one company by another, Congress did not imply artificial tests of control. This is an issue of fact to be determined by the special circumstances of each case. So long as there is warrant in the record for the judgment of the expert body it must stand. The suggestion that the refusal to regard the New York ownership of only one-third of the common stock of the Rochester as conclusive of the former's lack of control of the latter should invalidate the Commission's findings, disregards actualities in such intercorporate relations."

The Court went on to discuss further the minority ownership of the Rochester Telephone Corporation by the New York Telephone Co. After discussing the history of the relationship between these companies, the financial transactions between them, the operation of a voting trust, and the existence of certain charter restrictions, the Supreme Court said (p. 145):

"Putting all these factors in the context of the circumstances under which the Rochester came into being, the manner in which it was financed, the operation of the voting trust, and the stake of the New York in the Rochester, the Commission, after full hearing and due consideration, concluded that 'the New York Co., through stock ownership, is the dominant financial factor in the respondent company and also that this, taken together with their contractual arrangements and other pertinent facts and circumstances appearing in the record, unquestionably gives the New York Co. power to control the functions of the Rochester Telephone Corporation.' "[22]

Considering the matter as though no voting trust had been created and as though Byllesby continued to hold the 330,000 shares of common stock, series B, of Standard Power directly, we should be impelled to hold that Byllesby, both "alone" and "pursuant to an agreement or understanding" with the other investment bankers exercised "a controlling influence" over the management and policies of Standard Power and Standard Gas. Among the facts in the record which would require this conclusion are: (1) The past relationships between Byllesby and the Standard companies have resulted in a personnel and tradition which make the Standard companies responsive to Byllesby's desires; (2) Byllesby alone can elect one less than a majority of the directors of Standard Power; (3) Byllesby together with the other investment bankers can elect all of the directors of Standard Power; (4) five out of the nine present directors of Standard Gas, elected since the reorganization of 1938, represent Byllesby and the other bankers; (5) Byllesby and the bankers have been able to allocate as they have pleased the underwriting of the Standard system companies' securities among themselves and other bankers of their selection.[23]

We turn next to a consideration of whether the creation of the voting trust has destroyed the controlling influence otherwise existing. We have already stated that a mere change in legal form of control is insufficient; the actual facts are determinative. In *International Paper and Power Company* (2 S. E. C. 274 (1937)), after referring to the general standard laid down in section 2 (a) (7), we said at pages 277–278:

"But what the act points to both explicitly and implicitly, is that these questions of 'ownership,' 'control,' 'holding with power to vote,' are to be determined by reference to *realities and not by reference to legal abstractions*. In other words, whether the voting trust device—a device adverted to in the hearings before the Congress—was effective to sterilize the ownership of stock of New England Power Association must be determined by this Commission on the basis of examination not of legal formalisms but of whether actual control does or does not exist."[24] [Italics supplied.]

We are doubtful that a voting trust (except possibly a voting trust established solely for the purpose of liquidation) can ever operate effectively to insulate the

[22] The question in the *Rochester Telephone case* involved the meaning of "control" as used in sec. 2 (b) of the Federal Communications Act of 1934. This statute subjected to the jurisdiction of the Communications Commission any carrier directly or indirectly controlling or controlled by any other carrier engaged in interstate or foreign communication. It will be observed that the statutory language is very similar to that used in sec. 2 (a) (7) of the Holding Company Act.

Compare also *Electric Bond and Share Company* v. *Securities and Exchange Commission*, 303 U. S. 419 (1938).

[23] It is clear that controlling influence over one phase of a company's business, such as over underwriting policies. is "controlling influence" within the meaning of the act. The statutory language is "a controlling influence over the management or policies"; the word "or" shows that a controlling influence over the details of management is not required so long as a controlling influence is exerted over policies. Obviously any other construction would enable a holding company to evade the provisions of the act merely by limiting its supervision to underwriting and such other particular matters as were profitable to it.

[24] Our decision in the *International Paper and Power Company case* was reversed on jurisdictional grounds by the Circuit Court of Appeals for the First Circuit in *Lawless* v. *Securities and Exchange Commission* (— F. (2d) —— (1939)). The court's opinion did not discuss or pass upon the question of control or the legality of the use of voting trusts.

control which ownership of a block of stock carries. But apart from that fact, it is clear that a voting trust in which the voting trustees are not completely independent of the depositors does not operate to insulate control. Serious question exists as to whether the voting trust agreement in this case permits the voting trustees to act independently of the wishes of Byllesby. As we have previously pointed out, the voting trust agreement contains a provision which enables Byllesby to prevent the deposit of common stock, series B, held by other persons. To date no other stockholders have deposited under the voting trust agreement. Byllesby is, therefore, the sole beneficiary of the trust, and the trustees are bound to act for Byllesby's benefit. Moreover, Byllesby and the voting trustees may terminate the agreement by mutual consent at any time.[25] In fact it was admitted that one of the principal reasons for the provisions preventing deposits without Byllesby's consent was to make possible dissolution of the trust should circumstances make it desirable.

The original voting trustees, Lynch, Morrison, and Cummins, who held office throughout the period during which most of the hearings were held before the trial examiner, were not in fact sufficiently independent to insulate Byllesby's control over Standard Gas. They had long been intimately connected with Byllesby and with the Standard System under Byllesby's domination. Moreover, they continued to hold securities in the Byllesby Corporation. In view of these circumstances, it could have been expected that these trustees would, if possible, insure Byllesby's participation in Standard underwriting.[26] The record of experience from November 1936 to September 1938, during which these voting trustees were in office, bears out their expectation. Byllesby secured underwritings during this period on the same basis as before. In fact, except for the removal of interlocking directors and officers, there was no change in management or business relationships. Byllesby continued to maintain its offices on the same floor as those of Standard Gas. Byllesby and Standard Gas used the same telephone number. Offices of Standard Gas and of Standard Power continued throughout most of this period to use Byllesby's private wire between New York and Chicago. Many of the officers and directors of the Standard System who continued to operate the system were substantial stockholders of Byllesby.

Thus it is clear that in spite of the creation of the voting trust, Byllesby continued to retain a controlling influence over the Standard System Companies. Nothing in the record indicates any change in this situation either prior to or subsequent to September 8, 1938, the date of appointment of the new voting trustees.

Applicants urge that, even assuming the exercise of a "controlling influence" by Byllesby over the Standard System Companies, that influence was not such "as to make it necessary or appropriate in the public interest or for the protection of investors or consumers" that the applicants be held holding companies under the act.

To give effect to the standards of "the public interest," "the protection of investors," and "the protection of consumers," we must look to the evils which the act is designed to eliminate. Thus, section 1 (c) provides:

"* * * it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, * * *."

Among the evils enumerated by the Congress which the act was intended to eliminate were those resulting "from an absence of arms-length bargaining" and "from restraint of free and independent competition" (sec. 1 (b) (2)). One of the manifestations of these abuses was the monopoly exercised by investment bankers over security issues of holding companies and their subsidiaries. Excessive charges by investment bankers in control of utility companies for underwriting the latter's securities were not uncommon. Further, such bankers, desirous of obtaining underwriting fees, were sometimes guilty of causing security issues to be floated even though they were ill adapted to the security structure of the issuer

[25] It is well settled that all parties in interest may terminate a trust. *Helvering* v. *Helmholz* (296 U. S. 93, 97 (1935)); *Western Battery and Supply Co.* v. *Hazlett Storage Battery Co.* (61 F. (2d) 220, 231 (C. C. A. 8th. 1932), cert. den., 288 U. S. 608); *Rowley* v. *American Trust Co.* (144 Va. 375, 132 S. E. 347, 45 A. L. R. 738 (1926)); *O'Brien* v. *Holden* (104 Vt. 338, 160 Atl. 192 (1932)); *Fredericks* v. *Near* (268 Mich. 627, 245 N. W. 537, 538 (1933)); *Riedlin's Guardian* v. *Cobb* (222 Ky. 654, 1 S. W. (2d) 1071 (1928)). See also annotations in 38 A. L. R. 941, 965, and 45 A. L. R. 743. Several of these authorities indicate that the sole beneficiary may terminate a trust even without the consent of the trustees.

[26] The underwriting of securities of Standard system companies bulks large in Byllesby's total business; from 1930 to 1937, its underwriting of securities of Standard system companies comprised 46.3 percent of all of its underwriting business.

and even though they bore no reasonable relation to the economical and efficient operation of the issuer's business.[27] As pointed out in the report of the National Power Policy Committee, transmitted to Congress by the President in March 1935 (H. Rept., 74th Cong., 1st sess., Doc. 137, p. 6):

"Fundamentally the holding-company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry."

Arm's-length bargaining concerning security issues by companies in the Standard System has been conspicuously absent ever since the organization of Standard Gas in 1910. From 1910 to 1929 Byllesby completely dominated all Standard financing. Since 1929 Byllesby has shared its monopoly with a few investment bankers who have held Standard Power common stock. At no time has any attempt been made by the Standard System Companies to secure financing on a more favorable basis from investment bankers other than those in this group.

This absence of arm's-length bargaining and the many other manifestations of investment banker control throughout the period of September 1938 would have made it impossible to find that Byllesby did not exercise "either alone or pursuant to an arrangement or understanding with one or more other persons such a controlling influence over the management or policies" of Standard Power and Standard Gas "as to make it necessary or appropriate in the public interest or for the protection of investors or consumers" that Byllesby be declared a holding company under the act. Accordingly, had there been no change in the personnel of the voting trust, we should be compelled to deny the applications under section 2 (a) (7).

We consider next the effect of the appointment of the new trustees. At the time the case was argued before us, these trustees had been in office only a few weeks. As pointed out above, at the reopened hearing they testified that they had performed no duties as trustees and had done no more than consider in a general way the nature of their duties as voting trustees.

Applicants urge that the new trustees are completely independent of Byllesby. The evidence merely shows that these trustees had not been actively identified with Byllesby, although Doriot's past connections might cast some doubt upon his independence.[28] In our opinion, the facts contained in the record are not sufficient to permit us to find that the new trustees are completely independent of Byllesby, the creator of the trust.

Under the terms of the act we can, of course, pass upon an application only upon the basis of the facts contained in the record presented to us. On the present record we cannot find that the facts bring the applicants within the exemption provisions contained in section 2 (a) (7), and the applications for orders declaring that applicants are not holding companies under that section must, therefore, be denied.[29]

As alternative relief, applicants have applied for orders exempting them from the provisions of the act, under sections 3 (a) (3) and 3 (a) (5).

Section 3 (a) (3) provides:

"The Commission, by rules and regulations upon its own motion, or by order upon application, shall exempt any holding company and every subsidiary company thereof as such, from any provision or provisions of this title, unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers, if— * * *.

"(3) Such holding company is only incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public-utility company and (A) not deriving, directly or indirectly, any material part of its income from any one or more subsidiary companies, the principal business of which is that of a public-utility company, or (B) deriving a material part of its income from any one or more such subsidiary companies, if substantially all the outstanding securities of such companies are owned, directly or indirectly, by such holding company; * * *."

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[27] The policy of Congress with respect to relationships between holding companies and investment bankers is illustrated by the provisions of sec. 17 (c). That section, among other things, forbids any executive officer, director, partner, appointee, or representative of an investment banker to serve (subsequent to Aug. 26, 1936) as a director or officer of any registered holding company or subsidiary thereof except in cases permitted by rules and regulations of this Commission. The application of that section to the present case is not before us.

[28] Doriot had previously been elected a director of Standard Gas. Prior to March 1937, he had been connected with Ladenburg, Thalmann & Co. Doriot also has had business connections with the Schroder interests. The trustees testified that they expected to receive compensation from Byllesby.

[29] Since applicants are applying for an exemption, it would appear that the burden rests upon them to establish facts bringing them within the exemption provisions. See *Securities and Exchange Commission* v. *Sunbeam Gold Mines Co.*, 95 F. (2d) 699 (C. C. A. 9th, 1938), wherein it was held that the burden was on a security issuer to prove facts bringing it within an exemption provision of the Securities Act of 1933. See also *Houston Natural Gas Corporation*, 3 S. E. C. — (1938), Holding Company Act Release No. 1184.

Section 3 (a) (5) authorizes us to grant an exemption under the same conditions if—

"* * * such holding company is not, and derives no material part of its income, directly or indirectly, from any one or more subsidiary companies which are, a company or companies the principal business of which within the United States is that of a public-utility company. * * *."

Byllesby contends that if it be deemed a holding company within the meaning of the act, it is only incidentally so, its primary business being investment banking. To this it adds the further contention, upon the validity of which the availability of an exemption under those sections depends, that it does not derive, directly or indirectly, any material part of its income from a subsidiary public utility. More specifically, the latter contention is that when Byllesby participates in an underwriting, it is merely buying a commodity—securities. At the time of purchase from the issuer, that transaction is complete, and no profit or loss is then realized. It is only after the securities are marketed that profit or loss occurs. Profits, it is claimed, are derived from purchasers, not from the issuer of the securities. Accordingly, so the argument runs, while the underwriting of securities of Standard System Companies admittedly is a principal source of Byllesby's income, that income is derived from the purchasers of the securities rather than from such companies, and the terms of sections 3 (a) (3) and 3 (a) (5) are met.

This argument ignores the realities of an underwriting transaction. It is true that the underwriter must sell securities before it can derive a profit. But that profit, in a real sense, represents compensation in the form of an underwriting spread for the performance of services for the issuer. There can be no doubt that in the so-called "best effort underwriting contract," where the underwriter agrees to use its best efforts to sell the securities of the issuer, and where it receives a designated fee on the basis of the securities it sells, the underwriter is deriving its compensation from the issuer. In such a case, the underwriter occupies a position analogous to that of a salesman of securities, and its remuneration comes from the issuer. So far as the source of the underwriter's income is concerned, the situation does not appear to us to be different where the underwriter enters into a "firm commitment" with the issuer, either purchasing an entire issue outright or agreeing to take up the unsold portion of an issue, at a designated price. Congress could not have intended that the availability of an exemption under sections 3 (a) (3) and 3 (a) (5) should turn upon the form which underwriting contracts take. On the facts before us, which show that from 1930 to 1937, the underwriting of securities of Standard System Companies comprised 46.3 percent of all of Byllesby's underwriting business, we hold that Byllesby derives a material part of its income from Standard Gas subsidiaries.

Conclusion.—On the basis of the facts presented by the record, we find it necessary to deny the applications, both with respect to section 2 (a) (7) and sections 3 (a) (3) and 3 (a) (5).

In order that applicants may have an opportunity to adjust their business to the situation, we shall, if requested by applicants, defer the issuance of a final order for a period of 60 days during which applicants may make such adjustments as they deem necessary, and shall treat the applications as pending before us until such final order is entered.

By the Commission.

[SEAL]

FRANCIS P. BRASSOR,
Secretary.

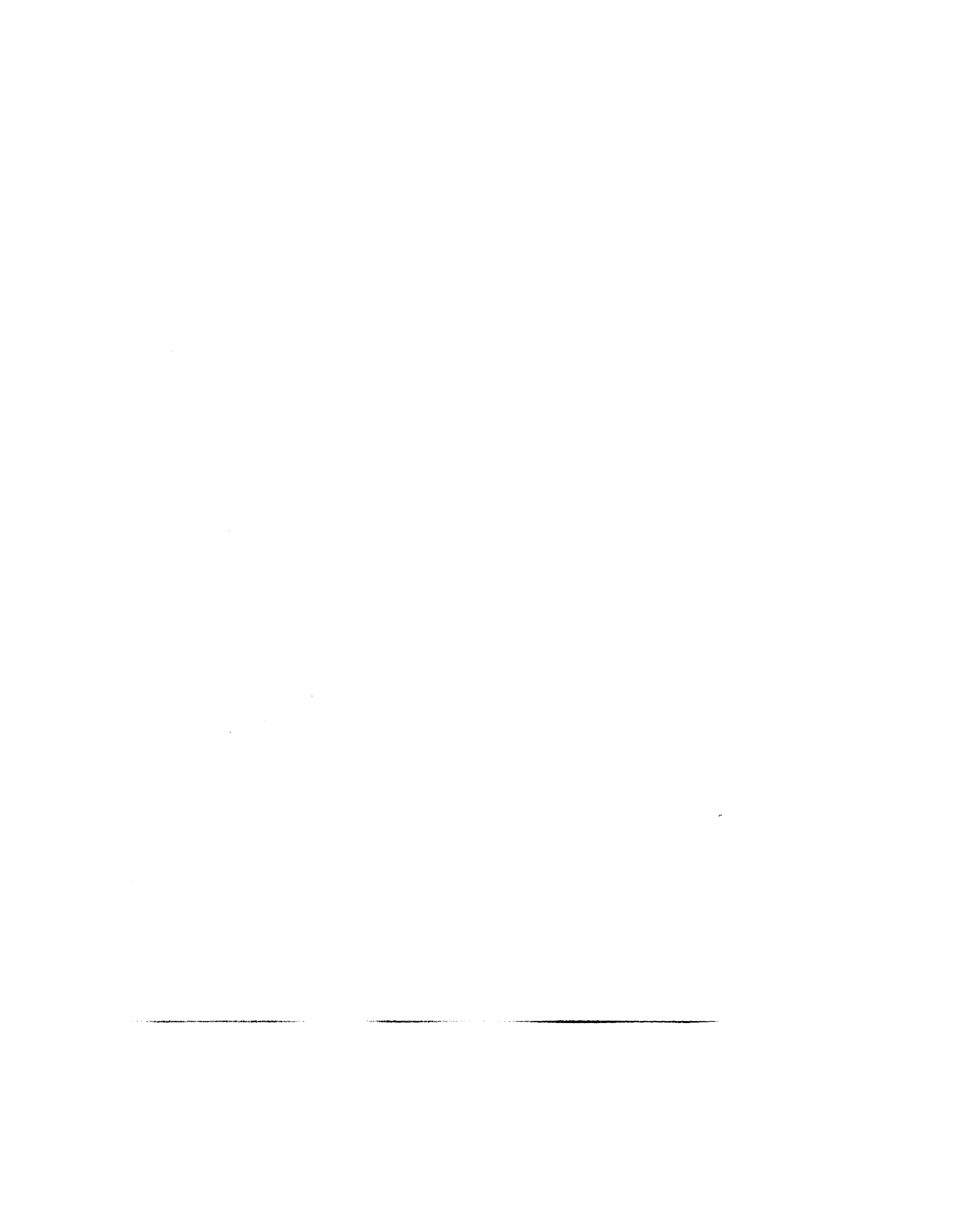
JANUARY 15, 1940.

Senator HUGHES. I want to ask a question off the record.

(A discussion was had which, at the direction of Senator Hughes, was not recorded.)

Senator WAGNER (chairman of the subcommittee). We will adjourn now until 10:30 tomorrow morning, and Mr. Schenker will be the first witness.

(Thereupon at 12:30 p. m. an adjournment was had until tomorrow, Friday, April 5, 1940, at 10:30 a. m.)



INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, APRIL 5, 1940

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

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

Present: Senators Wagner (chairman of the subcommittee), Hughes and Frazier.

Senator WAGNER. I think the subcommittee had better proceed with its hearing. I have proxies of members to account for a quorum, and no doubt some of them will come in a little later on.

Mr. Schenker, were you to testify first this morning? I see that Mr. Mathews is here.

Mr. SCHENKER. Mr. Mathews will go on directly after I close, and I hope not to be long with this statement.

Senator WAGNER. Then you may proceed.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUST STUDY, WASHINGTON, D. C.—Resumed

Mr. SCHENKER. Yesterday Mr. Stern described the rise in the United Founders Corporation, and during the course of his discussion he showed that Founders raised $500,000,000 of the public's money.

In 1933 the group that was controlling Founders sold their controlling block of stock to another investment trust—but I will discuss that a little bit more in detail shortly. At the time that this controlling block of stock was sold the assets of United Founders Corporation were $47,000,000, so that from $500,000,000 it was down to $47,000,000 in 1933.

Now, one would assume that after a person managing half a billion dollars of other people's money, lost all of it except $47,000,000, he would take his hat and coat and go home. But that was not the fact. After the assets of that company dropped from half a billion to $47,000,000, those insiders took their class A stock, which I will describe in a moment, and sold it for $1,200,000 to another group, controlling another investment trust, and turned over the $47,000,000 of other people's money to this new group.

The fact of the matter is that at the time of this transfer of $47,000,000 of other people's money to a new management group, the stock of the insiders was worth only $45,000.

Now, let me just describe briefly what this class A stock was. You will remember that Mr. Stern described how, first, they organized one company and sold that stock, they organized another company and sold that stock, and organized still a third company and sold that stock, I mean to the public.

Now, the feeling one gets from this entire picture is that these companies were being created, not because those people had any faith in the economic soundness of these companies but organized these companies because the public was prepared to buy their stock. So you had this picture of company after company after company being formed merely because the public was prepared to buy stock and they could thereby increase their funds.

After they organized one, two, three, four, five, six and seven companies, and had interests in other companies, they wanted to solidify their control of this $500,000,000. What did they do? They organized United Founders Corporation, which is the top holding company shown on this chart, and this is the capitalization of that company: There are two classes of common stock, one being A stock, and the other being common stock. The class A stock, which is the voting stock, had this voting power: that regardless of the number of shares of other common stock outstanding the A stock had a vote at least equal to one-third of all the outstanding stock.

Now, ultimately there were 6,000,000 shares of common stock held by the public, and the A stock, which was issued to the insiders, then had a vote of 3,000,000 shares; because if you take the six million and the three million it gives you nine million votes, and their stock always had one-third of the voting power. So you had the situation where they raised half a billion dollars of the public's money—and through their management as described by Mr. Stern yesterday, you saw what happened in the case of United States Electric Power Corporation, and what happened in the case of General Investment Corporation, where the assets of General Investment went from $78,000,000 down to $8,000,000, and the assets of United States Electric Power Corporation went down from $130,000,000 to $132.

Well, those people still had the power to vote the A stock, and to control the A stock, so they sold it for $1,200,000, and thereby turned other people's money over to a new group. And we will see what the new group did with the balance of the funds which they had.

Now, we say and recommend, and the bill incorporates that recommendation, that this recurrent promotion of companies, which seems to be generated not through any impulse that there is any economic significance to that type of promotion but merely for the purpose of generating merchandise that they can sell to the public, we say that that is unhealthy economically and undesirable, and the bill says: Hereafter you cannot at your whim organize an investment trust every time you think you can sell stock to the public.

And what other situation do you have here? You have these companies, one piled on top of another, and then superimposed upon that still another company.

Now, I do not know much about holding companies, but it seems to me in the public utility situation at least a holding company performs some economic function. You have an operating company here, there and elsewhere, and you superimpose upon them the holding company which will keep those three plants together, and

possibly raise funds from the public which can be supplied to the underlying companies.

But there is nothing like that in the case of an investment trust. There is no economic purpose served by piling one company upon another. It is just a device to sell securities, to raise more money.

When we come to discuss the section of the bill which deals with pyramiding of these companies, one investment trust owning another, we will give you not one but innumerable examples of where this has been done. In other words, pyramiding is not rare but exists at the present time.

The Commission says they feel the time has arrived, and it must not be forgotten that the bill at the present time does not try to disturb the pyramided situations as they exist; that such a situation as I have described is unhealthy economically and is undesirable. We say: A stockholder can never tell what the value of his stock is, but we say: You exist and we will maintain the status quo, but as far as the future is concerned you ought not to be permitted to pile one investment trust upon another.

You cannot get an idea of the complicated structure here until you learn that each one of these underlying companies had two, three, and four different kinds of stock. How to figure out the value of the stock is beyond us.

We feel that as far as the future is concerned nobody should be permitted to organize investment trusts just because he can sell their securities. We feel he should not be permitted to pyramid them, one upon another, so that he can get concentration of control of great wealth through the device of management stock.

Senator WAGNER. Can you offhand tell us what time intervened between the organization of these companies, one after the other in the group?

Mr. SCHENKER. The fact of the matter is, as I recall it, that the first company was organized in 1922. The United Founders Corporation, the one shown at the top of the chart, was organized in 1929. Do not be shocked by this, but we will give you cases where one group organized six investment trusts in 1 year and we will show why that sort of thing should not be permitted to continue.

One cannot organize six banks, one after another; one cannot organize six insurance companies, one after another; one cannot organize six building and loan associations, one after another; one cannot organize six mortgage associations, one after another, unless he gets permission from some governmental agency that there is nothing undesirable about these recurrent promotions.

Senator WAGNER. Didn't the shareholders sense the unfortunate situation in this other case?

Mr. SCHENKER. You might have got the impression yesterday from Mr. Stern that this was ancient history, and that this only took place back in 1928 and 1929. The fact of the matter is that the last little brush took place in the middle of 1939, after you had the 1933 act, and after you had the 1934 act, and after you had the 1935 act, because in November of 1935 what did they do? They sold this United Founders Corporation, which at the time only had $47,000 to The Equity Corporation.

Now, when I say The Equity Corporation you may think this is a simple little company, with one class of stock; but it was a pyramid of these investment trusts managing other people's money.