investment committee, he participated in several of Penphil's investment decisions. Stevens was the managing partner of the Philadelphia office of Hemphill, Noyes & Co., a registered broker-dealer, and its successor, Hornblower & Weeks-Hemphill, Noyes & Co. during his association with Penphil.

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[38] When Penphil made its investment in National Homes without the benefit of an inside position, Hodge stated in a letter dated June 7, 1968 to D. Bevan:

"I was notified after the fact this morning that Penphil has bought 5,000 shares of National Homes. Larry called me and explained it was an oversight that I was not notified, and this oversight is understandable and I am certainly not put out. However, I must go on record, while this will be a popular and fast moving stock I do not agree with the fundamental purpose nor do I agree with the management of the Price brothers who have not demonstrated any ability in this field. I am confident that stockmarketwise we will probably make some money in it, but would like to go on record that this is not one to hold blindly."

[39] The pension plan is a qualified pension plan for employees of the PRR, PCC and their subsidiaries earning more than the amount covered by the Railroad Retirement Act. The compensation plan is a deferred compensation plan for employees of the PRR and the PCC earning an annual salary of more than $30 thousand.

Robert Haslett has been a member of Penphil's investment committee from the date it was formed until the present and for most of that period served as its chairman. During his association with Penphil he has held the positions of director of investments of the PRR and PCC and also vice president, investments of the PRR and PCC. In such positions he has made, under the supervision of Bevan, all investment decisions for the pension plan and the compensation plan.

Benjamin F. Sawin, although never an officer of Penphil, played a significant role in several of Penphil's investments. While a Penphil stockholder, Sawin was also president and later vice chairman of the board of directors of Provident National Bank of Philadelphia.

Francis A. Cannon was administrative vice president of the First Boston Corp., a registered broker-dealer.

Warren H. Bodman was a partner of Yarnall, Biddle & Co., a registered broker-dealer.

C. Carroll Seward was also a partner of Yarnall, Biddle & Co.

William R. Gerstnecker was treasurer of the Pennsylvania Railroad and later vice president—corporate of the Penn Central Co., a director of Arvida and Great Southwest and vice chairman, Provident National Bank.

Paul D. Fox was a vice president of the Pennsylvania Railroad and vice president—administration of the Penn Central Co.

Theodore K. Warner was vice president—taxation of the Pennsylvania Railroad and of the Penn Central Co.

F. B. Holmes was vice president of P. H. Glatfelter Co.

Edward D. Meanor managed his personal investments.

John K. Acuff was a partner of Brooke, Sheridan, Bogan & Co., Inc., a registered broker-dealer.

Other persons who became Penphil stockholders subsequent to June 1962

Herbert E. Fisher became a Penphil stockholder on or about June 30, 1963. Fisher was the president and chairman of the board of Kaneb Pipe Line Co., Inc., a company in which Penphil invested in 1962.

Angus G. Wynne, Jr., became a Penphil stockholder in the summer of 1963. Wynne was the president and chairman of the board of Great Southwest Corp., a company in which Penphil invested in 1963.

Fred H. Billups became a Penphil stockholder on or about June 30, 1963. Billups was the president and chairman of the board of Tropical Gas Co., a company in which Penphil invested in 1963.

Edwin B. Horner became a Penphil shareholder in the summer of 1963. He was with the First Colony Life Insurance Co.

Samuel A. Breene became a Penphil shareholder in June 1967. He was a Pennsylvania attorney.

Thomas F. Fleming, Jr., became a Penphil stockholder in August 1968. Fleming was chairman of the board of First Bank & Trust Co. of Boca Raton (N.A.) and also of the University National Bank of Boca Raton, companies in which Penphil invested in 1966 and 1967.

Hobart Ramsey became a Penphil stockholder on June 30, 1963. While a member of Penphil's Investment Committee Ramsey participated in some of Penphil's investment decisions. During his association with Penphil, Ramsey was a limited partner of Glore Forgan and a director and member of the executive committee of Symington Wayne Corp., a company in which Penphil invested in 1968.

Brown L. Whatley became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president and a director of Arvida Corp., a company acquired by the Pennsylvania Company in 1965, and president of Stockton, Whatley, Davin & Co., a large real estate and mortgage banking company which provided operating management for Arvida since 1961.

Joseph W. Davin became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was vice president and a director of Arvida and first vice president of Stockton, Whatley, Davin & Co.

Alfonso Manero became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was a partner of Glore Forgan & Co.

Olbert F. Lassiter became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president of Executive Jet Aviation.

Harry F. Ortlip became a Florphil stockholder on January 13, 1967, and a Penphil stockholder on February 19, 1968. He was president of his own company.

Cornelius A. Dorsey became a Penphil shareholder in August 1968. He was Haslett's assistant at Penn Central.

APPENDIXES

Appendix A—H.R. 12128.

Appendix B—S.E.C. comments on H.R. 12128.

Appendix C—I.C.C. comments on H.R. 12128.

APPENDIX A

92D CONGRESS
1ST SESSION

H. R. 12128

IN THE HOUSE OF REPRESENTATIVES

DECEMBER 8, 1971

Mr. STAGGERS introduced the following bill; which was referred to the Committee on Interstate and Foreign Commerce

A BILL

To extend the protection provided by the Federal securities laws to persons investing in securities of carriers regulated by the Interstate Commerce Commission.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 AMENDMENTS TO SECURITIES ACTS

4 SECTION 1. (a) (1) Section 3 (a) (6) of the Securities
5 Act of 1933 is repealed.

6 (2) The second sentence of section 19 (a) of such Act
7 is amended by striking out "; but insofar as they relate to any
8 common carrier subject to the provisions of section 20 of the
9 Interstate Commerce Act, as amended, the rules and regula-
10 tions of the Commission with respect to accounts shall not be

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1 inconsistent with the requirements imposed by the Interstate
2 Commerce Commission under authority of such section 20".
3 (3) Section 214 of the Interstate Commerce Act is
4 amended by striking out the second proviso.
5 (b) Section 13 (b) of the Securities Exchange Act of
6 1934 is amended by striking out ", and in the case of carriers
7 subject to the provisions of section 20 of the Interstate Com-
8 merce Act" and all that follows in such subsection, and insert-
9 ing in lieu thereof " (except that such rules and regulations
10 of the Commission may be inconsistent with such require-
11 ments to the extent that the Commission determines that the
12 public interest or the protection of investors so requires)."
13 (c) Section 304 (a) (4) (A) of the Trust Indenture Act
14 of 1939 is amended by striking out " (6),".
15 (d) Section 3 (c) (7) of the Investment Company Act
16 of 1940 is repealed.
17 EFFECTIVE DATES
18 SEC. 2. (a) The amendments made by subsections (a)
19 and (c) of section 1 shall take effect on the sixtieth day after
20 the date of enactment of this Act, but shall not apply with
21 respect to any security which was bona fide offered to the
22 public by the issuer or by or through an underwriter before
23 such sixtieth day.
24 (b) The amendment made by subsection (b) of section
25 1 shall not apply to any report by any person respecting a

1 fiscal year of such person which began before the date of
2 enactment of this Act.
3 (c) The amendment made by subsection (d) of section
4 1 shall take effect on the sixtieth day after the date of enact-
5 ment of this Act.

APPENDIX B

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

BY SPECIAL MESSENGER

Honorable Harley O. Staggers
Chairman, Committee on Interstate
and Foreign Commerce
House of Representatives
2125 Rayburn House Office Building
Washington, D. C. 20515

Re: H.R. 12128, 92nd Congress.

Dear Mr. Chairman:

In the absence of Chairman Casey, I am pleased to send you herewith three copies of a memorandum setting forth the Commission's views on H.R. 12128. This is in response to your request for a report on that bill.

We have just been advised by the Office of Management and Budget that there is no objection to the submission of this report from the standpoint of the Administration's Program.

Sincerely yours,

Hugh F. Owens
Commissioner

Enclosures (3)

MEMORANDUM PREPARED BY THE SECURITIES AND EXCHANGE COMMISSION FOR THE HOUSE OF REPRESENTATIVES COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE WITH RESPECT TO H. R. 12128, 92ND CONGRESS

H.R. 12128 would amend Sections 3(a)(6) and 19(a) of the Securities Act of 1933 [15 U.S.C. 77c(a)(6), 77s(a)], Section 13(b) of the Securities Exchange Act of 1934 [15 U.S.C. 78m(b)], Section 304(a)(4)(A) of the Trust Indenture Act of 1939 [15 U.S.C. 77ddd(a)(4)(A)], Section 3(c)(7) of the Investment Company Act of 1940 [15 U.S.C. 80a-3(c)(7)], and also Section 214 of the Interstate Commerce Act which was added under Part II of that Act by Section 214 of the Motor Carrier Act of 1935 [49 U.S.C. 314].

The effect of these amendments would be the repeal of certain exemptions under the federal securities laws administered by the Securities and Exchange Commission which are now available in connection with the issuance of securities and the filing of reports by certain interstate carriers by rail and motor which are subject to the jurisdiction of the Interstate Commerce Commission. An analysis of each amendment is set forth below.

While the Commission has been aware for some time of the existence of a weak spot in disclosures to, and protection of, securities investors who may acquire securities issued by ICC-regulated carriers which are exempt under the above mentioned provisions of the federal securities laws, the dangers inherent in this situation became much more apparent during recent Congressional hearings relating to the bankruptcy of Penn Central Transportation Company.[1/] In the light of this background and for the reasons which are more fully described below, the Securities and Exchange Commission strongly supports enactment of H.R. 12128 in its present form.

1/ See Hearings before the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong. 2nd Sess., Sept. 24, 1970 "Penn Central Transportation Company: Adequacy of Investor Protection"; also Staff Study for the same Special Subcommittee, July 27, 1971 "Inadequacies of Protections for Investors in Penn Central and Other ICC-Regulated Companies" (Committee Print).

I. Repeal of Section 3(a)(6) of the Securities Act of 1933.

The Securities Act of 1933 (the "Securities Act"), commonly called the "Truth in Securities" law, has two basic objectives: (a) to provide investors with material financial and other information concerning securities offered for public sale in interstate commerce or through the mails; and (b) to prohibit misrepresentation, deceit and other fraudulent acts and practices in the sale of securities generally. Such information is made available through the requirement that a registration statement be filed with this Commission by the issuer or seller of the securities which must become effective before sales may be effected, and that a prospectus which must be filed as part of that registration statement and must contain the minimum disclosures specified by the Securities Act be furnished to prospective purchasers so that they may exercise an informed judgment on whether or not to invest in such securities. Civil remedies are provided by the Act to an investor who suffers a loss as a result of violations of the registration, disclosure or anti-fraud requirements of the Act by the issuer or seller of the securities, and such remedies may also be asserted against others who participated in the violations.

Section 3(a)(6) of the Securities Act exempts from the registration and prospectus requirements of the Act securities of common or contract carriers, the issuance of which is subject to the provisions of Section 20(a) of the Interstate Commerce Act, as amended [49 U.S.C. 20(a)]. The term "carrier, as defined for purposes of Section 20(a), includes virtually all companies which are engaged in interstate transportation as common or contract carriers by rail or motor.

One result of the exemption under Section 3(a)(6) of the Securities Act has thus been that investors in such carriers have not been afforded the protections provided through registration as envisioned under Section 5 of that Act. To this extent, such carriers have been in a class by themselves among industrial corporations. Only banks, savings and loan associations, and insurance companies have specific exemptions comparable to those granted to such carriers. Moreover, it should be noted that not <u>all</u> carriers enjoy the exemption under Section 3(a)(6), for example, air carriers while ostensibly not different from railroads or trucks in such respects, are subject to the requirements of the Securities Act in the same manner as other industrial corporations. Nevertheless, while subject to the federal securities laws, an air carrier is also subject to concurrent supervision by the Civil Aeronautics Board, without any special problems arising from such dual jurisdiction.[2/]

There is very little in the legislative history of Section 3(a)(6) to provide an explanation for vesting of sole jurisdiction over carriers in the Interstate Commerce Commission including jurisdiction over issuance of securities. However, there appears in a statement by the Honorable Huston Thompson, a former member of the Federal Trade Commission in which supervision of the Securities Act was originally vested, and one of the framers of H.R. 4314 and S. 875 (the original versions of this Act in both houses of the 73d Congress), the following explanation of the purpose underlying what was to become Section 3(a)(6):

> We do not want to have railroad companies file their information with the Federal Trade Commission and then go ahead and have to file it also with the Interstate Commerce Commission. So we say that where they are covered by a division of the Federal Government that has supervision, then they shall file their information with that division, but not with the Federal Trade Commission.

* * * * *

2/ This is applicable also with respect to the concurrent jurisdiction by the SEC and Federal Power Commission over gas and electric public utility holding companies; see Subcommittee Staff Report, fn 1 supra, pg. (III).

> But when it comes to advertising, anyone, no matter where they have filed other information, becomes responsive to the provisions of this bill, so far as advertising is concerned. 3/

The section of H.R. 4314 dealing with advertising, and referred to above, was section 8 of the bill. Those sections of the Securities Act into which the originally proposed section 8 has been incorporated, i.e. Sections 5(b)(1), 5(b)(2), 6(d), 10(a)(1), 10(a)(2), 10(c) and 10(d), related to the form and content, availability for inspection, and requirement of delivery of prospectuses covering securities proposed to be sold in interstate commerce. These sections do not, however, apply to carriers, by virtue of the Section 3(a)(6) exemption. A possible explanation for the decision, at the time the Securities Act was enacted into law, not to carry through the original intention to require compliance with the advertising provisions, may be found in a statement by R. V. Fletcher, General Counsel of the Association of Railway Executives during the same hearings:

> Section 8 was one of the matters I wanted to touch on. I have not had time to do that. That is the section, of course, which deals with advertisements, so called, and various things which might be put in there, and it seems to me that this is another feature which will burden the carriers unnecessarily, and accomplish no useful purpose insofar as the carriers and those purchasing their securities are concerned. 4/

The most significant effect of the repeal of Section 3(a)(6) of the Securities Act would be to abolish the exemption now available to ICC-regulated carriers from the registration and prospectus requirements of Section 5 of that Act and as a result place the securities of companies now under the jurisdiction of ICC alone under the concurrent jurisdiction of both the ICC and this Commission. With enactment of this provision of H.R. 12128, ICC-

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3/ Hearings, House Comm. on Interstate and For. Commerce on H.R. 4314, 73d Cong., 1st Sess. at 29-30 (Mar. 31, Apr. 1, 4, 5, 1933).

4/ Id. at 204.

regulated companies would be required to file registration statements and prospectuses with the SEC, and have them become effective prior to any public distribution of their securities, and in this connection would be required to comply with other applicable provisions of the Securities Act and the rules and regulations promulgated thereunder which relate to the registration process.

While this memorandum will not go into a detailed analysis of all the differences which exist in connection with issuance of securities by companies which are subject to ICC regulation and those which are subject to the Securities Act, 5/ there are several important areas where the requirements under the latter legislation do not appear to have counterparts which apply at present to ICC-regulated carriers but which would do so with the repeal of the exemption in Section 3(a)(6) of the Securities Act. Among these, for example, are (1) the prospectus delivery provisions in Section 5(b)(2) of the Securities Act which require the dissemination of a prospectus to underwriters, and dealers, as well as to actual or prospective investors, prior to or simultaneously with the delivery of a security for purposes of sale or delivery after sale; (2) the obligations of the issuer to amend or update the prospectus after a registration statement has become effective and prior to completion of the offering; (3) assurance by the underwriter, pursuant to SEC Rule 460 [17 CFR 230.460], that proper steps have been taken to secure adequate distribution of the preliminary prospectus a reasonable time in advance of the anticipated effective date of the registration statement; and (4) compliance by all dealers effecting transactions in the

5/ The SEC does not have expertise on ICC procedures or requirements of the Interstate Commerce Act such as might qualify it to go into a detailed discussion of all such differences. However, these have been set out in the Hearings and Subcommittee Staff Report noted in footnote 1 above.

registered securities, whether or not they are participating in the distribution of the securities, with SEC Rules 174 and 425A [17 CFR 230.174, 230.425a] regarding the prospectus delivery duties of those dealers in the after-market. These rules relate to the obligation of dealers, including underwriters no longer acting as underwriters, to deliver a prospectus in transactions involving any securities of the same class as those registered, during the 40-day or 90-day period after the effective registration date as specified in Section 4(3) of the Securities Act (except where they can prove that such securities are not part of the issue so registered), and require a statement to that effect to appear on the cover of the prospectus. Moreover, SEC Rules 135, 137, 138, and 139 under the Securities Act [17 CFR 230.135, 230.137, 230.138 and 230.139] spell out certain prohibitions and restrictions with respect to statements that may be published or circulated regarding the registered securities in the absence of an accompanying statutory prospectus, and provide an additional degree of protection which would not appear to be provided for under the ICC requirements.

Repeal of Section 3(a)(6) of the Securities Act would subject secondary distributions of securities by the corporate parent of the carrier, or by persons controlling, controlled by or under common control with the carrier, to the same requirements as initial offerings by the issuer itself. At present, as pointed out in the Subcommittee Staff Study[6/] of the House Committee on Interstate and Foreign Commerce, the ICC does not have the statutory authority to regulate such distributions because they do not involve the issuance by a carrier of its own securities. Since such large scale offerings by "insiders" of a carrier may possess all of the dangers attendant upon a new offering of securities, to insulate such distributions from the investor protection

6/(See fn 1, supra.)

provisions of the Securities Act would not seem to be in the public interest.

Information now contained in prospectuses filed by carriers with the ICC is not ordinarily examined by the staff of the SEC, and, therefore, is not commented on. However, there are certain important differences both in textual requirements and accounting procedures followed by these two agencies, as was brought out during the above-mentioned House Committee hearings. For example, SEC forms under the Securities Act call for more detailed disclosure of such items as management compensation, stock options, and material interests in certain transactions involving management and the issuer. The accounting differences are discussed more fully below under the heading dealing with the proposed amendments to Section 13(b) of the Securities Exchange Act of 1934.

Certain additional advantages would result from repeal of Section 3(a)(6). Foremost among these, from the standpoint of investor protection as well as assistance to issuers in complying with the Act, is the reviewing process employed by the SEC staff. This process of review is directed to all filings with the SEC, and the staff is able to draw on considerable expertise gained over a period of many years relating to investor protection to assure compliance with the disclosure and protective provisions of the Securities Act.

Moreover, repeal of this exemption would bring into play certain administrative procedures which are now available to the SEC in aid of its reviewing process, such as investigatory powers conferred by Section 20(a) of the Securities Act [15 U.S.C. 77t(a)], the injunctive powers of Section 20(b) [15 U.S.C. 77t(b)] whereby this Commission may ask a court to enjoin or restrain any person whenever it determines that such person is engaged or about to engage in any act or practice which constitutes or will constitute a violation of the Act, and the power conferred on the Commission under Section

8(b) [15 U.S.C. 77h(b)] to issue a "stop order" which will delay the effectiveness of a registration statement until all deficiencies are remedied or which can stop all sales under an effective registration statement where such deficiencies are discovered after the effective date thus making any sales thereafter illegal until the deficiencies are remedied and the "stop order" has been lifted. When compliance with the disclosure requirements of the Securities Act is not obtained, or when any of the provisions of the Act or the rules or regulations promulgated thereunder are wilfully violated, the penalty provisions of Section 24 may be invoked by the SEC [15 U.S.C. 77x] under which a court may impose fines up to $5,000 or imprisonment up to five years or both upon convinction. Finally, the civil remedies provided by Sections 11 and 12(1) of the Act [15 U.S.C. 77k, 77l(1)] would be available to purchasers of such securities not sold in compliance with the Act, remedies which would be in addition to the civil anti-fraud remedies provided by Sections 12(2) and 17(a) of the Act [15 U.S.C. 77l(2), 77q(a)] and by Rule 10b-5 under the Securities Exchange Act of 1934 [17CFR 240.10b-5] which are already available to purchasers of securities of carriers subject to ICC jurisdiction. The benefits inherent in bringing a civil action under Sections 11 and 12(1) of the Securities Act, which have no counterpart under ICC legislation, are that affirmative responsibility for complete and truthful disclosure is placed on the various classes of persons participating in the sale or distribution of the securities, and as a general rule the defrauded investor is entitled to recover upon proof of the misstatement or omission of a material fact in a registration statement or prospectus without being required to establish reliance thereon or the defendant's knowledge or intent to deceive as was required at common law, or upon a showing of failure to register such securities with the SEC when such registration is required.

II. Striking Out the Last Clause of the Second Sentence of Section 19(a) of The Securities Act of 1933

Section 19(a) of the Securities Act provides that the Commission shall have authority to make, amend and rescind such rules and regulations as may be necessary to carry out the provisions of the Act, including those governing registration statements and prospectuses for various classes of securities and issuers, defining accounting, technical and trade terms used in the Act, and prescribing the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in appraisal or valuation of assets and liabilities, in determining depreciation and depletion, in differentiation of recurring and nonrecurring income and of investment and operating income, and in the preparation of consolidated balance sheets and income accounts of persons in a control relationship to the issuer. Such authority is qualified, however, by a final clause reading: "but insofar as they relate to any common carrier subject to the provisions of section 20 of the Interstate Commerce Act, as amended, the rules and regulations of the Commission with respect to accounts shall not be inconsistent with the requirements imposed by the Interstate Commerce Commission under authority of such section 20."

Section 1(a) of H.R. 12128 would strike out the above quoted language from Section 19(a) of the Securities Act. The effect of this amendment would be to extend to the SEC the same authority with respect to rules and regulations which it may adopt under Section 19(a) of the Securities Act for carriers whose securities are now issued under Section 20(a) of the Interstate Commerce Act as it now has for other issuers. Thus financial statements of such carriers would have to meet the same general requirements as those of other issuers now subject to the Securities Act.

Should Section 3(a)(6) of the Securities Act be repealed, the proposed amendment to Section 19(a) would be necessary in order that the full benefit and impact of the deletion of the Section 3(a)(6) exemption be achieved. Without such amendment, ICC-regulated carriers brought under the registration requirements of Section 5 of the Securities Act might be able to continue to utilize their own methods of presenting financial information which now vary materially from those required by the SEC for other issuers. (The shortcomings of these alternatives from an accounting standpoint are discussed in those portions of this memorandum which deal with the proposed amendments to Section 3(a)(6) of the Securities Act and Section 13(b) of the Securities Exchange Act of 1934.) The proposed amendment to Section 19(a) of the Securities Act, on the other hand, would insure uniformity of reporting under this Act and would enable the average investor to make a more meaningful comparison between competing investment opportunities. Moreover, in the opinion of this Commission, applying present SEC requirements to financial statements of such carriers would make more readily apparent the true financial condition of such carriers. The SEC requirement that financial statements be certified by an independent public accountant would strengthen investor confidence in such reports and thus also benefit the carriers in this respect.

III. Amendment Of Section 214 Of The Interstate Commerce Act

Section 214 of the Interstate Commerce Act was added under Part II of that Act by Section 214 of the Motor Carrier Act of 1935. The second *proviso* in Section 214 states:

> *Provided further*, That the exemption in section 3(a)(6) of the 'Securities Act,' is hereby amended to read as follows: '(6) any security issued by a common or contract carrier, the issuance of which is subject to the provisions of section 20(a) of the Interstate Commerce Act as amended;'

The effect of that addition was to extend the exemption under Section 3(a)(6) of the Securities Act to motor carriers which the 1935 Act brought under the jurisdiction of the ICC.

Section 1(a)(3) of H.R. 12128 would repeal this exemption for contract motor carriers and place such carriers on the same basis with respect to issuance of their securities for public sale as common carriers by rail under the proposed repeal of Section 3(a)(6) of the Securities Act.

This amendment to Section 214 of the Interstate Commerce Act would be necessary since the repeal of Section 3(a)(6) of the Securities Act with respect to rail carriers would otherwise create the anomalous situation of continuing the Securities Act exemption as to motor carriers while abolishing it as to rail carriers.

Since the reasons for repealing the exemption are the same as to both types of carriers and have been fully stated earlier, they are not repeated here.

IV. Amendment of Section 13(b) of The Securities Exchange Act

In addition to providing for registration with the Securities and Exchange Commission of securities exchanges, securities associations and broker-dealers, and for market surveillance and certain restrictions on trading and prohibitions against market manipulation and fraud, and for regulating proxy and tender offer solicitations, the Securities Exchange Act of 1934 extends on a continuing basis the disclosure doctrine of investor protection which was initiated with the Securities Act. Its requirements in this area apply to companies with securities traded on national securities exchanges, and to those with securities traded in the over-the-counter market which have total assets of more than one million dollars and whose shareholders of a class of equity security number 500 or more, all of which are required to be registered with the Securities and Exchange Commission under Section 12 of the Act. For purposes of this memorandum, only the financial reporting requirements and related provisions will be discussed as they constitute the primary continuing disclosure mechanisms of the Securities Exchange Act.

Section 13(a) of that Act requires every issuer subject to the registration requirements of Section 12 of the Act to file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security, (1) such information and documents as the Commission shall require to keep reasonably current the information and documents filed under Section 12 of the Act (with one minor exception not pertinent to this discussion), and (2) such annual reports, certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports as the Commission may prescribe.

Section 13(b) of the Securities Exchange Act authorizes the Commission to prescribe the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in differentiating between recurring and nonrecurring income and also between investment and operating income, and in the preparation (where the Commission deems it necessary or desirable) of separate and/or consolidated balance sheets or income accounts of any person in a control relationship with the issuer.

Section 13(b) contains two qualifications to such authorizations, the first of which states:

> "... but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter."

In essence, this qualification places the Commission in a subordinate position with respect to the prescription of the proper method of accounting to be used in reports filed with the Commission under the Securities Exchange Act when the companies in question are also under the jurisdiction of other laws of the United States prescribing proper methods of accounting for those companies. Specific examples of such companies would be those regulated by the Interstate Commerce Commission, the Federal Power Commission, the Civil Aeronautics Board, the Federal Communications Commission, the Federal Home Loan Bank Board, and the Board of Governors of the Federal Reserve System.

This limitation on the Commission's authority in this area is further defined with respect to ICC-regulated carriers by the second qualification in

Section 13(b) which states:

> [...the rules and regulations of the Commission with respect to reports] ... ", in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act, as amended, or carriers required pursuant to any other Act of Congress to make reports of the same general character as those required under such section 20, shall permit such carriers to file with the Commission and the exchange duplicate copies of the reports and other documents filed with the Interstate Commerce Commission, or with the governmental authority administering such other Act of Congress, in lieu of the reports, information and documents required under this section and section 12 in respect of the same subject matter."

As a consequence of the language quoted immediately above, ICC-regulated carriers presently file with the SEC duplicate copies of reports which they have filed with the ICC in lieu of reports which would otherwise be required of them. As a result, such carriers are not required to file annual reports with the SEC on SEC Form 10-K, quarterly reports on SEC Form 10-Q, or occasional reports of material changes on SEC Form 8-K.

The substitute forms filed by such carriers do not parallel SEC forms in several important respects. For example, the financial statements included in ICC reports are not required to be prepared in accordance with generally accepted accounting principles, nor are they required to comply with the provisions of SEC's Regulation S-X [17 CFR Part 210] regarding the form and content of financial statements.[7/] Specifically, the ICC does not permit

7/ The ICC did adopt, on January 25, 1962, in Docket No. 33581, a statement that:

> Carriers desiring to do so may prepare and publish financial statements in reports to stockholders and others, except in reports to this Commission, based on generally accepted accounting principles for which there is authoritative support, provided that any variance from this Commission's prescribed accounting rules contained in such statements is clearly disclosed in footnotes to the statements.

Thus, even though certain accounting practices followed by the SEC, which are based on generally accepted accounting principles, may differ from corresponding practices followed by the ICC, ICC-regulated companies now have the discretion to prepare reports for dissemination to shareholders either in accordance with the rules of the ICC or with generally accepted accounting principles. Reports which are required to be submitted to the ICC, however, must still be prepared in accordance with ICC rules.

financial statements to be prepared on a consolidated basis or the recording of equity in earnings of unconsolidated subsidiaries, nor does it require that the statements be certified by independent public accountants. The ICC forms do not permit carriers to record provisions for deferred income taxes in their accounts, nor do they follow the method prescribed by the Accounting Principles Board of the American Institute of Certified Public Accountants for reporting prior period adjustments. On the other hand, SEC forms do call for financial statements prepared in accordance with generally accepted accounting principles which require consolidation of subsidiaries, recording of equity in unconsolidated subsidiaries, provisions for deferred income taxes and adjustment of surplus for prior period adjustments, and they also require that the annual financial statements be certified by independent public accountants (with one exception for insurance companies not pertinent to the present discussion).

From a textual standpoint, the ICC forms are not required to contain itemized reports of security issuances during the year, grants of stock options, other corporate events which may affect security valuations, and management remuneration and bonuses; whereas all of these are required to be included in the usual SEC Form 10-K because they are essential for a meaningful analysis of the companies involved.[8/]

With respect to the Form 10-Q quarterly reports required by Sections 12 and 13 of the Securities Exchange Act, Rule 13a-13(c) promulgated under this

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8/ The SEC, constrained by the statutory limitations of Section 13(b) of the Securities Exchange Act, has adopted certain rules affecting the reports of the above-mentioned carriers. In lieu of Form 10-K, carriers file on SEC Form 12-K which does make provision for disclosure of securities issuances during the last fiscal year but which also allows them to file as the major portion of the Form 12-K the carrier's annual report to the ICC.

Act [17 CFR 240.13a-13(c)] permits common carriers which submit financial statements to the ICC to file as exhibits to reports on this form copies of certain quarterly reports submitted to the ICC. While the ICC forms in this case provide more detail regarding revenue and expenses than is required by SEC Form 10-Q for other corporations, they lack some of the information which this Commission deems essential, such as per share data, capitalization data, and other financial data prepared on a consolidated basis.

Section 1(b) of H.R. 12128 would delete from Section 13(b) of the Securities Exchange Act all of the second qualification (quoted above on page 14) which specifically concerns ICC-regulated carriers; and would substitute for such deletion a parenthetical clause. The result of these changes would be that Section 13(b) would then read:

> (b) The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter <u>(except that such rules and regulations of the Commission may be inconsistent with such requirements to the extent that the Commission determines that the public interest or the protection of investors so requires)</u>. 9/

The effect of the deletion alone would be to place ICC-regulated carriers on an equal footing with the companies whose methods of accounting are prescribed

9/ The parenthetical "except" clause, which we have underscored, is what would be added by Section 1(b) of H.R. 12128.

by the provisions of any federal law (other than the Securities Exchange Act) or by rules and regulations under such laws. The Commission's authority with respect to these carriers, in the context of periodic reports filed with the Commission, would remain in a subordinate position to the ICC and its rules and regulations regarding inconsistencies "in respect of the same subject matter." The one important exception to this generalization, however, would be provided by the parenthetical "except" clause to be inserted in Section 13(b). This clause would allow the Commission to require compliance with its own rules pertaining to proper accounting procedures in reports filed with it by ICC-regulated carriers, even if inconsistent with procedures called for by ICC rules, "to the extent that the Commission determines that the public interest or the protection of investors so requires." As a result, under the limited circumstances stated in that clause, ICC carriers would be subject to filing annual, quarterly, and periodic reports of changes in conformity with the requirements of SEC rules and regulations. This would eliminate the present inconsistencies as outlined above between reports of such carriers and those of issuers subject to the full reporting requirements under the Securities Exchange Act. Not only would the investor receive documents containing more information relevant to his investment objectives and purposes, but he would be provided with a uniformity of reporting not now available to him with respect to ICC-regulated carriers which would be more useful for making comparative analyses of companies of different industries.

In closing this discussion of the amendments to Section 13(b), one final point is noted. The insertion of the parenthetical "except" clause discussed above, coupled with the language left unchanged in Section 13(b), would appear to remove the present limitations on SEC authority to prescribe accounting

procedures as to any person who reports to any other agency whose laws, rules or regulations impose requirements as to methods of accounting which differ from those of the SEC in respect of the same subject matter when the Commission determines that the public interest or the protection of investors so requires. In other words, under the circumstances mentioned in the parenthetical "except" clause, the Commission would have the discretionary power to exercise pre-eminent authority over the proper accounting procedures to be used in reports required to be filed with it by companies subject not just to ICC jurisdiction, but also the jurisdiction of other agencies such as the FPC, CAB, FCC, and FHLBB. It should be noted, however, that such a grant of pre-eminent authority would merely parallel that already granted the Commission under the Securities Act of 1933 regarding the issuance of securities (with the exception of securities issuances by ICC-regulated carriers, an exception which the present bill would remove). Although the drafters of the proposed legislation may have intended the thrust of this amendment to be limited to ICC-regulated carriers, it thus appears that in fact it would have a much wider impact in terms of the Commission's relationship with other agencies in accounting and reporting areas.

Assuming that H. R. 12128 would enlarge the scope of the Commission's authority in this broader fashion, not just vis-a-vis ICC requirements, the Commission would favor this aspect of the bill because it would move the requirements of the Securities Exchange Act closer to those of the Securities Act of 1933, something for which the Commission has been striving for some time. It would also afford investors information as to not just ICC-regulated carriers, but all companies regulated by any other agency whose accounting and reporting requirements vary from those of this Commission, which would better compare with that which they presently receive from other publicly held companies.

V. Deletion of Reference to Section 3(a)(6) of the Securities Act Contained in Section 304(a)(4)(A) of the Trust Indenture Act of 1939

The Trust Indenture Act of 1939 (the "1939 Act") was enacted as a supplement to the Securities Act after studies by the SEC had revealed the frequency with which trust indentures failed to provide minimum protections for security holders and absolved so-called trustees from minimum obligations in the discharge of their trusts. This Act applies in general to bonds, notes, debentures and similar debt securities offered for public sale which are issued pursuant to trust indentures under which more than one million dollars of securities may be outstanding at any one time.

The 1939 Act requires that such debt securities may not be offered to the public, even though registered under the Securities Act, unless they are issued pursuant to a qualified trust indenture which conforms to the minimum requirements specified in the Act. It requires also that the trustee, or at least the principal one, be a domestic corporation with minimum combined capital and surplus; imposes high standards of conduct and responsibility on the trustee; requires that the indenture trustee be free of conflicting interests which might interfere with the faithful exercise of its duties in behalf of purchasers of the securities; precludes preferential collection of certain claims owing to the trustee by the issuer in the event of default; provides for the issuer's supplying evidence to the trustee of compliance with indenture terms and conditions such as those relating to release and substitution of mortgaged property, issuance of new securities, or satisfaction of the indenture; and provides for reports and notices by the trustee to security holders. Other provisions prohibit impairment of the security holders' right to sue individually for principal and interest except under certain circumstances, and require the maintenance of a list of security holders which may be used by them

to communicate with each other regarding their rights as security holders.

The provisions of Section 304(a)(4)(A) of the 1939 Act exempt from the indenture and trustee qualifications requirements of the Act those securities which are also exempt under certain provisions of the Securities Act. Included therein is a reference to securities which are exempt under the provisions of Section 3(a)(6) of the Securities Act. The effect of this exemption, therefore, is to exclude from the requirements and proscriptions of the 1939 Act all debt securities which are subject to ICC jurisdiction under Section 20(a) of the Interstate Commerce Act.

The amendment proposed under Section 1(c) of H.R. 12128 is necessary, therefore, to conform Section 304(a)(4)(A) of the 1939 Act to the Securities Act exemption as it would be amended by Section 1 of the bill. Moreover, the reasons supporting repeal of the exemption in Section 3(a)(6) of the Securities Act would apply equally to the repeal of the exemption under the 1939 Act. The importance of this change is supported by the fact that the 1939 Act deals not only with disclosure of the terms of an indenture, but also with the substantive nature of the relations between obligor, obligee and trustee. For example, where indentures are required to be qualified under the 1939 Act, the Act prohibits certain relationships or transactions between the trustee and the obligor or the underwriter for securities of the obligor in certain instances which arise from certain interlocking management or directorships, ownership of securities or claims against the obligor or collateral for outstanding obligations of the obligor which are in default; it restricts the right of the trustee, if it becomes a creditor of the issuer, to improve its position as creditor to the detriment of security holders; and requires certain periodic reports by the trustee to the security holders for whom he acts as trustee.

Indentures now filed with the ICC by such carriers are not required to contain the provisions specified in the 1939 Act, nor are trustees subject to the same proscriptions by virtue of any federal statute. Thus security holders of debt obligations of such carriers are not afforded the same protections as are purchasers of securities subject to the 1939 Act. Enactment of the bill with Section 1(c) would extend such requirements and proscriptions to those carriers and their indenture trustees and would provide substantive protections and consistency of treatment to debt securities issued by such carriers.

VI. Repeal of Section 3(c)(7) of The Investment Company Act of 1940

The Investment Company Act of 1940 (the "1940 Act") resulted from a study of the activities and abuses of investment companies and investment advisers which was conducted by the Securities and Exchange Commission pursuant to direction of Congress. Under this Act, the activities of companies engaged primarily in the business of investing, reinvesting, owning, holding and trading in securities and whose own securities are offered and sold to and held by the investing public, are subject to certain statutory prohibitions and to SEC regulation in accordance with prescribed standards deemed necessary to protect the interests of investors and the public. Such companies are required to register with the Commission, and to disclose their financial condition and investment policies so as to afford investors full and complete information about their activities.

The Act provides a comprehensive framework of regulation which, among other things, prohibits changes in the nature of an investment company's business or its investment policies without shareholder approval, protects

against management self-dealing, embezzlement or abuse of trust, and provides specific controls to eliminate or to mitigate inequitable capital structures. The 1940 Act also provides other basic investor protections including a requirement that management contracts be submitted to shareholders for approval; a prohibition against underwriters, investment bankers or brokers constituting more than a minority of the investment company's board of directors; and requirements for safekeeping of its assets. It also bars persons guilty of security frauds from serving as officers and directors; forbids issuance of senior securities by such companies except under specified conditions and terms; prohibits pyramiding of such companies and cross-ownership of their securities; and provides specific controls designed to protect against unfair transactions between investment companies and their affiliates.

At present, Section 3(c)(7) [10/] of the 1940 Act as amended excludes from the definition of an investment company for purposes of this Act:

> (7) Any company subject to regulation under the Interstate Commerce Act, or any company whose entire capital stock is owned or controlled by such a company; Provided, That the assets of the controlled company consist substantially of securities issued by companies which are subject to regulation under the Interstate Commerce Act.

In effect, Section 3(c)(7) establishes two criteria, with the satisfaction of either one being sufficient to remove a company from the regulatory ambit of the 1940 Act. The first excludes a company subject to regulation under the Interstate Commerce Act, and the second excludes its controlled companies the assets of which consist substantially of securities of issuers which are themselves subject to regulation under the Interstate Commerce Act.

10/ Present Section 3(c)(7) was originally enacted as Section 3(c)(9), but was redesignated as Section 3(c)(7) by the Investment Company Amendments Act of 1970 which became effective December 14, 1970 (§3(b), P.L. 91-547, 84 Stat. 1414).

Section 1(d) of H.R. 12128 would repeal Section 3(c)(7) of the 1940 Act which now excludes ICC-regulated companies from regulation by the SEC under the 1940 Act. The effect of such repeal would be to extend SEC jurisdiction over ICC-regulated companies, which would fall within the definition of an investment company under the Act but for such exemption, in the same manner as it now applies to other investment companies.

The protective framework of the 1940 Act reflects the concern for the national public interest which Congress found to be affected by investment companies which customarily invest and trade in securities issued by companies engaged in business in interstate commerce, and which may dominate and control or otherwise affect the policies and management of such companies. This public interest, historically sensitive to abuse or imbalance, is further affected adversely when investment companies engage directly or indirectly in the business of an interstate carrier subject to the Interstate Commerce Act, the policy of which is, inter alia, to foster sound economic conditions in transportation.

Within this context of critical public concern, it is anomalous that an investment company can free itself of the regulation Congress deemed necessary to protect the public against abuse, not by a policy of self-restraint, but rather, as described below, by expansion into an area in which it may detract from sound economic conditions in transportation. This dichotomy is made possible by the gap in federal regulation that arises from the juxtaposition of the 1940 Act and the Interstate Commerce Act. The House Subcommittee Staff Study[11/] dramatically documents the detriments to

11/ (See n. 1 above)

public investors flowing from the regulatory gap created by the Section 3(c)(7) exclusion in the 1940 Act.

The Commission has on a number of occasions in past years called to the attention of Congress that Section 3(c)(7) provides a means whereby a corporation which largely may be engaged in the business of investing, reinvesting, owning, holding and trading in securities can avoid regulation under the 1940 Act simply by acquiring, with a small fraction of its assets, a common carrier, or to some minor extent directly engaging in the business of an interstate carrier.[12/] This avoidance is possible in a variety of ways. First, a company may itself be a carrier subject to regulation by the ICC, but its carrier assets may represent only a small fraction of its total assets. Second, a parent company, by the simple expedient of controlling a single carrier becomes subject to regulation by the ICC and is thus excluded from the definition of an investment company even though such control is exercised by stock ownership representing an insignificant

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12/ See Annual Reports of the Securities and Exchange Commission: 21st Report, pp. 101-102 (1955), 22nd Report, pp. 188-189 (1956), 23rd Report, p. 10 (1957), 25th Report, p. 11 (1959); Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives (86th Cong., 1st Sess. 1959) pp. 124, 132, 140-141, 397-416; Hearing before a Subcommittee of the Committee on Banking and Currency, United States Senate (86th Cong. 1st Sess. 1959) pp. 130-133, 518-634; Memorandum of the Division of Corporate Regulation entitled "Possible Dual Regulatory Status of Investment Company-Carriers" transmitted by the Commission to Chairman Staggers on October 30, 1969; Memoranda of the Division of Corporate Regulation concerning the Pennsylvania Company, dated July 14 and September 15, 1970 and transmitted by the Commission to Chairman Staggers; Memorandum of the Division of Corporate Regulation concerning Alleghany Corporation, transmitted by the Commission to Chairman Staggers on August 21, 1970. The latter three memoranda are printed in Hearings "Penn Central Transportation Company--Adequacy of Investor Protection," (see n. 1 above) pp. 30-43 and 218-236.

At the time of the foregoing reports, hearings and memoranda the present section 3(c)(7) was 3(c)(9). (See n. 10 above).

percentage of the parent's assets. Further, with regard to the controlled company, since the Act does not define the term "substantially," a controlled company which has more than 50 per cent of its assets in non-carrier securities and an even greater percentage of its income which is derived from such securities, might claim it was excluded from being an investment company on the theory that its assets consist substantially of securities issued by ICC regulated companies.

H.R. 12128 would eliminate these anomalies by repealing Section 3(c)(7) of the 1940 Act so that those companies currently relying on that exclusion would be subject to registration and regulation under the 1940 Act if they otherwise fall within the Act's definition of an investment company.

Section 3(a)(1) of the 1940 Act defines as an investment company any company which is primarily engaged, or holds itself out as being primarily engaged in the business of "investing, reinvesting, or trading in securities." To cover situations in which such primary engagement is not readily apparent because the company is either directly, or through controlled companies, engaged in an industrial or other business together with investing in securities, Section 3(a)(3) provides a statistical definition of an investment company to include a company if, among other things, more than 40 per cent of the company's assets consist of securities other than those of majority-owned subsidiaries.

Section 3(b)(2) of the 1940 Act provides a means whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition of Section 3(a)(3), is nevertheless not an investment company. Thus a company which can demonstrate that it is primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, either directly or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses, can be relieved from registration and regulation under the 1940 Act. In determining whether a company is so primarily engaged the Commission has traditionally considered the company's historical development; its public representations of policy; the activities of its officers and directors; and, most important, the nature of its present assets and the sources of its present income.

Though the original purpose of Section 3(c)(7) was to avoid subjecting companies to dual regulation, we believe that any adverse affect of such regulation has been exaggerated. Investment company-carriers, in fact, fall within the policy and purpose of both the Investment Company Act and the Interstate Commerce Act. Although regulation under both Acts may be dual, it is not duplicative because each has a different purpose with its own point of focus and concern.

To the extent, however, that duplicative regulation may arise as a result of the repeal of Section 3(c)(7), the Committee might consider

an amendment to Section 6 of the 1940 Act to add a new subsection (f)[13/] to provide:

> (f) If, with respect to the issue, sale, or guaranty of a security, or assumption of obligation or liability in respect of a security, the method of keeping accounts, the filing of reports, or the acquisition or disposition of any security, money, or other property, and with respect to any other subject matter, any person is subject both to a requirement of the Investment Company Act of 1940, as amended, or of a rule, regulation or order thereunder and to a requirement of the Interstate Commerce Act or of a rule, regulation, or order thereunder, the requirements of the Investment Company Act of 1940, as amended, shall apply to such person, and such person shall not be subject to the requirements of the Interstate Commerce Act, or of any rule, regulation, or order thereunder, with respect to the same subject matter unless the Securities and Exchange Commission has exempted such person from such requirement of the Investment Company Act of 1940, as amended, by rule, regulation or order, in which case the requirements of the Interstate Commerce Act shall apply to such person. 14/

13/ This suggestion is patterned after Section 318 of the Federal Power Act which eliminates duplicative regulation with respect to transactions which might otherwise be subject to regulation by the Commission under the Public Utility Holding Company Act of 1935 and the Federal Power Commission under the Federal Power Act.

14/ As a further safeguard against any unanticipated duplicative regulation which may arise, it may be appropriate, after experience is acquired, to adopt rules under the 1940 Act exempting normal and traditional transactions or practices from sections of the 1940 Act which prove to be unnecessarily burdensome, or which should be subject to ICC oversight rather than that of the S.E.C. Such rules could be adopted pursuant to Section 6(c) which states that the "Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

The Commission, as noted above, has long recognized the regulatory gap created by Section 3(c)(7) and strongly supports repeal of that section. [15/]

CONCLUSION

For the reasons set forth above, the Commission favors prompt enactment of H.R. 12128.

15/ The Commission has supported earlier bills on this subject including H.R. 2481 (86th Cong. 1st Sess. 1959). That bill was reported out by the Interstate and Foreign Commerce Committee, (H.R. Rep. No. 2178, 86th Cong. 1st Sess.), was passed by the House and transmitted to the Senate. No action was taken thereon by the Senate. S. 1181, the counterpart of the House bill, was introduced on February 26, 1959, but was never reported out of Committee.

February 22, 1972

APPENDIX C

Office of the Chairman

Interstate Commerce Commission
Washington, D. C. 20423

April 10, 1972

Honorable Harley O. Staggers
Chairman
Committee on Interstate and
Foreign Commerce
House of Representatives
Washington, DC 20515

Dear Chairman Staggers:

The purpose of this letter is to set forth the requested comments of the Interstate Commerce Commission upon H.R. 12128 which seeks to amend the following existing statutes - the Securities Act of 1933, the Interstate Commerce Act, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939 and the Investment Company Act of 1940.

Section 1(a)(1) of H.R. 12128 would repeal section 3(a)(6) of the Securities Act of 1933 which currently provides:

> Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:
>
> (6) Any security issued by a common carrier, the issuance of which is subject to the provisions of Section 20a of Title 49;

The appropriate conforming repeal of the second proviso of section 214 of the Interstate Commerce Act is contained in section 1(a)(3) of the proposed bill. The result of such repeals would be to subject securities of carriers to the dual jurisdiction of the Securities and Exchange Commission (SEC) and this Commission.

Section 1(a)(2) would amend the 1933 Act by striking out the language in section 19(a) which requires SEC's accounting requirements covering common carriers subject to section 20 of the Interstate Commerce Act to be consistent with those issued by this Commission.

Section 1(b) of the bill would amend the Securities Exchange Act of 1934 to authorize the SEC to issue rules and regulations covering carriers subject to section 20 of the Interstate Commerce Act which are inconsistent with those of this Commission's to the extent the SEC determines it is necessary to protect investors or the public interest.

The Trust Indenture Act of 1939 deals with the disclosure of the terms of an indenture and with the substantive relationship between obligors, obligees and trustees. Section 304(a)(4)(A) presently provides an exemption for those securities which are exempt from the Securities Act--including, of course, those of ICC regulated carriers. To bring the Trust Indenture Act into conformity with the aforementioned repeal of the carrier exemption in the Securities Act, section 1(c) of H.R. 12128 would delete the exemption.

Section 3(c)(7) of the Investment Company Act of 1940, as amended, currently excludes from the definition of an "investment company":

> any company subject to regulation under the Interstate Commerce Act, or any company whose entire outstanding capital stock is owned or controlled by such a company: Provided, That the assets of the controlled company consist substantially of securities issued by companies which are subject to regulation under the Interstate Commerce Act.

Section 2 of H.R. 12128 would provide appropriate lead times for the effective date of the various changes in regulation provided for in section 1.

The 1970 hearings before the Special Subcommittee on Investigations chaired by you focused needed attention on the gap in the exercised regulatory jurisdiction of the SEC and this agency. For example, it was developed during the course of those hearings that carriers offering securities pursuant to

section 20a of the Interstate Commerce Act are not in all cases required to tender a prospectus to investors as is required under the Securities Act of 1933.

As a result of your Subcommittee's hearings and our own staff report completed in 1969 and published by your full Committee in 1970, the Commission on November 8, 1971, instituted Ex Parte No. 279, Securities Regulations-Public Offerings. The proposed rules and regulations set forth in Ex Parte No. 279 would require carriers desiring to issue securities totalling $100,000 or more to 25 or more investors to file an "offering circular" similar to the registration statement and prospectus used by the Securities and Exchange Commission. The "circular" will contain information and procedures, which will adequately inform the investing public in their investigation and properly protect them in the purchase of carriers' securities. Financial data will be furnished in accordance with generally accepted accounting principles. A copy of the order and proposed regulations are enclosed. We believe that the anticipated results of this proceeding negate any need for the changes contemplated in sections 1(a)(1), (2), and (3) and 1(c) of H.R. 12128.

We also oppose the change proposed in section 1(b) of the bill which would permit the SEC to establish accounting requirements which carriers subject to ICC regulation would have to meet in filing financial data with the SEC.

Section 13(b(of the Securities Exchange Act of 1934 empowers the SEC to prescribe the form or forms in which the required information shall be set forth, and when and how it should be submitted. However, it further provides that:

> . . . in the case of carriers subject to the provisions of section 20 of the Interstate Commerce Act. . .[it] shall permit such carriers to file. . . duplicate copies of the reports and other documents filed with the Interstate Commerce Commission.

Pursuant to those requirements, reports filed with the SEC by carriers subject to our jurisdiction need not follow generally accepted accounting principles but instead can be filed on the basis of our Uniform System of Accounts. This, according to the SEC, creates a gap in information.

As pointed out in our letter to the Subcommittee, dated November 25, 1970, our accounting regulations differ slightly from generally accepted accounting principles. However, we remain convinced that by following our "Uniform System of Accounts", carriers are actually required to submit more complete and uniform statements than would be required if they merely followed "generally accepted accounting principles". We fail to see how the enactment of this section of the bill is necessary to protect investors.

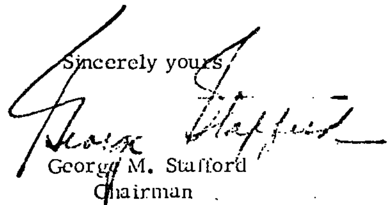
We support the change proposed in section 1(d) of the bill. The repeal of section 3(c)(7) of the Investment Company Act would subject companies now exempt from SEC regulation to the concurrent regulatory jurisdiction of that agency and this Commission. There are sound reasons for this. A carrier falling within the statutory definition of investment company may have a significant carrier operation which would warrant economic regulation by us to the same extent as any other carrier. A noncarrier holding company in control of two or more carriers which do not constitute a single system, and thus subject to our regulation under section 5(3) of the Interstate Commerce Act, may be extensively involved in transportation so that economic regulation by this Commission is similarly justified. Enactment of H.R. 11030 which expands our jurisdiction over holding companies would also include controls over their issuance of securities. We have the power, in any case, to decline jurisdiction when it appears that the company's involvement in transportation is relatively slight, and we conceive of no reason why we should pass on noncarrier operations and financing. Pursuant to dual jurisdiction, we would retain our full powers where such a company is a carrier, and, at the same time, be fully informed and be in a position to protect the carrier's interest. Concurrently, the SEC could exercise its jurisdiction and oversee the investor aspects. The overall protection of the carrier's and investor's interests far outweighs any additional burdens imposed upon the investment companies as a result of dual jurisdiction.

There is a matter not covered in the bill which warrants consideration, and that is the matter of secondary offerings. By statute our jurisdiction is restricted to situations where carriers are issuing securities. If someone other than a carrier makes a secondary offering of carrier securities, we have no authority to regulate that offering. We believe the Interstate Commerce Act or the Securities Act of 1933 should be appropriately amended so as to vest jurisdiction over such offerings in either this agency or the SEC.

In addition, although we have indicated that we do not favor the elimination of the carrier exemption by the repeal of section 3(a)(6) of the Securities Act of 1933, and related provisions, there is a matter that the Committee may want to consider if its decision is otherwise. This matter deals with a very unique form of security, the equipment trust certificate, and for the reasons outlined below, we are of the view that equipment trust certificates should be excepted from any general elimination of the carrier exemption. For one, these instruments are well-secured, low-risk forms of securities. The carrier usually puts up 20 percent of the purchase money, while the equipment itself stands as collateral for the other 80 percent. Secondly, while bids on these certificates are offered to the general public, it is invariably the case that these securities are purchased by sophisticated investing groups, such as syndicates of institutional investors. The successful bidder will designate a trustee who takes title to the equipment. Then, the trustee leases the equipment to the carrier, and when the indebtedness is satisfied through payment of the lease moneys, the trustee passes title to the carrier. It therefore seems that these certificates are marketed more in a manner like private placements, rather than public offerings.

Because of the nature of the instrument and the nature of the investor dealing in these instruments, it does not appear that the holders of these securities require the degree of protection such as is afforded the general public by the SEC. At the same time, one must consider the fact that since these certificates constitute a substantial part of carrier business, subjecting them to the full range of SEC regulation would place unwarranted burdens on carriers in terms of additional time and costs, all to little purpose in terms of public benefits. Accordingly, we feel that the processing of these securities should remain solely under the provisions of section 20a of the Interstate Commerce Act. If any future changes in the general marketing patterns for these securities, or a particular issue, indicates that the public needs further protection, our regulations to be promulgated in Ex Parte No. 279 could take such factors into account.

Sincerely yours,



George M. Stafford
Chairman

Enclosure

SERVICE DATE
November 8, 1971

NOTICE OF PROPOSED RULEMAKING AND ORDER

TITLE 49 - TRANSPORTATION
CHAPTER X - INTERSTATE COMMERCE COMMISSION
SUBCHAPTER E - PRACTICE AND PROCEDURE
PART 1115 - ISSUANCE OF SECURITIES, ASSUMPTION OF OBLIGATIONS, AND FILING OF CERTIFICATES AND REPORTS

At a General Session of the INTERSTATE COMMERCE COMMISSION, held at its office in Washington, D. C., on the 29th day of October, 1971.

EX PARTE NO. 279

SECURITIES REGULATIONS - PUBLIC OFFERINGS

FORM OF OFFERING CIRCULAR REQUIRED FOR PUBLIC SALES OF SECURITIES AUTHORIZED UNDER SECTION 20a OR 214 OF THE INTERSTATE COMMERCE ACT

Securities issued pursuant to Commission authority under section 20a or 214 of the Act are subject to "such terms and conditions as the Commission may deem necessary and appropriate in the premises..." (section 20a(3)). In those instances where carriers desire to issue securities to the public at large, it has been the standard practice of the Commission to require the applicant to sell such securities by prospectus or offering circular only, in the general form and manner prescribed by the Securities and Exchange Commission.

Currently, the volume of these public offerings has reached a sufficient number so that, in the interests of convenience and standardization, the Commission proposes to amend its form BF-6, Item 7, to set forth its required form and procedure in these matters. Our proposed new Item 7 is contained in appendix I attached to this Notice and Order.

The information required in the I.C.C. "prospectus", termed "Offering Circular of Security by Transportation Company," is essentially styled after the Securities and Exchange Commission S-1 form. Bold type statements with regard to I.C.C. jurisdiction will notify the public that the Securities and Exchange Commission does not have jurisdiction over the issue. Persons concerned with securities matters should carefully review the tendered regulation to note other departures from standard S.E.C. practices.

Anyone wishing to present their views and evidence, either in support of, or in opposition to, the action proposed in this order may do so by the submission of written data, views, or arguments.

Ex Parte No. 279

It is ordered, That a proceeding be, and it is hereby, instituted under the authority of the Interstate Commerce Act and the Administrative Procedure Act (60 Stat. 237, as amended; 5 U.S.C.A. § 553 and 559) for the purpose above described; that any views to be expressed by persons interested in this matter shall be filed with this Commission within 30 days of the publication of this order in the Federal Register; and that such views should specifically show any objection to these proposed regulations, with such responses to be presented on any item-by-item basis.

It is further ordered, That an original and 15 copies of such data, views, or arguments shall be filed with the Commission on or before December 11, 1971 and a copy thereof shall be served simultaneously upon each of the Commission's regional headquarters identified in appendix II of this notice and order. All statements will be a part of the record of this proceeding and will be available for public inspection at the offices of the Interstate Commerce Commission, 12th and Constitution Ave., N. W., Washington, D. C., during regular business hours.

It is further ordered, That notice to the general public of the matter here under consideration will be given by depositing a copy of this notice in the Office of the Secretary of this Commission, and in each of this Commission's regional headquarters identified in appendix II to this notice for public inspection and by filing a copy with the Director, Office of the Federal Register.

And it is further ordered, That these proposed regulations shall become effective 60 days from their publication in the Federal Register, unless otherwise ordered by this Commission.

By the Commission.

ROBERT L. OSWALD,
Secretary.

(SEAL)

APPENDIX I

PROPOSED ITEM 7 OF FORM BF-6

Item 7. Contracts, underwritings, and other arrangements; public offerings.

(a) How and to whom, and by or through whom, it is proposed to issue the securities, with copies of all contracts, underwritings, and other arrangements made or proposed to be made in connection with the issue. The applicant must require the underwriter to undertake to provide copies of any required offering circular to prospective investors and persons directly solicited to invest their funds in the security.

(b) If applicant is effecting, causing to be effected, or has arranged for, the public offering of a transportation security, and said offer will be tendered to 25 or more prospective investors at a total price of not less than $100,000, applicant must submit an offering circular for consideration by this Commission. Separate issuances made within one year will be considered as one issuance for the purposes of this paragraph.

(1) General instructions:

(i) The financial representations contained in the offering circular should conform to generally-accepted principles of accounting. However, where there is a dissimilarity between a figure computed pursuant to generally-accepted accounting principles, and the figure produced under the Commission's Uniform System of Accounts, 49 CFR 1200-1219, the difference should be explanied by footnoting the item under consideration. Any such footnote should be in language which adequately explains the reason for the difference to the ordinary investor.

(ii) A copy of any advertisement connected with the issue, such as "tombstone" or "red herring" advertisement, shall be attached to the application.

(iii) In the event the price of the security will not be determined by an existing market, or a formula relevant to market prices, as in the case of new issuances, the offering circular shall be made available to prospective investors, and likewise shall be furnished to those directly solicited to invest their funds in the security, when the order of the Commission authorizing the issuance of the securities becomes effective; but no sales or contracts to sell the securities, except to underwriters, may be made until 14 days, or as otherwise ordered, after the distribution of the authorized offering circular has taken place, this time period beginning from midnight of the day the distribution was initiated, including weekends and holidays. In all other cases, the same requirements as those in the above portion of this paragraph shall be applicable, except the waiting period will run for a period of three days, or as otherwise ordered by the Commission. Where an applicant elects to take the shorter three-day period, the reasons for the inapplicability of the fourteen-day period shall be specified.

(iv) The information presented in the offering circular should be presented in plain and concise language. Excessively verbose or complex descriptions may confuse the investor and should be avoided. Inapplicable items may be omitted and cross-references, unless otherwise indicated, may be employed.

(v) The offering circular shall contain an opinion of a Certified Public Accountant as to the financial representations contained therein.

(vi) For purposes of this form, and as a term of art limited in its application to these particular regulations, a "speculation" or "speculative security" is one where applicant has not had any substantial gross revenues or receipts from transportation or from the sale of services, or any substantial net income from any source, for any fiscal year ended the past 5 years, has not succeeded and does not intend to succeed such a concern, and does not have and does not intend to have any subsidiaries other than inactive subsidiaries with no more than nominal assets. If this offering is a speculation, an introductory statement shall be made in the offering circular summarizing the factors which make the offering a speculation and setting forth such matters as a comparison, in percentages, of the securities being offered to the public for cash and those issued or to be issued to promoters, directors, officers, controlling persons and underwriters for cash, property and services. Such applicants will follow the special instructions in the offering circular.

(vii) Attach to the offering circular, for the use of the Commission, a check list of the items required in the offering circular form. Identify the page(s) at which the item appears in the draft offering circular.

(2) Form and content of offering circular:

I. CAPTION AND DISTRIBUTION SPREAD

The outside front cover of the offering circular shall contain the information below in substantially the form indicated.

OFFERING CIRCULAR OF SECURITY BY TRANSPORTATION COMPANY

DISTRIBUTION OF THIS OFFERING CIRCULAR WAS INITIATED ________(Date). INVESTORS MAY NOT BUY, NOR CONTRACT TO BUY THIS ISSUE UNTIL ________. (See General Instructions (iii)).

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Appendix I

(number of shares)

(name of issuer as it appears on securities)

(type of security; description)

THE ISSUANCE OF THESE SECURITIES HAS BEEN AUTHORIZED BY THE INTERSTATE COMMERCE COMMISSION WHICH DOES NOT PASS UPON THE INVESTMENT MERIT OF THESE SECURITIES NOR UPON THE ACCURACY OF THE INFORMATION THEREIN.

THIS OFFERING CIRCULAR IS AN INTEGRAL PART OF ISSUER'S APPLICATION UNDER SECTION 20(a) OR 214 OF THE INTERSTATE COMMERCE ACT. THIS ISSUE IS NOT SUBJECT TO THE JURISDICTION OF SECURITIES AND EXCHANGE COMMISSION.

		Price to public	Underwriting discounts and commissions	Proceeds to registrant or other persons
Per Unit	________	______	__________	__________
Total	________	______	__________	__________

Instructions. 1. Only commissions paid by the applicant or selling security holders in cash are to be included in the table. Commissions paid by other persons, and other considerations to the underwriters, shall be set forth following the table with a reference thereto in the second column of the table. Any finder's fee or similar payments shall be appropriately disclosed.

2. If the securities are to be offered at the market, or if the offering price is to be determined by a formula related to market prices, indicate the market involved and the market price as of the latest practicable date. Otherwise, the authorized offering circular must contain the sales price and commissions.

II. PLAN OF DISTRIBUTION

(a) If the securities are to be offered through underwriters, give the names of the principal underwriters, and state the respective amounts underwritten. Identify each such underwriter having a material relationship to the issuer and state the nature of the relationship. State briefly the nature of the underwriters' obligation to take the securities.

Instruction. The description of the nature of the underwriters' obligation shall disclose whether the underwriters are, or will be, committed to take and to pay for all of the securities if any are taken, or whether it is merely an agency or "best efforts" arrangement under which the underwriters are required to take and pay for only such securities as they may sell to the public. Conditions precedent to the underwriters' taking the securities, including "market outs", need not be described except in the case of an agency or "best efforts" arrangement. All purchase agreements, underwriting agreements and agreements among underwriters must be submitted as part of the application.

(b) State briefly the discounts and commissions to be allowed or paid to dealers, including all cash, securities, contracts or other consideration to be received by any dealer in connection with the sale of the securities.

Instruction. If any dealers are to act in the capacity of sub-underwriters and are to be allowed or paid any additional discounts or commissions for acting in such capacity, a general statement to that effect will suffice without giving the additional amounts to be so paid.

(c) Outline briefly the plan of distribution of any securities to be applied which are to be offered otherwise than through underwriters.

III. USE OF PROCEEDS ACCRUING TO APPLICANT

State the principal purposes for which the net proceeds from the securities to be offered are intended to be used, and the approximate amount intended to be used for each such purpose.

Instructions. 1. Details of proposed expenditures need not be emphasized; for example, it is necessary to furnish only a brief outline of any program of construction or addition of equipment. If any material amount of other funds is to be used in conjunction with the proceeds, state the amount and sources of such other funds. If any material amount of the proceeds is to be used to acquire assets, otherwise than in the ordinary course of business, briefly describe the assets and give the names of the persons from whom they are to be acquired. State the cost of the assets to the registrant and the principle followed in determining such cost.

2. In the case of speculative securities, include a statement as to the use of the actual proceeds if they are not sufficient to accomplish all of the purposes set forth, whether or not the funds will be returned to subscribers in such case and, if not, the order of priority in which the proceeds will be used for the respective purposes.

IV. SALES TO CURRENT HOLDERS

If any of the securities are to be offered for the account of security holders, name each such security holder and state the amount of securities of the class owned by him, the amount to be offered for his account and the percentage of the class (if one percent or more) to be owned by him after completion of the offering.

V. CAPITAL STRUCTURE

Furnish the information called for by the following table, in substantially the tabular form indicated, as to each class of securities of the applicant and each class of securities, other than those owned by the applicant or its totally-held subsidiaries, of all subsidiaries whose financial statements are filed with the offering circular on either a consolidated or individual basis:

Title of class	Amount authorized or to be authorized	Amount outstanding as of a specified date within 90 days	Amount to be outstanding if all securities being registered are sold

Instructions. 1. Securities held by or for the account of the issuer thereof are not to be included in the amount outstanding, but the amount so held shall be stated in a note to the table.

2. Indebtedness evidenced by drafts, bills of exchange, bankers' acceptances or promissory notes may be set forth in a single aggregate amount under an appropriate caption such as "Sundry Indebtedness."

3. Applicant may, at its option, include in the table the capital share liability in dollars, as well as the amount, of each class of shares shown in the table, together with surplus attributed to each class of stock. Surplus shall be shown in the same manner as in the balance sheet of applicant, or in the consolidated balance sheet of the applicant and subsidiaries, if such a consolidated balance sheet is included in the offering circular.

VI. SALES OTHER THAN FOR CASH

If any of the securities are to be offered otherwise than for cash, state briefly the general purposes of the distribution, the basis upon which the securities are to be offered, the amount of compensation and other expenses of distribution, and by whom they are to be borne.

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Instruction. If the distribution is to be made pursuant to a plan of acquisition, reorganization, readjustment or succession, describe briefly the general effect of the plan and state when it became or is to become operative. If any of the securities are to be offered in exchange for securities of any other issuer, the offering circular shall contain a description of the exchange. State the relationship of the recipient of the securities to the company, including any promoter.

VII. INFORMATION REGARDING ISSUER

State the year in which applicant was organized, its form of organization, and the name of the State or other jurisdiction under the laws of which it was organized, and each of the States under above laws it is authorized to operate.

List all the parents of applicant showing the basis of control and, as to each parent, the percentage of voting securities owned or other basis of control.

Briefly describe the parent's business activities, other than those of applicant. If applicant's parent is, in turn, controlled by another parent company, etc., describe that relationship.

Instructions. What is required is information that will describe any complex control situation to the prospective investor. And will inform him as to any proposed plans, such as acquisitions, sales, intercorporate transfers, dividend payments, spinoffs, etc., by the management of the parent corporation that will have a direct bearing on the financial well being of the carrier subsidiary in which the investor is being asked to invest.

Briefly describe the business actually done and intended to be done (not merely relating the powers authorized in the charter). The relative importance and size of various service and manufacturing endeavors should be furnished specifying those areas subject to regulation under the Interstate Commerce Act.

If the applicant and its subsidiaries are engaged in more than one line of business, state, for each of the applicant's last five fiscal years, the approximate amount or percentage of (i) total sales and revenues, and (ii) income (or loss) before income taxes and extraordinary losses, attributable to each line of business which during either of the last two fiscal years accounted for--

(A) 10 percent or more of total sales and revenues,

(B) 10 percent or more of income before income taxes and extraordinary items computed without deduction of loss resulting from operations of any line of business, or

(C) a loss which equalled or exceeded 10 percent of the amount of income specified in (B) above.

If it is impracticable to state the contribution to income (or loss) before income taxes and extraordinary items for any line of business, state the contribution thereof to the results of operations most closely approaching such income, together with a brief explanation of the reasons why it is not practicable to state the contribution to such income or loss.

Instructions. 1. If the number of lines of business for which information is required exceeds ten, the applicant may, at its option, furnish the required information only for the ten lines of business deemed most important to an understanding of overall operations. In such event, a statement to that effect shall be set forth.

2. In grouping products or services as lines of business, appropriate consideration shall be given to all relevant factors, including rates of profitability of operations, degrees of risk and opportunity for growth. The basis for grouping such products or services and any material changes between periods in such groupings shall be briefly described.

3. Where material amounts of products or services are regularly transferred from one line of business to another, the receiving and transferring lines may be considered a single line of business for the purpose of reporting the operating results thereof.

4. If the method of pricing intra-company transfers of products or services or the method of allocation of common or corporate costs materially affects the reported contribution to income of a line of business, such methods and any material changes between periods in such methods and the effect thereof shall be described briefly.

5. Information regarding sales or revenues or income (or loss) from different classes of products or services in operations regulated by Federal, State or municipal authorities may be limited to those classes of products or services required by any uniform system of accounts prescribed by such authorities.

VIII. DESCRIPTION OF PROPERTY

Briefly describe carrier revenue equipment, trackage, terminals, and other material tangible equipment and properties. Also describe trackage rights, certificates of public convenience and necessity, and other intangible operating authorities.

Separately describe other properties not used for providing transportation by applicant or its subsidiaries.

Instructions. Provide information which will fairly appraise the potential investor of the scope and potential of applicant's business. Detailed descriptions of the physical characteristics of tangible properties or reproductions of operating authorities are not required and should

[illegible] should be employed.

IX. BUSINESS CONDITIONS: REGULATION

Indicate briefly, to the extent material, the general competitive conditions applicant faces in its transportation services and, where applicable, in its non-transportation enterprises. Discuss any important changes in the technology or type of service applicant or its subsidiaries render to the public. Separate consideration should be given to different regions or modes.

List any material financial restrictions imposed upon applicant or its subsidiaries by the Interstate Commerce Commission to which it may be presently subject. Specify any such restrictions imposed in connection with this issue.

Reproduce the order of the Commission authorizing this issue.

X. PENDING LEGAL PROCEEDINGS

Briefly describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the applicant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted and the principal parties thereto. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

> Instructions. If the business ordinarily results in actions for negligence or other claims, no such action or claim need be described unless it departs from the normal kind of such actions. Any material bankruptcy, receivership, or similar proceeding with respect to the issuer or any of its significant subsidiaries shall be described. Any material proceedings to which any director, officer or affiliate of the applicant, or any associate of any such director, officer or security holder, is a party adverse to the applicant or any of its subsidiaries shall also be described.

XI. STATEMENT OF INCOME AND EARNED SURPLUS

Furnish in comparative columnar form a statement of income for each of the last five fiscal years of the applicant and for any interim period between the end of the latest of such fiscal years and the date of the latest balance sheet furnished herein, and for the corresponding interim period of the preceding fiscal year. Include comparable data for any additional fiscal years necessary to keep the statement from being misleading. Where necessary, include information or explanation of material significance to investors in appraising the results shown, or refer to such information or explanation set forth elsewhere in the offering circular. An analysis of earned surplus shall be furnished for each period covered by an income statement, as a continuation thereof or elsewhere in the offering circular.

> Instructions. 1. If common stock is to be offered, the statements shall be prepared to show earnings applicable to

2. If preferred stock is to be offered, there shall be shown the annual dividend requirements on such preferred stock. To the extent that an issue represents refinancing, only the additional dividend requirements shall be stated.

3. If debt securities are to be issued, the applicant shall show in tabular form for each fiscal year or other period the ratio of earnings to fixed charges. A pro forma ratio of earnings to fixed charges, adjusted to give effect to the issuance of the securities to be registered and any presently proposed issuance, retirement or redemption of securities, shall also be shown for the latest fiscal year or 12-month period.

4. Statements of income and earned surplus conforming to the foregoing may be furnished on a consolidated basis, but applicant must also present, for the most recent fiscal year, statements of income for each subsidiary (or appropriate groups of subsidiaries).

XII. DESCRIPTION OF SECURITIES TO BE ISSUED

If capital stock is to be issued, state the title of the class and furnish the following information:

(a) Outline briefly (1) dividend rights; (2) voting rights; (3) liquidation rights; (4) pre-emptive rights; (5) conversion rights; (6) redemption provisions; (7) sinking fund provisions; and (8) liability to further calls or to assessment by the applicant.

(b) If the rights of holders of such stock may be modified otherwise than by a vote of a majority or more of the shares outstanding, voting as a class, so state and explain briefly.

(c) If preferred stock is to be issued, outline briefly any restriction on the repurchase or redemption of shares by the issuer while there is any arrearage in the payment of dividends or sinking fund installments. If there is no such restriction, so state.

Instructions. 1. This item requires only a brief summary of the provisions which are pertinent from an investment standpoint. A complete legal description of the provisions referred to is not required and should not be given. Do not set forth the provisions of the governing instruments verbatim; only a succinct resume is required.

2. If the rights evidenced by the securities are materially limited or qualified by the rights of any other class of securities, include such information regarding such other securities as will enable investors to understand the rights evidenced by the securities to be registered. No information need be given, however, as to any class of securities all of which will be redeemed and retired, provided appropriate steps to assure such redemption and retirement will be taken prior to or upon delivery of the securities to be issued.

3. If the securities described are to be offered pursuant to warrants or rights, state the amount of securities called for by such warrants or rights, the period during which and the price at which the warrants or rights are exercisable.

If debt securities are to be issued, outline briefly such of the following as are relevant:

(a) Provisions with respect to interest, conversion, maturity, redemption, amortization, sinking fund or retirement.

(b) Provisions with respect to the kind and priority of any lien securing the issue, together with a brief identification of the principal properties subject to such lien.

(c) Provisions with respect to the subordination of the rights of holders of the securities registered to other security holders or creditors of the registrant.

(d) Provisions restricting the declaration of dividends or requiring the maintenance of any ratio of assets, the creation or maintenance of reserves or the maintenance of properties.

(e) Provisions permitting or restricting the issuance of additional securities, the withdrawal of cash deposited against such issuance, the incurring of additional debt, the release or substitution of assets securing the issue, the modification of the terms of the security, and similar provisions.

Instructions. 1. In the case of secured debt, there should be stated (i) the approximate amount of unsecured property available for use against the issuance of bonds, as of the most recent practicable date, and (ii) whether the securities being issued are to be issued against such property, against the deposit of cash, or otherwise.

2. Provisions permitting the release of assets upon the deposit of equivalent funds or the pledge of equivalent property, the release of property no longer required in the business, obsolete property or property taken by eminent domain, the application of insurance moneys, and similar provisions, need not be described.

(f) The name of the trustee, if any, and the nature of any material relationship with the applicant or any of its affiliates; the percentage of securities of the class necessary to require the trustee to take action, and what indemnification the trustee may require before proceeding to enforce the lien.

(g) The general type of event which constitutes a default and whether or not any periodic evidence is required to be furnished as to the absence of default or as to compliance with the terms of the indenture.

Instruction. The instructions regarding capital stock, as pertinent, shall apply to debt securities.

If securities other than capital stock or debt are to be issued, outline briefly the rights evidenced thereby. If subscription warrants or rights are to be issued, state the title and amount of securities called for, the period during which and the price at which the warrants or rights are exercisable.

Instruction. The instructions regarding capital stock shall also apply to this item.

XIII. DIRECTORS AND EXECUTIVE OFFICERS

List the names of all directors and executive officers of the applicant and all persons chosen to become directors or executive officers. Indicate all positions and offices with the applicant held by each person named, and the principal occupations during the past five years of each executive officer and each person chosen to become an executive officer.

Instructions. 1. If any person chosen to become a director or executive officer has not consented to act as such, so state.

2. For the purpose of this item, the term "executive officer" means the president, vice president, secretary and treasurer, and any other officer who performs similar policymaking functions for the applicant.

XIV. REMUNERATION OF DIRECTORS AND OFFICERS

(a) Furnish the following information in substantially the tabular form indicated below as to all direct remuneration paid by the applicant and its subsidiaries during the applicant's last fiscal year to the following persons for services in all capacities:

(1) Each director, and each of the three highest paid officers, of the applicant whose aggregate direct remuneration exceeded $30,000, naming each such person.

(2) All directors and officers of the applicant as a group, without naming them.

(A)	(B)	(C)
Name of individual or identity of group	Capacities in which remuneration was received	Aggregate direct remuneration

Instructions. 1. This item applies to any person who was a director or officer of the applicant at any time during the period specified. However, information need not be given for any portion of the period during which such person was not a director or office of the applicant.

2. The information is to be given on an accrual basis if practicable. The tables required by this paragraph and paragraph (b) may be combined if the applicant so desires.

3. Do not include remuneration paid to a partnership in which any director or officer was a partner, but see item XVII.

4. If the applicant has not completed a full fiscal year since its organization or if it acquired or is to acquire the majority of its assets from a predecessor within the current fiscal year, the information shall be given for the current fiscal year, estimating future payments, if necessary. To the extent that such remuneration is to be computed upon the basis of a percentage of profits, it will suffice to state such percentage without estimating the amount of such profits to be paid.

(b) Furnish the following information, in substantially the tabular form indicated below, as to all pension or retirement benefits proposed to be paid under any existing plan in the event of retirement at normal retirement date, directly or indirectly, by the applicant or any of its subsidiaries to each director or officer named in answer to paragraph (a)(1) above:

(A)	(B)	(C)
Name of Individual	Amounts set aside or accrued during applicant's last fiscal year	Estimated annual benefits upon retirement

Instructions. 1. The term "plan" in this item includes all plans, contracts, authorizations or arrangements, whether or not set forth in any formal document.

2. Column (B) need not be answered with respect to amounts computed on an actuarial basis under any plan which provides for fixed benefits in the event of retirement at a specified age or after a specified number of years of service.

3. The information called for by Column(C) may be given in a table showing the annual benefits payable upon retirement to persons in specified salary classifications.

4. In the case of any plan (other than those specified in Instructions 2) where the amount set aside each year depends upon the amount of earnings of the applicant or its subsidiaries for such year or a prior year, or where it is otherwise impracticable to state the estimated annual benefits upon retirement, there shall be set forth, in lieu of the information called for by Column (C), the aggregate amount set aside or accrued to date, unless it is impracticable to do so, in which case there shall be stated the method of computing such benefits.

(c) Describe briefly all remuneration payments (other than payments reported under paragraph (a) or (b) of this item) proposed to be made in the future, directly or indirectly, by the applicant or any of its subsidiaries pursuant to any existing plan or arrangement to (i) each director or officer named in answer to paragraph (a)(1), naming each such person, and (ii) all directors and officers of the applicant as a group, without naming them.

Instruction. Information need not be included as to payments to be made for, or benefits to be received from, group life or accident insurance, group hospitalization or similar group payments or benefits. If it is impracticable to state the amount of remuneration payments proposed to be made, the aggregate amount set aside or accrued to date in respect of such payments should be stated, together with an explanation of the basis for future payments.

XV. OPTIONS TO PURCHASE SECURITIES

Furnish the following information as to options to purchase securities from the applicant or any of its subsidiaries, which are outstanding as of a specified date within 30 days prior to the date of filing.

If, however, the options are "qualified stock options" or "restricted stock options" or options granted pursuant to a plan qualifying as an "employee stock purchase plan," as those terms are defined in Sections 422 through 424 of the Internal Revenue Code of 1954, as amended, only the following is required: (i) a statement to that effect, (ii), a brief description of the terms and conditions of the options or of the plan pursuant to which they were issued, and (iii) a statement of the provisions of the plan or options with respect to the relationship between the option price and the market price of the securities at the date when the options were granted, or with respect to the terms of any variable price option.

(b) State (i) the title and amount of securities called for by such options; (ii) the purchase prices of the securities called for and the expiration dates of such options; and (iii) the market value of the securities called for by such options as of the latest practicable date.

> Instruction. In case a number of options are outstanding having different prices and expiration dates, the options may be grouped by prices and dates. If this produces more than five separate groups then there may be shown only the range of the expiration dates and the average purchase prices, i.e., the aggregate purchase price of all securities of the same class called for by all outstanding options to purchase securities of that class divided by the number of securities of such class so called for.

(c) Furnish separately the information called for by paragraph (b) above for all options held by (i) each director or officer named in answer to paragraph (a)(1) of item XIV naming each such person, and (ii) all directors and officers as a group without naming them.

> Instructions. 1. The term "options" as used in this item includes all options, warrants and rights other than those issued to security holders as such on a pro rata basis.
>
> 2. The extension of options shall be deemed the granting of options within the meaning of this item.
>
> 3. Where the total market value of securities called for by all outstanding options as of the specified date referred to in this item does not exceed $10,000 for any officer of director named in answer to paragraph (a)(1) of Item 17, or $30,000 for all officers and directors as a group, or for all option holders as a group, this item need not be answered with respect to options held by such person or group.

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Appendix I

XVI. PRINCIPAL HOLDERS OF SECURITIES.

Furnish the following information as of a specified date within 90 days prior to the date of filing in substantially the tabular form indicated:

(a) As to the voting securities of the applicant owned of record or beneficially by each person who owns of record, or is known by the applicant to own beneficially, more than 10 percent of any class of such securities. Show in Column (3) whether the securities are owned both of record and beneficially, of record only, or beneficially only, and show in Columns (4) and (5) the respective amounts and percentages owned in each such manner:

(1) Name and Address	(2) Title of Class	(3) Type of Ownership	(4) Amount Owned	(5) Percent of Class

(b) As to each class of equity securities of the applicant or any of its parents or subsidiaries, other than directors' qualifying shares, beneficially owned directly or indirectly by all directors and officers of the applicant, as a group, without naming them.

(1) Title of Class	(2) Amount Beneficially Owned	(3) Percent of Class

Instructions. 1. The percentages are to be calculated on the basis of the amount of outstanding securities, excluding securities held by or for the account of the issuer. In any case where the amount owned by directors and offers as a group is less than 1 percent of the class, the percent of the class owned by them may be omitted.

2. If the equity securities are being issued in connection with, or pursuant to, a plan of acquisition, reorganization, readjustment or succession, indicate, as far as practicable, the status to exist upon consummation of the plan on the basis of present holdings and commitments.

3. If any of the securities being issued are to be offered for the account of security holders, name each such security holder and state the amount of the securities owned by him, the amount to be offered for his account, and the amount to be owned after the offering.

4. If, to the knowledge of the applicant or any principal underwriter of the securities being issued, more than 10 percent of any class of voting securities of the applicant are held or are to be held subject to any voting trust or other similar agreement, state the title of such securities, the amount held or to be held and the duration of the agreement. Give the names and addresses of the voting trustees and outline briefly their voting rights and other powers under the agreement.

Ex Parte No. 279
Appendix I

XVII. INTEREST OF MANAGEMENT AND OTHERS IN CERTAIN TRANSACTIONS

Describe briefly, and where practicable, state the approximate amount of any material interest, direct or indirect, of any of the following persons in any material transaction during the last three years, or in any material proposed transactions, to which the applicant, or a person in control of applicant as defined in Item VII or any of its subsidiaries was, or is to be, a party:

(a) Any director or officer of the applicant;

(b) Any security holder named in answer to XVI(a);

(c) Any person listed in Item VII.

(d) Any associate of any of the foregoing persons.

Instructions. 1. See Instruction 1 to Item XIV(a). Include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, the approximate amount involved in the transaction shall be indicated.

2. As to any transaction involving the purchase or sale of assets by or to the applicant or any subsidiary, otherwise than in the ordinary course of business, state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction.

3. This item does not apply to any interest arising from the ownership of securities of the applicant where the security holder receives no extra or special benefit not shared on a pro rata basis by all other holders of the same class.

4. No information need be given in answer to this item as to any remuneration not received during the applicant's last fiscal year or as to any remuneration or other transaction disclosed in response to Items XIV or XV.

5. Information should be included as to any material underwriting discounts and commissions upon the sale of securities by the applicant where any of the specified persons was or is to be a principal underwriter or is a controlling person, or member, of a firm which was or is to be a principal underwriter. Information need not be given concerning ordinary management fees paid by underwriters to a managing underwriter pursuant to an agreement among underwriters the parties to which do not include the applicant or its subsidiaries.

6. No information need be given in answer to this item as to any transaction or any interest therein where:

(i) the rates or charges involved in the transaction are fixed by law or determined by competitive bids;

(ii) the interest of the specified persons in the transaction is solely that of a director of another unaffiliated corporation which is a

(iii) the transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture, or other similar services;

(iv) the interest of the specified persons, including all periodic installments in the case of any lease or other agreement providing for periodic payments or installments, does not exceed $30,000;

(v) the transaction does not involve remuneration for services, directly or indirectly, and (a) the interest of the specified persons arises from the ownership individually and in the aggregate of less than 10% of any class of equity securities of another corporation which is a party to the transaction, (b) the transaction is in the ordinary course of business of the applicant or its subsidiaries, and (c) the amount of such transaction or series of transactions is less than 10% of the total sales or purchases, as the case may be, of the applicant and its subsidiaries.

7. Information shall be furnished in answer to this item with respect to transactions not excluded above which involve remuneration, directly or indirectly, to any of the specified persons for services in any capacity unless the interest of such persons arises solely from the ownership individually and in the aggregate of less than 10% of any class of equity securities of another corporation furnishing the services to the applicant or its subsidiaries.

8. This item does not require the disclosure of any interest in any transaction unless such interest and transaction are material.

XVIII. OTHER FINANCIAL STATEMENTS AND "BALANCE SHEETS" SCHEDULES.

(a) There shall be furnished a balance sheet of the applicant and a consolidated balance sheet of the applicant and its subsidiaries as of a date within six months prior to the date of filing the application.

Instructions. The individual balance sheets of the applicant may be omitted if (i) consolidated balance sheets of the applicant and one or more of its subsidiaries are furnished, (ii) either one of the following conditions is met, and (iii) the Commission is advised as to the reasons for such omission:

(1) The applicant is primarily an operating company and all subsidiaries included in the consolidated balance sheets furnished are totally-held subsidiaires; or

(2) The applicant's total assets, exclusive of investments in and advances to the consolidated subsidiaries, constitute 85% or more of the total assets shown by the consolidated balance sheets filed and the applicant's total gross revenues for the period for which its profit and loss statements would be filed, exclusive of interest and dividends received from the consolidated subsidiaries, constitute 85% or more of the total gross revenue shown by the consolidated profit and loss statements filed.

(b) There shall be furnished for each majority-owned subsidiary of the applicant not included in the consolidated statements, the balance sheets which would be required if the subsidiary were itself an applicant. If the applicant owns, directly or indirectly, approximately 50% of the voting securities of any person and approximately 50% of the voting securities of such person is owned, directly or indirectly, by another single interest, there shall be filed for each such person the balance sheets which would be required if it were an applicant. The statements filed for each such person shall identify the other single interest. Where appropriate, group statements may be filed for such persons.

Instructions. 1. Insofar as practicable, these balance sheets shall be as of the same dates as those of the applicant.

2. There may be omitted all balance sheets of any one or more unconsolidated subsidiaires or fifty percent owned persons if all such subsidiaires and persons whose balance sheets are so omitted, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary.

(c) (1) There shall be filed for any business directly or indirectly acquired by the applicant after the date of the latest balance sheet filed pursuant to (a) above and for any business to be directly or indirectly acquired by the applicant, the financial statements which would be required if such business were an applicant.

(2) The acquisition of securities shall be deemed to be the acquisition of a business if such securities give control of the business or combined with securities already held give such control.

(3) No financial statements need be filed, however, for any business acquired or to be acquired from a totally-held subsidiary. In addition, the statements of any one or more business may be omitted if such businesses, considered in the aggregate as a single subsidiary, would not constitute a significant subsidiary.

APPENDIX II

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