

**Seventh Annual Report**  
of the  
**Securities and Exchange  
Commission**



**Fiscal Year Ended June 30, 1941**



UNITED STATES  
GOVERNMENT PRINTING OFFICE  
WASHINGTON : 1942

**SECURITIES AND EXCHANGE COMMISSION**

**Office: 1778 Pennsylvania Avenue NW.  
Washington, D. C.**

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**Address All Communications  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D. C.**

## LETTER OF TRANSMITTAL

SECURITIES AND EXCHANGE COMMISSION,  
*Washington, January 5, 1942.*

SIR: I have the honor to transmit to you the Seventh Annual Report of the Securities and Exchange Commission, in compliance with the provisions of Section 23 (b) of the Securities Exchange Act of 1934, approved June 6, 1934, Section 23 of the Public Utility Holding Company Act of 1935, approved August 26, 1935, Section 46 (a) of the Investment Company Act of 1940, approved August 22, 1940, and Section 216 of the Investment Advisers Act of 1940, approved August 22, 1940.

Respectfully,

EDWARD C. EICHER,  
*Chairman.*

The PRESIDENT OF THE SENATE,  
The SPEAKER OF THE HOUSE OF REPRESENTATIVES,  
*Washington, D. C.*



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## Part I

# ADMINISTRATION OF THE INVESTMENT COMPANY ACT OF 1940

The Investment Company Act of 1940 requires the registration of and regulates investment companies, that is, companies engaged primarily in the business of investing, reinvesting, and trading in securities. Among other things, the Act requires complete disclosure of the finances and the investment policies of these companies, thus insuring to investors full and complete information with respect to their activities; prevents such companies from changing the nature of their business or their investment policies without the approval of the stockholders; prohibits persons guilty of security frauds from serving as officers and directors of such companies; prevents underwriters, investment bankers, and brokers from constituting more than a minority of the directors of such companies; requires management contracts in the first instance to be submitted to security holders for their approval; prohibits transactions between such companies and their officers and directors and other insiders except on the approval of the Commission; prohibits the issuance of senior securities of such companies except in specified instances; and prohibits pyramiding of such companies and cross ownership of their securities. The Commission is authorized to prepare advisory reports upon plans of reorganizations of registered investment companies upon request of such companies or 25 percent of their stockholders and to institute proceedings to enjoin such plans if they are grossly unfair. The Act also requires face-amount certificate companies to maintain reserves adequate to meet maturity payments upon their certificates.

## ENACTMENT

The Investment Company Act of 1940 (Public No. 768, 76th Congress) was approved on August 22, 1940, and became generally effective on November 1, 1940. This legislation was enacted after extensive hearings before subcommittees of the Banking and Currency Committee of the Senate and the Interstate and Foreign Commerce Committee of the House of Representatives. The original bill from which the statute as enacted was evolved was based upon the Commission's report and recommendations resulting from its detailed study of investment companies and investment trusts made pursuant to the direction of Congress contained in Section 30 of the Public Utility Holding Company Act of 1935.<sup>1</sup>

<sup>1</sup> For accounts of this study, see previous annual reports of the Commission.

Representatives of the investment companies opposed certain provisions of the original bill and suggested alternative regulatory provisions. With the approval of the Congressional committees concerned, the Commission and the industry endeavored to work out a compromise measure acceptable to both, and ultimately succeeded in doing so. It was this compromise measure, with certain modifications, which was enacted into law as the Investment Company Act of 1940.

The fact that this legislation was endorsed both by the Commission and the great majority of the persons whom it proposed to regulate excited considerable comment at the time of its passage<sup>2</sup> and deserves some mention at this point. The Commission, while of the opinion that "if you do not have a comprehensive and effective program of regulation, it is probably better to have none,"<sup>3</sup> felt that the compromise bill sufficiently carried out the Commission's major objectives and accordingly recommended its enactment.<sup>4</sup> Representatives of the industry, on their part, conceded that "abuses have existed in the industry and \* \* \* legislation is necessary to prevent their continuance,"<sup>5</sup> and joined in advocating passage of the compromise bill.

This cooperative relationship between the Commission and the industry has in general been preserved in the administration of the Act. The Commission believes that, while adhering scrupulously to the statute, it has given appropriate weight to the spirit in which it was conceived. Persons closely associated with the industry have frankly recognized that the Act is not "a complete cure of all possible evils in the investment company field," but is rather based upon a desire "to proceed cautiously and experimentally, attempting to prevent the main abuses which have been known to exist."<sup>6</sup>

It is probably safe to say that the Investment Company Act of 1940 represents the minimum workable regulation of investment companies. On the other hand, it does not follow that this minimum regulation is necessarily inadequate. Thus far the Commission has had only 8 months' experience in the administration of the Act. Further experience will presumably indicate a need for minor amendments and may or may not indicate a need for major amendments. If and when amendment seems advisable, the Commission has full power under Section 46 (a) of the Act to make appropriate recommendations to the Congress and will not hesitate to do so.

<sup>2</sup> See 86 Cong. Rec. 14916, 14922, 14924, 15413-14; Senate Banking and Currency Committee, Hearings on S. 3580, pp. 1110, 1130; House Interstate and Foreign Commerce Committee, Hearings on H. R. 10065, p. 77.

<sup>3</sup> Senate Banking and Currency Committee, Hearings on S. 3580, p. 133.

<sup>4</sup> Senate Banking and Currency Committee, Hearings on S. 3580, pp. 1105-1107; House Interstate and Foreign Commerce Committee, Hearings on H. R. 10065, p. 63.

<sup>5</sup> House Interstate and Foreign Commerce Committee, Hearings on H. R. 10065, pp. 72 et seq.

<sup>6</sup> See 26 Wash. U. Law Quarterly 303, 347 (April 1941).

## GENERAL NATURE OF ADMINISTRATIVE PROBLEMS

In part, perhaps, because the statute was the result of a compromise, but in greater measure because of the diversity of companies it covers and the intricacy of the problems they present, the Investment Company Act of 1940 is a complex and elaborate piece of legislation, calling for the use of a great variety of administrative procedures and techniques. The Act contains flat statutory prohibitions the violation of which may give rise to either injunctive or criminal proceedings in the courts; provisions which authorize the Commission to institute injunctive proceedings but the violation of which is not a criminal offense; requirements for filing financial and other data with the Commission, which is then open to public inspection; requirements for the transmission of financial and other data to security holders; provisions authorizing the Commission to render advisory reports to security holders; provisions authorizing the Commission to adopt rules and regulations in some circumstances for the purpose of giving content to statutory prohibitions which would otherwise be inoperative and in other circumstances for the purpose of relaxing statutory prohibitions which would otherwise obtain; provisions for administrative orders in proceedings initiated in some cases by the Commission and in other cases by the companies or persons affected; and provisions for the further study of certain aspects of investment company operations. Fortunately, most of these procedures have been employed in the same or a comparable form in one or more of the statutes already administered by the Commission, so that no serious difficulties have been encountered in fitting the administration of the new Act into the framework of the Commission's previous practice.

For the purpose of administering the Investment Company Act of 1940 (together with the Investment Advisers Act of 1940), the Commission created a new division of the staff, the Investment Company Division. The organization and functions of the new division are generally similar to those of the older divisions of the Commission.

The principal problems faced by the Commission during the first eight months of its administration of the Act can conveniently be grouped into seven categories, namely: (1) determining which companies are investment companies subject to the Act and which are not investment companies or are entitled to exemption; (2) the classification of companies subject to the Act; (3) prescribing the information to be filed with the Commission and that to be transmitted to security holders; (4) the administration and enforcement of those provisions of the Act which regulate the relationships and transactions of persons who are affiliated with investment companies; (5) matters relating to the distribution, redemption, and repurchase

of securities issued by management companies; (6) reorganizations of investment companies; and (7) the treatment accorded certain special types of companies, such as unit investment trusts, periodic payment plans, and face-amount certificate companies.

### THE "INVESTMENT COMPANY" CONCEPT

Although the terms "investment company" and "investment trust" have been part of the language of the financial community for some time, a definition precise enough to distinguish them sharply from holding companies on the one hand and operating companies on the other did not exist prior to the enactment of the Investment Company Act of 1940. The distinctive feature of the Act in this connection is its use of a quantitative or statistical definition, expressed in terms of the portion of a company's assets which are investment securities. Thus the statute provides, *inter alia*, that a company is an "investment company" if it is engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns investment securities (defined to exclude securities of majority-owned subsidiaries and of other investment companies) exceeding 40 percent of its total assets (exclusive of Government securities and cash items).

With this quantitative test as a starting point, the statute then proceeds to carve out exceptions. Certain types of companies are excluded from the investment company category by express statutory exceptions. These types include such organizations as banks, insurance companies, savings and loan associations, small loan companies, public utility holding companies, and charitable corporations. In addition, the Act provides machinery whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition, is nevertheless not an investment company. Thus, companies that believe that the application of the quantitative test would unreasonably cause them to be classified as investment companies are given the opportunity of obtaining administrative dispensation by showing that they are *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.

The experience of the Commission, during the 8 months the Act has been in effect, indicates clearly the general feasibility of working with the definitions of "investment company" contained in the Act and the administrative procedures provided in relation to them. During that time only 27 applications for declarative orders were filed. Of the applications which have so far been studied, 7 have been withdrawn by the applicants at some stage during the course of the administrative proceeding. Most of the with-

drawals resulted from the informal exchange of views with representatives of the particular companies involved. Of the 4 cases which were formally decided by the Commission prior to the end of the past fiscal year, all were clear cases for administrative relief, and in each the order prayed for was granted. It is true that knotty questions have been raised by some of the applications, but those questions relate to so few companies that they do not interfere with the effective regulation of the field as a whole.

#### EXEMPTION OF COMPANIES FROM THE INVESTMENT COMPANY ACT OF 1940

In addition to the provisions for excluding certain types of organizations from the concept of "investment company," the Act contains certain exemptive provisions applicable to companies which, while admittedly investment companies, should for one reason or another be relieved from some or all sections of the Act. Several of these exemptive provisions are provided by the statute itself, but three subsections of the Act leave exemption in whole or in part to administrative determination.

In Section 6 (b) the Commission is directed to exempt by order any employees' securities company from the provisions of the Act, to the extent that such exemption is consistent with certain specified standards. To date, 7 companies have filed applications for exemption under this section.<sup>7</sup> The most important are those applications filed by 4 investment companies holding funds for the benefit of more than 40,000 employees of General Electric Company. The total assets of these 4 companies amount to more than \$200,000,000.

The disposition of such applications presents many difficult problems and requires constant use of the Commission's informal conference procedure, for Section 6 (b), in effect, directs the Commission to study in detail the history and operations of each such company and to determine the effect which each section of the Act will have on one or more aspects of the applicant's business. After this is done, the Commission must, in effect, accommodate the Act to the particular circumstances of the employees' securities company involved, in the light of the considerations enumerated in Section 6 (b). This process, in relation to the applications of the four companies affiliated with General Electric Company, has almost run its course. Formal hearings have been set, and opinions and orders should be issued in the near future. The other applications under Section 6 (b) are in some stage of the same process.

<sup>7</sup> These do not include employees' stock bonus, pension, or profit-sharing trusts which meet the conditions of Section 165 of the Internal Revenue Code, since such trusts are excluded from the definition of "investment company" by Section 3 (c) (13).

Section 6 (d) of the Act directs the exemption by rule or order, to the extent consistent with the public interest and the protection of investors, of certain small closed-end investment companies whose securities are offered intrastate. At the end of the fiscal year the three applications filed under this section were pending.

The remaining exemptive provision, and in many ways the most important, is Section 6 (c) which reads as follows:

"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."

Sixty-two applications have been filed seeking orders under this section, of which 20 had been disposed of at the close of the fiscal year ended June 30, 1941. Many of the applications requested orders which amounted to little more than the formal expression of minor administrative determinations. For instance, requests were made for additional time in which to file with the Commission or to transmit to security holders documents and other forms of information; requests, in effect, for stays pending the outcome of proceedings instituted under other provisions of the Act; and requests for temporary exemption from specified provisions because of a variety of circumstances. For the purposes of such applications, the exemptive power vested in the Commission has helped to eliminate many small but irritating inconveniences, particularly those which inevitably occur during the period of adjustment to new regulatory law, without sacrificing substance or principle.

Some of the applications filed under Section 6 (c), however, have requested sweeping substantive exemptions. Such applications involve considerations in many respects similar to those discussed in relation to applications filed by employees' securities companies under Section 6 (b). During the period between the effective date of the Act and the close of the fiscal year, only one application for complete exemption from the Act was granted under Section 6 (c). This order related to an unusual situation—an investment company created to hold the assets of the New York agency of a European bank with no known American investor interest in either the investment company, the agency, or the bank. The exemption, however, was granted for only 1 year.

It will be noted that the exemptive function of the Commission may be exercised not only by order on application but also by rule on the Commission's own motion. No rules have been adopted under this

section giving complete exemption to any class of companies. The few rules which have been adopted are principally of two types: procedural rules and rules *de minimis*:

A typical example of a procedural rule is Rule N-6C-3, which provides, in effect, that any employees' securities company which filed an application under Section 6 (b) of the Act prior to November 15, 1940, is exempt from the provisions of the Act applicable to investment companies until the Commission has finally determined the application. Such a rule is, in effect, a *stay pendente lite* and is comparable to the procedural orders of exemption to which reference has already been made.

An example of a rule *de minimis* is Rule N-15A-1. The Act contains a number of provisions regulating investment advisers of investment companies and the contracts pursuant to which they give their advice. Among these provisions is a requirement that investment advisory contracts be approved by the shareholders of the investment company concerned. Since the remuneration under such contracts commonly is as high as one-half of 1 percent of the value of the assets of the investment company per year, the essential soundness of this requirement of shareholder approval is obvious. An occasional company, however, may retain an investment adviser for special purposes under an arrangement providing for such small compensation that to require shareholder approval of the contract would be an unnecessarily cumbersome procedure which, instead of protecting the shareholders in any substantial sense, would merely distract their attention from more important aspects of the investment company's operations.

Rule N-15A-1 was therefore adopted. It provides, in effect, that an investment adviser of a registered investment company may act under a contract which has not been approved by the voting securities of the registered company in accordance with the provisions of Sections 15 (a) and (e) if such adviser is not otherwise affiliated either with the registered company or with a principal underwriter thereof; if his compensation either is not more than \$100 a year or is not more than \$2,500 a year and one-fortieth of 1 percent of the company's net assets as determined in accordance with the rule; and if the aggregate compensation of all investment advisers of such registered company either is not more than \$200 a year or is not more than one-twentieth of 1 percent of the company's net assets.

#### CLASSIFICATION OF INVESTMENT COMPANIES

Investment companies are divided by the statute into three classes, namely, management companies, unit investment trusts, and face-amount certificate companies.

The management company is the most familiar type of investment company. Organized as a corporation, association, or business trust, it normally has a board of directors or trustees who have more or less freedom in selecting the investments to be made by the company and in otherwise managing the company's affairs.

Management companies are further divided by the Act into closed-end and open-end companies. The peculiarity of the open-end company is that it issues redeemable securities, the holders of which are entitled to withdraw from the company at any time by presenting their shares and receiving their proportionate value of the then assets of the company. Ordinarily, an open-end company is continuously engaged in selling and redeeming its own securities, and this constant process of sale and redemption presents serious regulatory problems. Closed-end companies are management companies whose securities are not redeemable and which ordinarily are not engaged in the continuous distribution and redemption of their securities, and which consequently present problems of a different character.

The statute also subdivides management companies, whether closed-end or open-end, into diversified and non-diversified companies. The distinction here is between the company whose investments are diversified among the securities of numerous issuers and the company which concentrates its investments in the securities of a few issuers or in blocks of voting securities which enable it to exercise a controlling influence in the affairs of the issuer. The statute contains a statistical test for determining whether a management company is diversified or non-diversified.

Unit investment trusts are organizations where portfolio management has been entirely eliminated or reduced to a minimum. Characteristically, the holder of a share in a unit investment trust has merely an undivided interest in a package of specified securities, which are held by a trustee or custodian. Few, if any, unit trusts are actively selling their shares today, with the exception of the shares being sold on a periodic payment basis.

The peculiarities of the face-amount certificate company are twofold. First, it publicly distributes certificates which are not equity securities representing a fluctuating interest in a fund, but evidence of indebtedness providing for the payment of a fixed amount at maturity. Second, these certificates are predominantly sold on a periodic payment basis, providing for the payment by the holder of a definite amount at specified periods. In order to give certificate holders some assurance that they will receive the amount promised them at maturity, the Act contains elaborate provisions requiring the setting up of reserves and the deposit by the companies of qualified investments equal to the reserves. It is the administration of these reserve requirements, together with supervision of the continuous

selling in which these companies usually engage, which present the principal problems in the regulation of this class of investment companies.

A proper determination of the classification and subclassification of an investment company is essential to the administration of the Act. A number of sections of the Act apply to all companies, regardless of classification, but because of the difference in problems presented by different types of companies, other sections of the Act relate only to one or two classes of companies, or in some instances only to a particular subclass of management companies.

### INFORMATIONAL REQUIREMENTS

#### Registration Statements.

The first step in the general scheme of regulation provided by the Act is the requirement that investment companies shall register with the Commission. A company registers under the Act by filing with the Commission a notification of registration. For this purpose the Commission has prepared Form N-8A, a short form which requires little more than the identification of the company and its management, and the classification of investment company within which the registrant considers itself to be. As of June 30, 1941, 436 companies with total assets of approximately \$2,500,000,000 were registered under the Act. Of these, 11 were registered as face-amount certificate companies, 181 as closed-end management companies, 141 as open-end management companies, and 81 as unit investment trusts. Twenty-two companies are of doubtful classification.

The next step in the course of registration is the filing with the Commission, in accordance with rules, regulations, and forms promulgated for the purpose, a detailed registration statement containing complete information regarding the company. Most of the required information is similar to that required in registration statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, however, the Investment Company Act of 1940 requires the registration statement to contain a recital of the policy of the registrant with respect to certain specified subjects, such as issuing senior securities, borrowing money, engaging in underwriting, making loans, or investing in real estate or commodities. These required statements of policy, which must be as specific as is practicable, constitute one of the keystones of the Act. Once having stated such a policy in its registration statement, a registrant may not deviate from it without the consent of a majority of its outstanding voting securities.

The first form for a detailed registration statement was promulgated by the Commission on May 23, 1941. It is designated Form N-8B-1 and applies to all registered management companies. Tenta-

tive drafts of the form were submitted to all registered management companies for their comments and suggestions before the definitive form was adopted.

Because of the importance of the portion of Form N-8B-1 dealing with recitals of policy, members of the Commission's staff have been made available for conferences with investment companies, prior to the filing of the registration statement, concerning the problems of the company in answering the items in that part of the form. A considerable number of such conferences have been held.

In connection with the informational requirements of the Investment Company Act of 1940, the Congress has directed the Commission to avoid duplication where reports and statements are also required to be filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. That policy has been carried into effect. Thus by rule, it has been provided that a company may, under proper circumstances, file copies of Form N-8B-1 in lieu of the annual report for the 1940 fiscal year required under the Securities Exchange Act of 1934. Similarly, rules have been adopted which are designed to allow companies having statements and reports already on file under the other Acts to file copies of such statements and reports in lieu of equivalent data required in Form N-8B-1. The Commission is presently engaged in developing a procedure whereby registration statements under the Investment Company Act of 1940 and the Securities Exchange Act of 1934 may be filed on a single form. Similar steps are being taken to correlate the information filed under the Investment Company Act of 1940 with that required for the registration of securities under the Securities Act of 1933, so that copies of registration statements and reports filed under the former Act may be used for the registration of subsequent issues of securities under the latter Act in lieu of the equivalent information otherwise required.

Forms of registration statements for classes of investment companies other than management companies are in preparation.

#### **Periodic Reports to the Commission.**

The Act requires registered investment companies to file annual reports with the Commission containing such information as is presently obtained from investment companies filing annual reports under the Securities Exchange Act of 1934 and, in addition, the Commission may require semi-annual and quarterly reports in order to keep current the information contained in registration statements.

The Commission has already adopted a rule requiring annual reports to be filed for each fiscal year after the filing of the registration statement, and a form is now in preparation for this purpose. It is the intention of the Commission to promulgate a single form which will satisfy the requirements of both the Investment Company Act of 1940 and the Securities Exchange Act of 1934.

Any action concerning semi-annual and quarterly reports will naturally be deferred until the forms for annual reports have been prepared. However, the Commission has been receiving, as required by the Act, copies of all periodic reports containing financial statements which are transmitted by registered investment companies to their security holders.

#### **Reports and Other Information Sent to Security Holders.**

Under the Act certain information is required to be transmitted to stockholders by registered investment companies at various times and under various circumstances. Thus, reports of condition must be rendered at least semi-annually. This requirement has already been implemented by rules applicable to management companies and to one type of unit trust. The significance of this requirement cannot be overestimated, when it is considered in the light of the power given to the Commission to bring about some standardization in the substance of information made public, particularly statements of accounts.

Other provisions designed to keep security holders better informed on matters relating to their investments are likewise important. When a dividend is paid by a registered company from a source other than certain types of income, or accumulated income, the payment to the security holder must be accompanied by a written statement indicating its source. The Commission has adopted a rule furthering this provision and all registered companies are now operating under it. The Act also provides that any solicitation of proxies, authorizations, and consents of security holders shall be made only in accordance with the rules of the Commission.<sup>8</sup>

#### **Financial Requirements.**

An especially important part of the informational requirements of the Investment Company Act of 1940 are those relating to financial statements and accounts. The Act authorizes the Commission to require a reasonable degree of uniformity in the accounting practices of investment companies, and work along this line has already been begun. Meantime, Regulation S-X, which is a compilation of the accounting requirements of the Commission developed in the administration of the Securities Act of 1933 and the Securities Exchange Act of 1934, is being employed under the Investment Company Act of 1940, with appropriate modifications. It has thus been possible to make provision for full and informative financial data in registration statements filed under the Act without unduly hastening the Commission's long-range program for developing uniform accounting practices in the industry.

<sup>8</sup> See page 232, *infra*.

**AFFILIATED PERSONS**

Section I of the Act states, among other things, that the national public interest and the interest of investors are adversely affected—

“when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business rather than in the interest of all classes of such companies' security holders.”

This declaration is based upon the disclosure of abuses in the reports of the Commission to the Congress on its study of investment companies. In order to eliminate such conditions as far as possible and to insure that the interests of all classes of security holders are paramount in the operation of investment companies, the Act contains a number of provisions imposing limitations and prohibitions with respect to the eligibility and activities of persons affiliated with investment companies and the transactions of such affiliated persons with those companies. It is in relation to these provisions that the Commission is delegated some of its most important administrative functions under the Act.

**Eligibility of Officers and Directors.**

First, there is the provision that a person may not serve as an officer or director or perform certain other functions for a registered company if he has been convicted of certain crimes involving security transactions, or if by reason of similar misconduct has been enjoined from specified activities. The Commission is directed to give relief from those prohibitions under proper circumstances by order upon application. Fifty applications for such relief have been filed and so far 10 of them have been granted with regard to affiliated persons of 4 companies. In all of these cases a consent injunction entered into prior to the enactment of the Investment Company Act of 1940 was the disqualifying element.

**Transactions with Investment Companies.**

By far the most important provision concerning the activities of affiliated persons is that which, with certain exceptions, prohibits any affiliated person, promoter, or principal underwriter of a registered company from selling to, or buying or borrowing property from, the investment company or any company it controls. The prohibition is supplemented by a provision that the Commission shall exempt by order upon application any proposed transaction if evidence establishes that its terms are reasonable and fair and do not involve overreaching, and that it is consistent with the company's recitals of

policy in its registration statement and with the general purposes of the Act.

From the effective date of the Act to the close of the fiscal year, 12 applications to exempt transactions between affiliated persons and investment companies or companies controlled by them were filed. During the fiscal year the Commission disposed of 7 of these applications. The disposition of such applications requires a nice balance of conflicting factors which points up the need in such cases for the review of a specialized agency. On the one hand, in most of the situations resolved, there was the necessity of a speedy determination because the transactions depended a great deal on security markets. On the other hand, many of the issues involved in the determination of fairness were of a complicated nature, requiring the fullest use of financial experience and a delicate exercise of administrative judgment.

An illustration of the complicated nature of issues presented in these proceedings can be found in an application of Aviation and Transportation Corporation. This corporation (hereinafter called ATCO) controlled The Aviation Corporation (hereinafter called AVCO) through stock ownership. AVCO proposed to issue additional stock and to give its existing stockholders preemptive rights to subscribe to such stock at discounts from the market prices. A special arrangement was to be made with ATCO, so that the latter company would subscribe not only to the portion of the new issue to which it was entitled because of its stock ownership in AVCO, but would also have a commitment to take up a portion of the securities not purchased by the other AVCO stockholders. The remainder of such securities were to be publicly issued by underwriters, and, to the extent the underwriters could not dispose of them, ATCO would acquire them within the limits of its resources. In payment for the shares ATCO would transfer all its non-cash assets (except its AVCO stock) at designated values and the difference between the amount due and the value of the assets to be transferred would be paid in cash. The non-cash assets consisted of investment securities. After the consummation of the proposed transaction, ATCO, the registered investment company, intended to dissolve and to distribute in kind to its security holders all its stock in AVCO—its only remaining non-cash asset. In the proposed group of underwriters who were to distribute the securities to the public were persons affiliated with the investment company, and for their services the underwriting group would, of course, receive commissions.

This case presented to the Commission the following issues:

- (1) Whether the offering price of the securities issued by AVCO was fair in relation to market values.

(2) Whether the valuations placed on the assets of ATCO which were to be exchanged for AVCO securities were fair and reasonable.

(3) Whether the underwriting fees obtained by the persons affiliated with ATCO would not result in overreaching on their part.

(4) Whether the entire transaction, including the proposed dissolution was within the policies of ATCO and consistent with the enumerated purposes of the Act.

All these issues required speedy determination because the transactions depended to a great extent on market conditions with respect to the outstanding securities of ATCO and AVCO. The application ultimately was granted.

Another case involved different considerations. A company that was a principal underwriter of a registered open-end company applied for an order permitting it to sell to the investment company certain securities which it was distributing publicly as a member of a selling syndicate. The application was the first of its kind, and up to that time the Commission had not announced its policy in relation to transactions of that general character. The Commission also recognized that the circumstances in this case were exceptional and, accordingly, permitted the consummation of the transaction. The importance of the case, however, is that the Commission, in its opinion, announced for future guidance of registered companies that the burden upon an applicant in any such case to show that a transaction of the kind here involved is consistent with the purposes of the Act is a heavy one and cannot be met merely by proof that the sales price is fair.

#### **Judicial Sanctions.**

The provision discussed above, which, in effect, requires persons affiliated with investment companies to obtain permission of the Commission in order that they may have certain dealings in money or property with such investment companies, is not the only kind of control the Congress gave to the Commission over the activities of such persons. Another such control is the power vested in the Commission to seek judicial sanction, i. e., an injunction, against any person for gross misconduct or gross abuse of trust in respect of any registered company that such person serves in any of certain designated capacities. In one instance, the Commission believed that the management of an investment company, with knowledge that they intended to dissolve such company, had acquired substantial blocks of the company's preferred stock from the public at a cost less than the value of that portion of the assets of the company to which such stock would be entitled on dissolution. At the suggestion of the Commission the management agreed to surrender to the com-

pany the stock they had acquired at a price equivalent to the cost of such shares to the management. As a result, the remaining holders of the company's preferred stock received a substantially higher proportion of the company's assets than they would otherwise have obtained.

#### **Protection Against Theft and Embezzlement.**

The Investment Company Act of 1940 has two provisions involving administrative functions, the purpose of which is to protect investment companies from theft and embezzlement by affiliated persons. First, there is a requirement with respect to the safekeeping of the securities and investments of such companies; and second, a provision concerning the bonding of persons connected with such companies who have access to securities and funds.

The safekeeping requirement in effect provides that the securities and similar investments of registered management companies shall be placed in the custody of a bank or in the custody of brokers who are members of a national securities exchange subject to rules and regulations of the Commission. The Commission is also given the power either by order on application or by rule to permit such companies to maintain in their own custody their securities and investments.

Soon after the effective date of the Act, the Commission adopted rules governing companies whose securities were in the custody of brokers. These rules require the execution of a written contract between the registered company and the broker which provide for physical segregation of the securities, prohibitions against hypothecation of or the creation of liens on such securities, and periodic examinations of such securities by the company's public accountants.

With regard to the power of the Commission to permit management companies to retain custody of their securities, 59 applications for orders were filed. The Commission analyzed these applications, classified the various methods employed to protect the securities maintained in this fashion, and, on the basis of the study, proposed to the interested companies uniform standards representative of the better practices as disclosed in the applications. The proposals were discussed with representatives of the industry and accounting societies, and submitted to the applicants for their suggestions.<sup>9</sup>

The provision concerning the bonding of persons having access to the securities and funds of registered management companies authorizes the Commission to adopt rules in that regard. Such rules are now in process of preparation.

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<sup>9</sup> Since the close of the fiscal year, the proposed standards have been revised in the light of the comments received and on July 31, 1941, Rule N-17F-2 embodying them was promulgated.

**Informal Matters under Other Requirements.**

The Act contains a group of provisions involving various classes of persons affiliated with investment companies, which provisions, by their terms, do not take effect until some time after the effective date of the Act. The purpose of the waiting period is to give the investment companies and the classes of persons concerned an opportunity to revise their relations to comply with the respective requirements. Among other things, such revision may require amendments to charters and bylaws, special meetings of security holders, and a vote of security holders on a variety of possible matters.

In this group of provisions are the following: that no more than 60 percent of the members of the board of directors of a registered company shall be investment advisers, affiliated persons of an investment adviser, or officers or employees of such company; that a registered company cannot employ as broker or principal underwriter a director or officer or a person affiliated with a director or officer, unless a majority of the board of directors are not such persons; that investment advisers shall serve as such only under a written contract with certain prescribed terms; that neither the charter, certificate of incorporation, or bylaws of any registered company shall contain provisions which purport to protect any director or officer against any liability to the company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties in the conduct of his office; that investment advisers and underwriters should not be similarly protected; and that security holders shall ratify the selection of the independent public accountant.

Various problems have already been raised by companies now in the process of revising their operations to comply with these provisions when they become effective. Among those problems is the question of how far the limitations placed on charters and bylaws prevent indemnification of directors and officers for liabilities or expenses resulting from litigation arising out of their activities in connection with a registered company. The Commission has interpreted the relevant provision to prohibit such indemnification for expenses and the amount of any judgment handed down against such persons. Where suits are settled, indemnity may be offered only where the reasonable expenses of prosecuting a case to judgment would exceed the amount paid in settlement. Without such limitations, the officers and directors of investment companies would be in a position to shift from themselves to the security holders whose investments had been impaired the liability for any loss caused by their misconduct.

**DISTRIBUTION, REDEMPTION, AND REPURCHASE OF SECURITIES****Redeemable Securities.**

It is the practice of open-end investment companies to sell their securities at prices based upon the value of their underlying assets and

to agree to redeem them at prices similarly based. Prior to the enactment of the Act, almost all open-end companies determined the market value of their underlying assets at 3 p. m., the time of the closing of most stock exchanges on which their portfolios were listed. The selling price of the shares based on this computation remained fixed until 3 p. m. of the next day when a new calculation was made. The effect of this one price system was often damaging to security holders. For example, if the asset value was \$10 a share at 3 p. m. on Monday and at 12 noon of the next day because of a rise in market values the asset value was \$15 a share, nevertheless the public could purchase such shares at a price to net the company \$10 a share. Under such circumstances the value of the existing shareholder's stock would be substantially diluted. Moreover, insiders such as directors and officers and underwriters who could obtain shares without payment of a sales load could purchase them at \$10 a share and redeem them at \$15 a share, since the redemption price per share was computed almost unanimously on the basis of the market value of assets at the time of the redemption.

The Act seeks to prevent these abuses by providing that any securities association registered under the Securities Exchange Act of 1934 may adopt rules setting out methods of computing prices at which their members may purchase, sell, or redeem open-end securities and the minimum time that must elapse between purchases and redemptions of such securities. Such associations may also adopt rules limiting and prescribing the method of computing the commissions their members may take on transactions in the securities in order to avoid excessive sales loads. After 1 year from the effective date of the Act, the power to make rules concerning these matters vests in the Commission. To the extent that such rules may be inconsistent with the rules of any registered securities association, the latter will be superseded. In this manner the Act in effect gave the organized security dealers a year to work out for themselves the highly complicated and technical problems involved.

The National Association of Securities Dealers, Inc., an association registered under the Securities Exchange Act of 1934, has already adopted such regulations. Among other things, the regulations provide that prices, heretofore computed generally only once a day, shall be computed twice daily. The effect of this rule is to diminish, but not to eliminate, possible dilution in the value of the shares of existing stockholders. Pursuant to the Securities Exchange Act of 1934, the rules of these associations become effective unless the Commission takes affirmative action with respect to them. In the instant case the Commission, without indicating approval, allowed the rules to become effective.

**Closed-end Companies.**

Registered closed-end companies are prohibited from purchasing securities of which they are the issuer, except (1) on national securities exchanges or other open markets designated by the Commission under specified circumstances, (2) pursuant to tenders, or (3) under such other circumstances as the Commission may permit by rule, regulation, or order. The primary purpose of this provision is to eliminate unfair discrimination in these transactions

The Commission has adopted a rule (Rule N-23C-1) as to repurchases of securities of closed-end companies other than on an exchange or by tender which, in effect, permits a registered investment company to purchase only its most senior security for cash under the following circumstances: the securities involved are not listed on an exchange; the seller is not an affiliated person; the purchases do not exceed more than 1 percent of such securities outstanding; the securities are bought pursuant to a firm commitment; the price paid is not above market or asset value, whichever is lower; the issuer discloses to the seller the underlying asset value of the subject securities; no brokerage commission is paid; the purchase is made without discrimination; and if the security is a stock, notice of intention to purchase must have been given to the stockholders at large. In any case the issuer must file reports of its repurchases with the Commission on Form N-23C-1 provided for that purpose.

During the past year, 17 applications for orders involving special situations were filed with the Commission. Many of them were with respect to purchases by investment companies of their own securities from the British Government. Of the 17 applications filed, 11 were granted and 6 were pending at the close of the fiscal year.

Although the Act does not expressly impose limitations on repurchases by closed-end companies of their own securities except for a requirement of prior notice to shareholders of the company's intention to repurchase, such repurchases may be of advantage to the management and detrimental to public shareholders. However, it has already been pointed out that the Act confers upon the Commission the power to seek an injunction of gross abuse of trust by managements. The existence of this power has enabled the Commission to prevail upon the management of one investment company to circumscribe repurchase of the company's preferred stock on a stock exchange so as to prevent the management from gaining an advantage at the expense of selling shareholders.

In this case the management held a substantial block of the company's common stock which had no asset value. Dividends on the company's preferred stock were passed although the company legally was in a financial position to meet the dividend requirements. Instead, the management caused the company to buy substantial blocks

of the preferred stock on the stock exchange at prices substantially less than the liquidating value of such stock. This practice tended to build up value in the common stock and thus served the interest of the management. On the other hand, to prevent the company from repurchasing the preferred stock would result in a substantial decline in the market value of the stock since the company was virtually the only buyer. After several conferences with the management, a plan was worked out which permitted repurchases in sufficient amount to maintain a satisfactory market for such stock but which prevented the management from profiting on the repurchases through an enhancement in the asset value of the common stock held by the management. The plan also required the company to pay out all current earnings as dividends on the preferred stock.

### PLANS OF REORGANIZATION

In connection with any reorganization<sup>10</sup> involving a registered investment company, the Act provides that copies of all the documents relevant to the solicitation of proxies, consents, and other type of action of security holders be filed with or mailed to the Commission. The Act also vests in the Commission two functions with reference to reorganizations. First, the Commission is authorized, if requested by any participating registered investment company or the holders of 25 percent of any class of its outstanding securities, to render an advisory report in respect of the fairness of any plan of reorganization and its effect upon any class or classes of security holders. Second, it may seek to enjoin the consummation of any such plan in the courts on the ground that it is grossly unfair or constitutes gross misconduct or gross abuse of trust on the part of officers, directors, or other specified persons sponsoring the plan.

With respect to the first—the power to render advisory reports on request—two such requests have been received. In both cases advisory reports were prepared and distributed to the interested security holders.

The first case involved a plan of reorganization proposing the consolidation of two investment companies followed by offers of the consolidated company to exchange its securities for outstanding securities of three other investment companies which were thereafter to dissolve. The companies involved were Standard Investing Corporation, International Equities Corporation, Central Capital Corporation, Atlantic Securities Company of Boston, and Beacon Participations, Inc. All of these companies were affiliated and were the component companies in a system of investment companies known as the Henderson Group. Standard Investing Corporation and

<sup>10</sup> The term includes among other things a dissolution, merger, consolidation, a sale of a substantial portion of assets, and recapitalizations.

International Equities Corporation were the consolidating companies, the other three the dissolving companies.

The complicated issues presented by this reorganization can be indicated merely by pointing out the complex capital structures of the companies (which created sharp conflicts of interest among the holders of the various classes of securities) and the types of assets which had to be valued (as a basis for determining the fairness of the treatment accorded by the plan to the various security holders). As to capital structure, Beacon Participations, Inc., had outstanding two classes of preferred stock and common stock; Atlantic Securities Company of Boston had outstanding debentures, a preferred stock, and a common stock; Central Capital Corporation had outstanding only common stock; Standard Investing Corporation had outstanding debentures, preferred stock, and common stock; International Equities Corporation had outstanding two classes of stock with different claims against the company's assets and profits. Various degrees of cross-ownership and circular-ownership existed among the companies and all of the companies were controlled by another company which was not being reorganized.

The underlying assets of these companies, upon the valuation of which depended in a large measure the fairness of the treatment accorded to all the classes of security holders involved, were as follows: real estate and hotel companies, service companies, a company manufacturing fiber containers, an aviation accessory company, and diversified investment securities.

After numerous conferences between the management of these companies and members of the Commission's staff some features of the original tentative plan desired by the management were altered. In the report of the Commission addressed to the security holders, the plan was carefully explained; the capital structures were outlined; the methods of evaluating the assets, particularly the assets having no quoted market values, were discussed; and the effect of the plan on the existing rights and privileges of each of the outstanding classes of securities were analyzed and defined.

It was indicated to the security holders that the Commission did not recommend or approve the plan. The stated purpose of the Commission was to assist security holders in exercising their judgment whether or not to accept the plan of reorganization. It was, however, the opinion of the Commission that the plan, on the basis of certain specified assumptions, was sufficiently within the limits of fairness to justify its submission to the security holders for their consideration.

The second case involved the proposed consolidation of Liberty Share Corporation and Western New York Securities Corporation. The situation in this case was simpler. Liberty Share Corporation had outstanding only one class of stock and its assets consisted chiefly

of cash, some bank stock, an oil property, and over 30 percent of the securities of the other consolidating company. Western New York Securities Corporation, beside cash and some stock of Liberty Share Corporation, held securities in over 35 different companies. The chief problems in this case were (1) the determination as to the reasonableness of the method of computing the relative interests the security holders of the respective companies were to receive in the consolidated company and (2) the determination as to the propriety of the appraised value on the oil property owned by Liberty Share Corporation. These problems were pointed out to the security holders in the report of the Commission, which report contained an analysis of the assets and capitalization of each of the companies, the plan, and its effect on the rights and privileges of the outstanding securities.

The function of the Commission in preparing advisory reports for the assistance of security holders of reorganizing investment companies fills a long-felt need. It enables security holders who often do not possess great financial knowledge to obtain an impartial analysis of the effects of a plan of reorganization on their securities, thus enabling them to arrive at an informed judgment as to the merits of the plan.

Although the Commission has authority to submit advisory reports only when requested by the reorganizing company's management or by 25 percent of its security holders, the existence of its power to seek an injunction restraining any grossly unfair plan of reorganization has resulted in the submission of several plans for informal consideration as to fairness before solicitation of security holder approval. The need for this type of analysis is particularly acute in the case of voluntary reorganizations which are at present substantially unsupervised by any governmental agency, administrative or judicial.

#### **PERIODIC PAYMENT PLAN CERTIFICATES AND UNIT INVESTMENT TRUSTS**

Many investment companies issue periodic payment plan certificates, that is, a type of investment contract whereby the holder makes payments on an installment basis and obtains an undivided interest in certain specified securities or in a unit or fund of securities.<sup>11</sup> One of the main problems in relation to the sale of such securities is the cost to the purchaser, namely, the "sales load". Since these periodic payment certificates are sold to persons of small means, who frequently default in their payments, the sales load, if it is deducted in

<sup>11</sup> This type of security, representing as it does a participating or equity interest in specified assets should not be confused with the face amount certificate which represents an unconditional promise of its issuer to pay a specified sum at a specified or ascertainable future date and is thus a claim by the holder of the security.

its entirety from the early payments, will result in substantial loss to those investors whose payments lapse early in the period of the contract.

The Act copes with this problem by providing that the sales load on such certificates shall not be more than 9 percent of the total payments. Not more than one-half of this sum may be deducted during the first year and the balance must be spread proportionately over the entire period of the contract. However, the Commission is authorized, upon application or otherwise, to grant qualified exemptions from the sales load requirements to smaller companies whose operating costs are relatively higher than those of larger companies. Fourteen applications have been received requesting such relief. Seven of them have been joined in one proceeding. In respect of those seven, the Investment Company Division is contesting the relief sought on the grounds either that the companies involved are not smaller companies within the meaning of the Act or that it does not appear they are subjected to higher costs on that account; that in either case it is not consistent with the protection of investors and the purposes of the Act to grant the applications. Briefs have been filed and the Commission has heard oral argument on the cases.<sup>12</sup>

At the present time the certificates of unit investment trusts are sold almost entirely to investment companies issuing periodic payment plan certificates and form the underlying security which the investor purchases through his periodic payments. The Act designates the types of financial institutions which may act as trustee for such trusts, prevents the charging of expenses against such trusts before they are incurred, and seeks to insure that all of the securities and other assets of the trusts will be held intact for the benefit of investors.

#### FACE-AMOUNT CERTIFICATE COMPANIES

In discussing above the different types of investment companies under the Investment Company Act of 1940 it was indicated that among the chief problems presented under the Act by face-amount certificate companies were those of certificate reserves and of selling methods. Since January 1, 1941 (the effective date of the Act for this type of investment company), the efforts of the Commission in relation to this type of company have been directed mainly to the enforcement of the reserve requirements and certain related provisions of the Act pertaining to eligibility of assets, custody of assets, and certain provisions relating to cash surrender and loan values.

<sup>12</sup> On November 6, 1941, the Commission issued its findings and opinion in these proceedings, denying the applications on the ground that the applicants had failed to show that exemption was necessary or appropriate in the public interest and consistent with the protection of investors *American Participations, Inc., et al.*, Investment Company Act Release No. 249.

Probably the most important of these provisions are those requiring the establishment of reserve liabilities on an actuarial basis and the maintenance of eligible assets against such reserves. As the basic reserve requirement the Act requires a reserve be set up from each installment payment in an amount which, improved at the rate of 3½ percent compounded annually, will, together with similar amounts from all other such payments, equal the face amount of the certificate at its maturity. Any face-amount certificate company in business before the effective date of the Act which continues to issue face-amount certificates thereafter is required to maintain these reserves not only on the newly issued certificates but on all certificates issued and outstanding. Additional reserve requirements embrace deficiency reserves in the case of companies whose effective reserve rate is less conservative than that required by the Act and reserves against various kinds of special contract provisions.

The Investment Company Act of 1940 in its application to face-amount certificate companies thus differs somewhat in concept from the Act in its application to the more common types of investment company. A very close resemblance to State statutes regulating life insurance companies may be noted. It is obvious, therefore, that in administering these sections of the Act important actuarial questions arise in addition to the usual legal, accounting, financial, and selling problems. In its efforts to obtain compliance with these requirements the Commission has devoted much time to conferences and correspondence, much of it of a highly technical nature.

As of the end of the fiscal year there were 11 companies registered under the Act as face-amount certificate companies. It is impossible to state with accuracy how many of these companies intend to continue in active operation, that is to say, to continue selling their face-amount certificates. The largest company in this field is Investors Syndicate which had assets on a consolidated basis at the end of the fiscal year of approximately \$176,000,000. This company discontinued the sale of its certificates at or prior to the effective date of the Act, although it registered and has otherwise indicated its intention to comply with all the applicable sections of the Act. Thus, Investors Syndicate is not required to maintain the reserves previously mentioned, nor is it required to comply with certain other provisions since those requirements pertain only to companies which have engaged in the public distribution of its securities after the effective date of the Act. In lieu of offering its own securities, Investors Syndicate organized a subsidiary face-amount certificate company—Investors Syndicate of America, Inc.—whose structure and securities were expressly devised to meet the requirements of the Investment Company Act of 1940 and in particular the provisions of Section 28. Investors Syn-

dicating acts as the underwriter for its subsidiary in the distribution of its face-amount certificates and as the manager of its assets.

Fidelity Assurance Association, formerly known as Fidelity Investment Association, likewise discontinued the sale of its face-amount certificates prior to January 1, 1941, and at the end of the fiscal year was in reorganization proceedings in the United States District Court at Charleston, W. Va., under Chapter X of the Bankruptcy Act. The future activities of this company are, of course, largely dependent upon the outcome of these proceedings.

A number of companies somewhat smaller than the foregoing companies have registered under the Investment Company Act of 1940 and have also filed registration statements under the Securities Act of 1933, thus indicating their intention of going forward with their selling program as soon as they have worked out the technical details of compliance with the Investment Company Act of 1940 and the other applicable statutes.

An interesting variant of the face-amount certificate company was found in a number of States. An insurance company (usually a fire or casualty company) is organized under State laws and an affiliated company organized by the promoters of the insurance company. The affiliated company then offers to the public a face-amount certificate under the terms of which the purchaser is to pay to the issuing company \$1,200 over a 10-year period in monthly or other periodic installments, on the representation that at the end of the period the purchaser will receive back in cash the total of his payments to the company plus a specified number of shares of stock in the insurance company. These shares, under the plan, are purchased by the face-amount certificate company out of the earnings on the payments of the installment purchasers to the face-amount certificate company which are to be invested in various media. It is urged by these enterprises that the plan not only returns all the principal to the investor but finances the insurance company and secures a wide distribution of its stock which promotes good will. While 4 such companies registered under the Act during the fiscal year, no company of this type has yet revised its structure so that it could comply fully with the provisions of the Act and proceed with its selling program. The sales of the securities of all the companies of this type had been discontinued pending compliance with the Act.

In addition to the 11 face-amount certificate companies registered, there were perhaps 10 or 15 other companies throughout the country which had corresponded with or had been discovered by the Commission. With respect to these companies, disposition is being made of the questions as to their status and compliance.

The assets of the registered face-amount companies amounted approximately to \$215,000,000 at June 30, 1941.

## RULES, REGULATIONS, AND FORMS

Pursuant to the provisions of the Investment Company Act of 1940 the Commission, during the past fiscal year, promulgated general rules and regulations, together with appropriate forms, as described below:

	<i>Effective Date</i>
Rule N-1----- Sets out definition of terms-----	Nov. 1, 1940
Rule N-2----- General requirements of papers and applica- tions; authorizations and verifications with respect to applications; procedure for using application as evidence.	Nov. 1, 1940
Rule N-2A-1----- Pursuant to Section 2 (a) (39), this rule pro- vides certain alternative methods of comput- ing values of portfolio securities for the pur- pose of determining whether a registered company is a "diversified" or "non-diversi- fied" company and for other specified pur- poses.	Nov. 1, 1940
Rule N-2A-2----- In connection with the valuation of securities under Section 2 (a) (39), this rule provides alternative bases of computation with respect to the elimination of securities from the portfolio of an investment company.	Aug. 6, 1941
Rule N-3----- Formal requirements of amendments to regis- tration statements and reports.	Aug. 6, 1941
Rule N-5B-1----- Defines the term "total assets" when used in computing the valuation of securities for the purposes of Sections 5 and 12 of the Act.	Aug. 6, 1941
Rule N-6C-1----- Provides a temporary exemption from the re- quirements of Sections 26 and 27 upon speci- fied conditions for certain companies issuing periodic payment plan certificates. The exemption terminates on February 15, 1941, or on disposition of an application filed prior to that date for an order pursuant to Section 27 (b), whichever is later.	Nov. 1, 1940
Rule N-6C-2----- Provides a temporary exemption for any man- agement company which filed, prior to No- vember 15, 1940, an application for an order pursuant to Section 17 (f) (3) permitting it to maintain in its own custody its securities and similar investments. The exemption ceases upon final determination of any par- ticular application.	Nov. 1, 1940
Rule N-6C-3----- Provides a temporary exemption for any em- ployees' securities company which applied prior to November 15, 1940, for an order pursuant to Section 6 (b), pending the dis- position of the application.	Nov. 1, 1940
Rule N-6C-4----- Provides a temporary exemption for any com- pany which applied prior to November 15, 1941, for an order pursuant to Section 6 (d) pending the disposition of the application.	Nov. 1, 1940

- Rule N-6C-5----- Exempts from the prohibitions of Section 17 (a) Nov. 4, 1940  
any transaction between a registered company and affiliated companies or between the affiliated companies of the registered company if the transaction was approved by the board of directors of the registered company prior to the effective date of the Act.
- Rule N-6C-6----- As amended, provides a temporary exemption Nov. 29, 1940  
from Section 19 (dealing with information to accompany dividend payments) until February 28, 1941.
- Rule N-6C-7----- Provides a temporary exemption upon speci- Jan. 2, 1941  
fied conditions from the requirements that the independent public accountant for a registered company must be selected by a majority of certain members of the board of directors, with reference to any selection made up to November 1, 1941.
- Rule N-6D-1----- Sets out the type of information which shall be Nov. 1, 1940  
included in any application for an order pursuant to Section 6 (d) concerning exemptions of small companies selling securities intrastate. (See discussion, *supra* at p. 6.)
- Rule N-8A-1----- Prescribes Form N-8A for use as the notifica- Oct. 22, 1940  
tion of registration pursuant to Section 8 (a). (See discussion, *supra* at p. 9.)
- Rule N-8B-1----- Permits registered companies to file recitals of Feb. 14, 1941  
policy under the Act prior to the filing of the detailed registration statement pursuant to 8 (b).
- Rule N-8B-2----- Prescribes Form N-8B-1 as the form of detailed May 23, 1941  
registration statement for management investment companies. (See discussion, *supra* at p. 9.)
- Rule N-8C-1----- Sets out the circumstances under which infor- May 23, 1941  
mation filed pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934 may be used in lieu of information otherwise required in Form N-8B-1. (See discussion, *supra* at p. 10.)
- Rule N-10F-1----- Exempts upon specified conditions certain un- Feb. 26, 1941  
derwriting transactions of management companies which otherwise are prohibited unless such companies act as principal underwriters.
- Rule N-13A-1---- Sets out certain conditions under which a com- Aug. 6, 1941  
pany registered as non-diversified which had temporarily become diversified, may bring itself again within the former classification without the vote of a majority of its outstanding voting securities.

- Rule N-15A-1..... Exempts from a requirement of Section 15 (a) and (e) (that advisory contracts shall be approved by a majority of the outstanding voting securities) any advisory contract of a person not otherwise affiliated with the registered company where the fees for such service are relatively small. (See discussion, *supra* at p. 7.) May 2, 1941
- Rule N-17A-1..... Exempts from the prohibitions of Section 17 (a) (1) any transaction falling within the provisions of Rule N-10F-1. Feb. 26, 1941
- Rule N-17F-1..... States the conditions under which registered management companies may maintain their portfolio securities and similar investments in the custody of companies which are members of a national securities exchange. (See discussion, *supra* at p. 15.) Nov. 1, 1941
- Rule N-17F-2..... States the conditions under which registered management companies may maintain in their own custody their portfolio securities and similar investments. (See discussion, *supra* at p. 15.) Aug. 15, 1941
- Rule N-19-1..... Sets out the information which must accompany dividend payments by management companies to stockholders and methods of determining the sources from which such payments are made. (See discussion, *supra* at p. 11.) Mar. 1, 1941
- Rule N-19-2..... Provides, for the calendar year 1941, a method of disclosure of the sources of dividend payments in lieu of that required by N-19-1. Mar. 1, 1941
- Rule N-20A-1..... Blankets solicitations of proxies, consents, and authorizations with respect to any security issued by a registered company under Regulation X-14. (See discussion, *supra* at p. 11.) Nov. 1, 1940
- Rule N-23C-1..... Sets up the conditions under which a registered closed-end company of a certain type may repurchase securities it issued where other methods provided by Section 23 (c) are not feasible. It also adopts Form N-23C-1. (See discussion, *supra* at p. 18.) Mar. 4, 1941
- Rule N-30A-1..... Requires, in effect, that annual reports to the Commission must be filed by registered companies for each fiscal year ending after the filing of the detailed registration statement. (See discussion, *supra* at p. 10.) Jan. 2, 1941
- Rule N-30B2-1... Requires to be filed with the Commission copies of any reports to stockholders which contain financial statements. (See discussion, *supra* at p. 10.) Jan. 2, 1941

- Rule N-30D-1---- Requires reports to be transmitted by registered management companies to stockholders at least semi-annually and prescribes the information which such reports shall contain. (See discussion, *supra* at p. 10.) Jan. 2, 1941
- Rule N-30D-2---- Requires reports to be transmitted by certain registered unit trusts to shareholders at least semi-annually and prescribes the information which such reports shall contain. (See discussion, *supra* at p. 10.) Jan. 2, 1941
- Rule N-30F-1---- Prescribes Form N-30F-1 for initial statements of beneficial ownership of securities of registered closed-end companies to be filed by the persons specified in Section 30 (f) with certain exceptions. (See discussion, *infra* at p. 235.) Nov. 16, 1940
- Rule N-30F-2---- Prescribes Form N-30F-2 for statements of changes in beneficial ownership of securities of registered closed-end companies to be filed by the persons required to file Form N-30F-1. (See discussion, *infra* at p. 235.) Nov. 16, 1940
- Rule N-30F-3---- Exempts from the requirements of Section 30 (f) securities held by certain classes of persons, including those held in estates, by guardians and receivers. Apr. 16, 1941
- Rule N-45A-1---- Provides that certain information (concerning the names and addresses of dealers distributing the securities of a registrant) supplied by open-end management companies in the registration statements shall be the subject of confidential treatment and made available to the public only under prescribed conditions. May 23, 1941

## Part II

# ADMINISTRATION OF THE INVESTMENT ADVISERS ACT OF 1940

The Investment Advisers Act of 1940 requires the registration of investment advisers, that is, persons engaged for compensation in the business of advising others with respect to securities. The Commission is empowered to deny or revoke registration of such advisers if they have been convicted or enjoined because of misconduct in respect of security transactions. The Act also makes it unlawful for investment advisers to engage in practices which constitute fraud or deceit; requires investment advisers to disclose the nature of their interest in transactions executed for their clients; prohibits profit sharing arrangements; and in effect prevents assignment of investment advisory contracts without the client's consent.

### ENACTMENT AND GENERAL NATURE OF ACT

The Investment Advisers Act of 1940 was enacted on August 22, 1940, largely as a result of the Commission's study of and report to the Congress on investment advisory services<sup>1</sup> conducted ancillary to its study of investment trusts and investment companies pursuant to Section 30 of the Public Utility Holding Company Act of 1935. This new statute became effective on November 1, 1940. On and after that date it became unlawful for individuals or organizations to use the mails or any means or instrumentality of interstate commerce, including the facilities of any national securities exchange, in connection with their business as investment advisers, unless they were effectively registered with the Securities and Exchange Commission.

The Act covers all individuals, partnerships, corporations, or other forms of organization which for compensation engage in the business of advising others, either directly or through publications or writings as to the value of securities or as to the advisability of investing in, buying, or selling securities, or who for compensation and as part of a regular business disseminate analyses or reports concerning securities. Exempted from the provisions of the Act, however, are newspapers, magazines, and financial publications of general and regular circulation; brokers and security dealers whose investment advice is given solely as an incident of their regular business for which no special fee is charged; banks; certain bank holding company affiliates; individuals or organizations which give advice solely with reference to securities issued or

<sup>1</sup> Report of Commission to Congress on "Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services," August 1939.

guaranteed by the United States or corporations in which it is interested; and lawyers, accountants, engineers, and teachers whose investment advice, if any, is furnished solely incidental to the practice of their professions.

Exception from the registration requirements of this Act is provided for: (1) individuals or organizations which act as investment advisers solely for investment and insurance companies; (2) individuals or organizations all of the clients of which are residents of the State in which they do business, provided no advice is given with respect to securities traded on national securities exchanges; and (3) individuals or organizations which do not hold themselves out as investment advisers generally to the public and which have had during the preceding year less than fifteen clients.

Registered investment advisers are prohibited from employing any device, scheme, or artifice to defraud any client or prospective client, or to engage in any transaction, or practice, or course of business which operates as a fraud or a deceit upon any client or prospective client. These fraud provisions are similar to those under the Securities Act of 1933 and the Securities Exchange Act of 1934. Furthermore, if an investment adviser acts as a principal for his own account in connection with the sale of any security to or purchase of any security from a client, he must disclose to such client, in writing, the capacity in which he is acting with respect to such transaction, and obtain the consent of the client to such transaction.

#### REGISTRATION OF INVESTMENT ADVISERS

##### **Application for Registration.**

During the fiscal year the Commission adopted Form 1-R, the form to be used by investment advisers in applying for registration with the Commission. This application for registration requires information relating to the form of organization of investment advisers, their partners, officers, directors, controlling persons, employees, the nature of their business, the nature and scope of authority with respect to investment advisory clients' funds and accounts, and the basis of compensation for the investment adviser.

Form 1-R was sent to approximately 1,400 persons. Of this number, 605 were effectively registered as at November 1, 1940. Approximately 250 claimed that they were not encompassed by the Act or that they were excepted from the registration requirements of the Act. Between November 2, 1940, and June 30, 1941, 196 additional persons became registered under the Investment Advisers Act. On June 12, 1941, the Commission effected a general check-up of the persons who failed to communicate in any way with the Commission with respect to their registration applications. As at June 30, 1941,

the Commission has been able to clarify the records with respect to approximately 370 additional persons.

The following table sets forth information with respect to the status of the registration of investment advisers under the Act as at the end of the fiscal year:

*Applications and registrations of investment advisers—Fiscal year ended June 30, 1941*

Applications:	
Filed.....	812
Withdrawn.....	4
Pending.....	6
Registrations:	
Effective.....	753
Withdrawn.....	29
Cancelled.....	19
Denied.....	1

The registrants which withdrew their applications had determined prior to effective registration to discontinue their activities as investment advisers. One application was withdrawn at the suggestion of the Commission. It was found that the registrant in question had been in the Wisconsin State Prison since 1930 on a charge of assault with intent to murder and was not subject to parole until 1942.

The largest number of registrants which requested withdrawal of their effective registration claimed that they had discontinued their activities as investment advisers. In some cases they had consolidated with other investment adviser firms; in other instances they entered other employment.

The Commission has by order cancelled the registration of nineteen firms after finding that they were no longer engaged in investment advisory activities. In some instances, the reason for the cancellation was due to the fact that the firms were dissolved. In nine cases, the old firms were succeeded by new investment advisers.

The Commission has authority by the provisions of Section 203 (d) of the Investment Advisers Act of 1940 to deny registration if an applicant, within the ten years prior to registration, has been convicted of a crime in connection with security transactions or if he is enjoined by a court in connection with a security or financial fraud, or if his application for registration is materially misleading. In the exercise of this power, the Commission has denied registration to one investment adviser. The Commission found that this registrant while acting as a broker had been enjoined on April 18, 1940, by the Superior Court of New York from engaging in various acts and practices in connection with the purchase and sale of securities. He had been guilty of selling securities at prices which represented a very high percentage of profit to him. His customers in every case were elderly

people of modest means, having little knowledge of financial matters, who relied on the applicant's knowledge of securities and investments.<sup>2</sup>

The Commission has excepted by order, pursuant to Section 202 (a) (11) (F), the following three institutions from the provisions of the Act: Marine Midland Group, Inc., First Service Corporation, and Savings Banks Association of Maine. The Commission found after a hearing that these institutions were, on the basis of their present activities, not intended to be encompassed by the Investment Advisers Act of 1940.

#### **Semi-annual Report of Registered Investment Advisers.**

To maintain reasonably current the information contained in the registration application, the Commission has adopted Form 2-R as the form for semi-annual reports to be made by all registered investment advisers. This form is required to be filed with the Commission by each such investment adviser within 10 days after June 30 and December 31 of each year. Each registered investment adviser is to disclose on this form that after an examination of his original application he finds either that (1) no changes have been effected in his business so that no amendments are required to the registration application, or (2) that changes were effected so that amendments are required for items in the original registration application. These corrections are to be supplied by using those pages of Form 1-R which include the items that require amendment.

### **STATISTICS [RELATING TO REGISTERED INVESTMENT ADVISERS**

#### **Classification of Registered Investment Advisers.**

*By date of organization.*—The number of investment advisers has increased steadily in the last 10 years. Significantly, approximately 84 percent of the total number of firms which, as at the end of the past fiscal year, were effectively registered with the Commission as investment advisers had commenced their investment advisory activities since 1930. Seventy-seven firms, the largest number to commence such activities in any one year, were organized in the year 1940. The following table shows the number of investment advisers organized during each year.

<sup>2</sup> George C. Crowder, 8 SEC 947 (1941), Investment Advisers Act of 1940 Release No. 16.

*Investment Advisers—By year of organization*

Date of commencement of investment adviser activities	Number organized annually	Annual cumulative total	Date of commencement of investment adviser activities	Number organized annually	Annual cumulative total
1898.....	1	1	1921.....	8	38
1899.....	0	1	1922.....	3	41
1900.....	0	1	1923.....	10	51
1901.....	0	1	1924.....	11	62
1902.....	2	3	1925.....	11	73
1903.....	1	4	1925.....	7	80
1904.....	1	5	1927.....	10	90
1905.....	2	7	1928.....	18	108
1905.....	0	7	1929.....	14	122
1907.....	1	8	1930.....	29	151
1908.....	1	9	1931.....	52	203
1909.....	0	9	1932.....	58	261
1910.....	1	10	1933.....	51	312
1911.....	0	10	1934.....	44	356
1912.....	1	11	1935.....	39	395
1913.....	0	11	1936.....	40	435
1914.....	3	14	1937.....	57	492
1915.....	2	16	1938.....	73	555
1916.....	0	16	1939.....	59	624
1917.....	2	18	1940.....	77	701
1918.....	0	18	1941 (first 6 months).....	52	753
1919.....	7	25			
1920.....	5	30	Total.....	753	753

*By number of employees and form of organization.*—Approximately 50 percent of the investment advisers effectively registered with the Commission are sole proprietors. The total number of their personnel, both part time and full time, constitutes only approximately 10 percent of the total personnel of all effectively registered investment advisers. Six firms, or less than 1 percent of the registered investment advisers, employ approximately 25 percent of the total personnel employed by all registered investment advisers. Among these 6 is 1 firm which is engaged exclusively in giving continuous investment advice on the basis of the individual needs of each client, and employs 173 full time persons. This constitutes the largest full time personnel of any registered investment adviser. The remaining 5 firms are engaged in part in selling uniform publications, and employ a large number of part time personnel. A large proportion of these persons functions in part as salesmen. Among these 5 firms is included 1 firm of which practically 80 percent of the personnel is employed on a part time basis. The following table shows the status of registered investment adviser firms classified by number of personnel and form of organization.

Number of personnel <sup>a</sup>	Sole proprietors		Partnerships		Corporations		Total	
	Number of firms	Number of persons <sup>a</sup> employed	Number of firms	Number of persons <sup>a</sup> employed	Number of firms	Number of persons <sup>a</sup> employed	Number of firms	Number of persons <sup>a</sup> employed
1.....	183	183	3	3	10	10	196	196
2.....	141	282	10	20	21	42	172	344
3.....	44	132	18	54	24	72	86	258
4.....	21	84	13	52	17	68	51	204
5.....	11	55	10	50	20	100	41	205
6.....	5	30	12	72	16	96	33	198
7.....	4	28	8	56	15	105	27	189
8.....	1	8	2	16	6	48	9	72
9.....	2	18	7	63	10	90	19	171
10.....	2	20	4	40	1	10	7	70
11-15.....	5	63	9	120	22	202	36	475
16-20.....	1	18	12	217	9	164	22	399
21-25.....	0	0	3	67	9	210	12	277
26-50.....	0	0	11	334	16	551	27	885
51-75.....	0	0	0	0	7	429	7	429
76-100.....	0	0	0	0	2	181	2	181
Over 100.....	0	0	1	173	5	1,311	6	1,484
Total.....	420	921	123	1,337	210	3,779	753	6,037

<sup>a</sup> Includes sole proprietors, partners, and officers; does not include directors.

*By nature of affiliation with other activities.*—Approximately 65 percent of the registered investment advisers indicated that they were engaged in no other activities but that of furnishing investment advice. However, the remaining investment advisers did indicate that they engaged in activities other than that of rendering investment advice. Only approximately 25 percent of the effectively registered investment advisers are also registered with the Commission as brokers and dealers.

The table below indicates the range and extent of other activities engaged in by registered investment advisers.

Other business	Number	Other business	Number
Accountant.....	9	News syndicate.....	1
Advertising.....	2	Physicist.....	1
Bank adviser and agent.....	2	Professor and lecturer.....	6
Broker, dealer, and underwriter.....	152	Publisher.....	19
Business and estate management.....	37	Railroad operator.....	1
Engineer.....	5	Real estate business.....	4
Factory assistant.....	1	Salesman (not of securities).....	2
Farming.....	2	W. P. A.....	1
Importer.....	1	Writer.....	4
Insurance broker.....	4		
Lawyer.....	11	Total.....	274
Manufacturer.....	2	Firms with no other affiliations.....	479
Medical and dental profession.....	2		
Merchant.....	4		753
Meteorologist.....	1		

*By method of compensation.*—The Investment Advisers Act of 1940 makes it unlawful for registered investment advisers to enter into any profit-sharing arrangements with their clients on or after the effective date of the Act. As at November 1, 1940, 60 firms indicated that they had such profit-sharing agreements with their clients.

Approximately 35 percent or 283 of the effectively registered investment adviser firms base their compensation on a percentage of the value of the funds under their supervision. The average fee is one-half of 1 percent per year of the value of the funds supervised. In most of these cases the fee is payable quarterly and usually in advance. In a few cases an average minimum of approximately \$300 is charged.

Approximately 30 percent or 227 of the effectively registered firms charge a flat fixed fee. Some firms base their fee on a daily rate. The average fee of this kind is about \$25 a day. In other cases, the charge is determined by the number and character of securities under supervision. For example, some firms may charge \$1 for each stock in the client's portfolio under their supervision and \$2.50 for each bond. Some firms, on the other hand, charge an annual fixed fee varying from \$100 to \$500 a year to supervise a client's portfolio.

In cases where the investment adviser sells uniform publications, his compensation is usually based on a fixed subscription for the publication. One hundred forty-six firms use this method of compensation. In some instances the fees are as low as \$5 a month for the publications.

Thirty-three investment advisers indicated that they fix their compensation through individual negotiation with each client. In most cases they indicated that the fee was dependent on the amount of work required in supervising individual portfolios.

*By nature of investment advisory service.*—The Investment Advisers Act of 1940 provides that only those investment advisers who are primarily engaged in furnishing continuous investment advice as to the investment of funds on the basis of the individual needs of each client can represent, after November 1, 1940, that they are investment counsel or can use the name "investment counsel" as descriptive of their business.

An examination of the applications for registration filed under the Act discloses that approximately 300 persons indicated that they were primarily engaged in furnishing this personalized investment service. Approximately 165 firms indicated that their investment advisory service consisted only of the sale of uniform publications. These persons, of course, could not use the designation of "investment counsel" as descriptive of their activities. Likewise, persons who were engaged in furnishing personalized investment service and also issued uniform publications, or were conducting businesses other than that of investment adviser<sup>3</sup> cannot use the designation of "investment counsel" as descriptive of their activities. It was found upon an examination of the applications for registration that 283 firms were included in this category.

<sup>3</sup> See p. 34, *supra*, for a description of the various other businesses conducted by investment advisers.



## Part III

# PARTICIPATION OF THE COMMISSION IN CORPORATE REORGANIZATIONS UNDER CHAPTER X OF THE BANKRUPTCY ACT, AS AMENDED

Chapter X of the Bankruptcy Act, as amended in 1938, affords appropriate machinery for the reorganization of corporations (other than railroads) in the Federal courts. The Commission's duties under Chapter X are, first, at the request or with the approval of the court to act as a participant in proceedings thereunder in order to provide, for the court and investors, independent expert assistance on matters arising in such proceedings, and, second, to prepare, for the benefit of the courts and investors, formal advisory reports on plans of reorganization submitted to it by the courts in such proceedings.

### SUMMARY OF ACTIVITIES

During the past fiscal year, the Commission actively participated in 143 reorganization proceedings involving the reorganization of 176 companies (143 principal debtor corporations and 33 subsidiary debtors).<sup>1</sup> The proceedings were scattered among Federal district courts in 28 States, and involved the rehabilitation of companies engaged in such varied businesses and industries as shipbuilding, oil and gas production and transmission, manufacture of engines, lumber products, electrical and metal supplies, coal mining, wheat and flour mills, wholesale drugs, and many others. The aggregate stated assets of these 176 companies totaled approximately \$2,214,638,000, and their aggregate indebtedness totaled approximately \$1,354,357,000.<sup>2</sup>

In the development of administrative law the Commission's functions under Chapter X possess aspects to some extent novel. In the first place, its work in this sphere is done as a party to the proceedings before the court. The Commission does not initiate proceedings or hold its own hearings, nor has it the power to adopt rules and regulations governing these cases. In the second place, the Commission's functions under Chapter X are purely advisory in character. It has no authority under the Act either to veto or to require the adoption of a reorganization plan. It has no authority to adjudicate any of the other issues arising in a proceeding. Nor has it the right of appeal. The facilities of its technical staff and its disinterested recommendations are simply placed at the service of

<sup>1</sup> Appendix IV, p. 357 contains a complete list of reorganization proceedings in which the Commission participated as a party during the fiscal year ended June 30, 1941.

<sup>2</sup> These totals and those appearing in tables 38 to 42 inclusive of Appendix II include unpledged assets and direct operating indebtedness of one of the debtors, an investment company, but do not include outstanding face amount certificates on which the company's net cash liability was approximately \$23,000,000, against which were deposited securities having a market value, as of June 30, 1941, of approximately \$20,000,000.

the Federal courts, affording the latter the views of experts in a highly complex area of corporate law and finance.

In the exercise of its functions under Chapter X the Commission has continued in its endeavor to assist the courts in achieving equitable, financially sound, expeditious, and economical readjustments of the affairs of corporations in financial distress. To aid in attaining these objectives the Commission has stationed qualified staffs of lawyers, accountants, and analysts in its various regional offices and has assigned them exclusively to the performance of the Commission's duties under Chapter X. The presence of these staffs in the field permits them to keep in close touch with all hearings and issues in the proceedings and with the parties, and makes them readily available to the courts, thus facilitating the work of the courts and the Commission. During the fiscal year the Commission also submitted briefs as *appellee* or as *amicus curiae* in various appeals raising significant legal questions in Chapter X proceedings.

Because the Commission's advisory reports on plans of reorganization are usually widely distributed, this aspect of the Commission's work under Chapter X stands out most prominently. These reports by no means, however, represent the major part of the Commission's activities in these cases. As a party to a Chapter X proceeding, the Commission is actively interested in the solution of every major issue arising therein from the time it becomes a participant to the close of the proceeding. The Commission has felt that to perform its duties as a party adequately it is required to undertake in every case the same intensive legal and financial studies which are required for the preparation of formal advisory reports, whether or not such reports are required or will be requested. In all cases such studies are essential in order to consider and discuss various reorganization proposals while plans are in the stage of formulation, and in cases where the plans are not submitted to the Commission for advisory report it is necessary that the Commission be prepared to comment fully upon all proposed plans at hearings on their approval or confirmation.

During the past fiscal year the Commission submitted 5 formal advisory reports on plans of reorganization. In addition, 4 supplementary advisory reports were filed in proceedings where advisory reports had previously been submitted, and 1 other advisory report and 2 supplementary advisory reports were in the course of preparation at the end of the fiscal year. In 50 other cases, which had reached the plan stage in the proceeding and in which no formal reports as such were to be submitted, the Commission made extensive studies of the debtor's problems, and participated in conferences with respect to the formulation of plans or at the hearings thereon presented to the court analyses of the Commission's views and its recommendations with respect to them.

In its Sixth Annual Report<sup>3</sup> the Commission emphasized that it has been in an advantageous position to encourage the development of uniformity in the interpretation of Chapter X of the Bankruptcy Act and in the procedure thereunder. Thus, the Commission has often been called upon by parties, referees, and special masters for advice and suggestions with regard to matters of procedure and the form and content of necessary orders in the proceedings. Thereby, the Commission has been able to afford substantial aid out of the store of experience accumulated through participation in many reorganization cases. The Commission has also been able, in this manner, to save the court officers and the parties much of the effort that would have been entailed in handling such questions *de novo*, as well as the time and expense involved in retracing steps improperly taken. This work of the Commission has been of special value due to the fact that the solutions of most procedural and interpretative questions are not likely to find their way into the official or unofficial reports and are, therefore, largely unavailable outside of the particular district of their decision. The Commission has also proceeded, primarily through the method of informal suggestion and conference, to call to the attention of parties any violations of or lack of compliance with the procedural provisions of Chapter X. These activities continued with increased success during the past fiscal year.

Another important phase of the reorganization proceeding to which the Commission has been giving increasing attention relates to the drafting and preparation of corporate charters, bylaws, trust indentures, voting trust agreements, and other similar instruments which are to govern the internal structure of the reorganized debtor after the reorganization proceedings are consummated. In general, the Commission has striven to obtain the inclusion in these instruments of various provisions which will assure to the investors a maximum of protection. Thus, special attention has been given to (1) provisions which comply with the statutory requirements that security holders receive complete and reasonably up-to-date information with regard to the enterprise, and (2) provisions setting up adequate machinery whereby the investors may act together for the protection of their interests and enforcement of their rights. In these matters the Commission has proceeded generally through the method of informal conferences and recommendations to the trustee and other parties who may have the primary responsibility for the preparation of the instruments. In cases where this method proved unsuccessful to obtain a revision of an instrument, and the need for revisions was deemed sufficiently important, the matters were brought to the attention of the judge in open court.

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<sup>3</sup> Page 59.

**STATISTICS ON CHAPTER X REORGANIZATIONS****Proceedings in which the Commission Participated.**

During the period from September 22, 1938 (the date the amended Bankruptcy Act became fully effective) to the beginning of the fiscal year, the Commission had filed its notice of appearance in 134 proceedings involving the reorganization of 168 corporations (134 principal debtor corporations and 34 subsidiary debtors). During the past fiscal year, the Commission filed its notice of appearance in 40 additional proceedings involving the reorganization of 45 corporations (40 principal debtor corporations and 5 subsidiary debtors). The Commission filed its notice of appearance at the request of the judge in 16 proceedings, while in the remaining 24 the Commission entered its appearance upon approval by the judge of the Commission's motion to participate. Of the 40 proceedings, 35 were instituted under Chapter X, and 5 under Section 77B. The debtors involved in these 40 proceedings had aggregate stated assets and aggregate indebtedness of approximately \$134,813,000 and \$97,621,000, respectively.<sup>4</sup>

Of the total of 174 proceedings in which the Commission became a party from September 22, 1938 to June 30, 1941, 3 were closed in the 1939 fiscal year, 28 (involving 6 subsidiary debtors) were closed in the 1940 fiscal year, and 29 (involving 6 subsidiary debtors) were closed in the 1941 fiscal year. (As used here, the word "closed" means that a final decree had been entered, or that the proceeding had been dismissed or otherwise terminated, or that reorganization was so near completion that active participation by the Commission was no longer necessary.) The remaining 114 proceedings, in which the Commission was actively participating as of June 30, 1941, involved 141 corporations (114 principal debtor corporations and 27 subsidiary debtors). These debtors had aggregate stated assets of approximately \$1,894,327,000 and aggregate listed liabilities of approximately \$1,201,782,000.<sup>4</sup> Tables 38 to 42 of Appendix II, pages 307 to 308, contain further statistical information of reorganization cases instituted under Chapter X and Section 77B in which the Commission filed a notice of appearance and in which it was actively interested in the proceedings during the past fiscal year.

**All Reorganizations under Chapter X.**

Section 265a of the Bankruptcy Act, as amended, provides that the clerks of the various Federal district courts shall transmit to the Commission copies of every petition for reorganization filed under Chapter X and copies of other specified documents filed in the proceedings. The Commission has analyzed and compiled the information in these petitions and documents and makes the information available, for public use, by issuing periodic statistical analyses of proceedings under Chapter X.

<sup>4</sup> See footnote 2, *Supra*, p. 37.

A statistical analysis of Chapter X proceedings instituted during the past fiscal year is contained in Appendix III, page 315.

#### THE COMMISSION AS A PARTY TO PROCEEDINGS

As stated previously, Section 208 of the Act provides that the Commission shall become a party to a proceeding under Chapter X if requested by the judge, and may become a party upon its own initiative with the approval of the judge. The Commission has not considered it appropriate or necessary that it move to participate in every Chapter X case. Apart from the fact that, with cases being instituted at the average rate of approximately 300 a year, the administrative burden would be very large, many of the cases are small, involving only trade or bank creditors and a few stockholders. As a general matter the Commission has deemed it appropriate to move to participate only in proceedings in which a definite public investor interest is involved. As a rough, practical test, proceedings are considered to have a public interest sufficient to warrant Commission participation if they involve securities outstanding in the hands of the public in the amount of \$250,000 or more. But mere size of public investor interest is, of course, not the only criterion. Often, the Commission may deem it appropriate to enter smaller cases where an unfair plan has been or is about to be proposed, where the public security holders are not adequately represented, where the proceedings are being conducted in violation of important provisions of the Act, or where other facts indicate that the Commission may perform a useful service by participating. On occasion, also, the Commission has entered smaller cases in response to a request by the judge.

By reason of the immediate availability of a large portion of the Reorganization Division staff in the field at the location of the proceedings themselves, and because the provisions of the amended Act require the prompt transmission to the Commission of all petitions for reorganization filed under Chapter X, the Commission's consideration of the question of participation is greatly facilitated. In cases involving a substantial amount of public investor interest, the Commission's appearance in the case as a party is generally noted within 1 or 2 weeks after the original petition is filed. In smaller cases where the desirability of participation may not be immediately apparent, a preliminary study is promptly undertaken to obtain the data necessary to decide the question.

As soon as the Commission has become a party to a proceeding, the first effort of the Commission is to assemble and analyze all available information concerning the debtor and its affairs. This information normally relates to the physical and financial condition

of the company, the causes of its financial collapse, the quality of its management, its past earnings and future prospects, and the reasonable worth of its properties. In obtaining this information the members of the Commission's staff who are assigned to the various regional offices of the Commission generally work on the scene in consultation with the trustee of the debtor, his counsel, and the other parties to the proceeding. The information thus acquired is complemented by independent examination of the debtor's books and records by the accountants and by independent research of the analytical and financial staff of the Commission with respect to general economic factors affecting the particular company and competitive and market conditions and prospects in the particular industry. The results of these studies provide a solid factual basis for the future direction of the Commission's activity in the case.

As a party to the proceeding the Commission is represented at all important hearings and, on appropriate occasions, files legal and financial memoranda in support of its views with respect to the various problems arising in the proceeding. However, the activities of the Commission as a party are not limited to those formal appearances and formal memoranda. Of equal, if not greater, importance, is the function performed in regularly participating in informal conferences and discussions with the parties to the proceeding. These conferences generally take place in advance of formal hearing and argument on the various important issues arising in connection with the formulation of a plan or the administration of the estate, with a view to ascertaining if these issues may be worked out in terms of practicable solutions consistent with the purpose of the proceedings. By consultation and discussion before formal action or hearing, the Commission has often been able to bring facts, arguments, or alternative solutions to the attention of the parties which they had not previously considered, and parties have often been prompted thereafter to modify or alter their proposed action. Frequently a course of action suggested during the conference meets the approval of all concerned. In general, the Commission has found these informal round-table discussions an effective means for cooperation and of great value in expediting the proceedings.

There is a multitude of diverse issues with which the Commission is concerned as a party to a Chapter X proceeding. To illustrate the scope of the Commission's activity, a brief account is presented below of some of the issues which arose in representative cases in which the Commission participated during the past fiscal year. These are necessarily but a minute sampling of the manifold issues, wholly apart from the preparation of advisory reports, with which the Commission was concerned in the 143 cases in which it was participating during the year.

(1) A voluntary petition for the reorganization of a relatively small manufacturing company was filed late in 1938. The petition was approved by the court and a trustee was appointed. After a preliminary investigation and inquiry into the affairs of the debtor, the Commission determined, in view of the small amount of public investor interest involved, to defer the matter of participation but to observe closely developments in the proceedings. In August 1940, the reorganization being no nearer consummation than it was when the petition was filed, and it appearing that the bondholders were not being adequately represented by disinterested parties, that there was a need for independent investigation of certain charges of fraud and mismanagement, that fees were being sought which seemed excessive, and that there had been a failure to observe important procedural requirements of Chapter X, the Commission filed a motion for leave to file its notice of appearance, which motion was granted.

Immediately after the Commission became a party to the proceeding, conferences were held with the trustee and other parties concerning the future progress of the case. The requirements of the statute concerning the investigation by the trustee of the affairs of the debtor and the transmission to the security holders of a report of the results of the investigation, were emphasized to the trustee. Also, the Commission assembled all available information relating to the debtor and undertook an independent investigation covering, *inter alia*, such matters as possible causes of action for mismanagement and fraud, the relationship between the debtor and certain affiliated companies, and the amount and propriety of fees charged in connection with a prior voluntary reorganization.

After preparation of the trustee's report of the results of his investigation of the property, liabilities, and financial condition of the debtor, a draft of such report was submitted to the Commission for its views. In the opinion of the Commission the report was inadequate to fulfill its primary purpose, viz., to give the security holders full and accurate information concerning the affairs of the debtor so that they may be in a position to make suggestions with respect to a plan and to vote on a plan on the basis of an informed judgment. Representatives of the Commission conferred with the trustee and the report was amended in accordance with the Commission's suggestions for improvement. The report was sent to security holders and filed with the court in November 1940.

A plan of reorganization was then filed by the trustee in December 1940. Upon consideration and analysis of the plan, the Commission was of the view that the plan was neither fair nor feasible and, accordingly, filed a comprehensive memorandum stating its objections to the plan. *Inter alio*, the Commission pointed out that (1) the securities to be issued to senior claimants did not provide for full compensa-

tory treatment for their claims; (2) there was an unfair distribution of voting power as between the various classes of claimants; and (3) the plan provided for a capital structure which was needlessly complex. Thereafter, the trustee filed an amended plan of reorganization which substantially met the objections raised by the Commission to the original plan. After hearings on the amended plan, it was approved by the court on March 19, 1941, and was thereafter accepted by the security holders and confirmed on May 1, 1941.

After confirmation of the plan the Commission continued to be active in the proceedings. The proposed new trust indenture, chattel mortgage, voting trust agreement, articles of incorporation, and by-laws of the reorganized company were examined. During informal conferences with the parties to the proceeding, the Commission made numerous suggestions for the revision of these instruments, which were adopted. In general, these suggestions were designed to assure greater protection for the interests of the public security holders.

The Commission also participated in the hearings and submitted to the court its recommendations with respect to the applications for allowance of compensation for services rendered and reimbursement of expenses incurred by the various parties. In addition, the Commission submitted its views with respect to the proper procedure to be followed in these matters and pointed out that the amounts requested by certain of the applicants were unreasonable because the services rendered by them were unnecessary and duplicative; and that certain of the requests were excessive in the light of the size of the estate, its ability to pay, and the benefit to the estate from the services rendered. Further, the Commission indicated that certain of the applicants should be denied any compensation because their services did not result in any benefit to the estate or contribute to the plan of reorganization, and that certain other applicants should be denied any compensation because they represented conflicting interests, on the basis of the recent United States Supreme Court decision of *Woods v. City National Bank and Trust Co. of Chicago*.<sup>5</sup>

Thus, within less than a year after the Commission became a party to the proceedings, a plan of reorganization has been confirmed and, except for the decision of the court on the applications for allowances, the reorganization has been completed.

(2) In another case, a voluntary petition was approved by the judge and a trustee was appointed for a debtor which had discontinued its manufacturing operations and was engaged in the leasing of its various plants and buildings. Over \$1,000,000 of the debtor's first mortgage bonds were widely distributed in small amounts in the hands of the public. In view of this substantial public investor interest the

<sup>5</sup> 61 Sup. Ct. 493.

Commission moved promptly to participate in this case, and filed its notice of appearance with the approval of the judge.

The following are some of the matters which the Commission considered during the course of the proceeding:

(a) After examining into the facts bearing upon the qualifications and disinterestedness of the trustee in accordance with the standards prescribed by Sections 156 and 158 of Chapter X, the Commission determined that there was no basis for objecting to the retention of the trustee in office.

(b) A petition for an order fixing the time and manner of presentation of claims was filed in the proceedings. The Commission pointed out to the trustee that the order on such petition should provide that individual bondholders be allowed to file proofs of claim, even though the trustee under the indenture for the bonds was also authorized to file a claim on behalf of all bondholders, because under the provisions of Chapter X only those bondholders who file proofs of claim could be counted in connection with voting on a plan of reorganization. The Commission also recommended that forms of proof of claim be sent to all bondholders, to make it unnecessary for individual bondholders to obtain the services of counsel in preparing their proofs of claim. These recommendations of the Commission were adopted by the trustee.

(c) The trustee had presented to the court *ex parte* applications, asking approval of proposed leases and authority to expend substantial sums of money for repairs. The Commission opposed the presentation of such matters *ex parte*. In discussions with the trustee, it was pointed out that, even if the matter was not of sufficient importance to require notice to all security holders, notice should at least be given to all parties to the proceedings, with which the trustee agreed. Again, the trustee requested from the court authority to sell certain of its machinery and equipment. The Commission discussed with the trustee the proper procedure to be followed in this matter and, as suggested by it, notice of the proposed sale was sent to all security holders; the sale was held by public auction, subject, however, to subsequent approval by the judge; and an opportunity was given all security holders to object to the terms of the sale before the judge.

(d) In July 1940, the trustee filed a plan of reorganization with the court. After examination thereof, the Commission advised the trustee that his plan was in many respects incomplete and that it disregarded the requirements of fairness and feasibility in that there was no attempt made in the plan to recognize the respective priorities of the claimants. Thereafter, the plan of reorganization was discussed with the trustee and other parties before the date set for hearing on the plan. These conferences led to a satisfactory plan of reorganiza-

tion, worked out with the trustee and the parties, which was filed with the court. After hearings thereon the plan was approved by the court; two alternative plans proposed by other parties were opposed by the Commission and rejected by the court.

(e) In connection with the plan which he later approved, the judge raised certain legal and procedural questions and requested that the Commission and certain other parties submit their views. The plan provided for a gradual liquidation of the debtor's assets and the principal question raised by the judge was whether such a plan was permissible under the statute. The Commission expressed the view that such a plan is within the statutory definition of a plan of reorganization.

#### **Activities with Regard to Allowances.**

Every reorganization case ultimately presents the difficult problem of allowances to the various parties for services rendered and expenses incurred in the proceeding. In this matter the general practice of the Commission has been, initially, to make certain that the individual applications contain full information as to the nature and the extent of the services and expenses for which allowances are sought, that the necessary affidavits are submitted, and that adequate notice of the hearing on the applications is given to the security holders. A detailed study is then made by the Commission of the amount and kind of work performed by the different applicants. At the hearing on the applications, the Commission advises the judge with respect to its recommendations concerning the merits of the respective applications and the total charges with which the estate can be burdened, in light of its financial condition and related factors.

The Commission has been able to provide considerable assistance to the Federal courts in dealing with this problem. The Commission itself may not receive allowances from the estate for the services it renders, and is able to present a wholly disinterested, impartial view of the problem. It has sought to assist the courts in protecting reorganized companies from excessive charges while, at the same time, equitably allocating compensation on the basis of the claimants' contributions to the administration of the estate and the formulation of a plan. In this connection, it has been deemed important that unnecessary duplication of work shall not be compensated and that the aggregate of allowances shall not exceed an amount which the estate can afford to pay. With these objectives in mind, the Commission may undertake to make specific recommendations to the courts as to the amount to be allowed in cases where the Commission has been a party throughout the proceeding and is thoroughly familiar with the activities of the various parties and all significant developments in the proceedings; in other cases, e. g., where it has entered the proceeding at an advanced stage, the Commission has undertaken at

least to advise the court generally as to whether it considers the requested amounts reasonable, moderately excessive, or exorbitant, and the reasons for these views.

#### PLANS OF REORGANIZATION UNDER CHAPTER X

The Act requires, as a condition to confirmation of a plan of reorganization, that the judge be satisfied that the plan is "fair and equitable, and feasible." The consummation of a plan which meets these requirements is, of course, the ultimate objective of any reorganization proceeding. The Commission's primary function under Chapter X is to aid the courts in the attainment of this objective.

In appraising the fairness of plans the Commission has consistently taken the position that, to be fair, plans must provide full compensatory treatment for claims and interests of creditors and stockholders according to the order of their legal and contractual priority, either in cash or new securities or both. The implications of this principle have been followed consistently by the Commission, and its position has been fully sustained by the decision of the Supreme Court in *Case v. Los Angeles Lumber Products Co., Ltd.*,<sup>6</sup> in which the principle was reiterated and given new vigor in its application to Chapter X proceedings.

The requirement of feasibility relates to economic soundness of the proposed financial structure. In a recent opinion, the Commission stated that the essence of feasibility "may be said to be that a plan is of such a character that it gives reasonable assurance that the reorganized enterprise will operate economically and efficiently, will be able to perform the purposes of its existence and will not so far as foreseeable result in the necessity for another reorganization with its attendant expense and injury to investors."<sup>7</sup> In appraising the feasibility of plans the Commission has given consideration to such matters as the adequacy of working capital, the relationship of the funded debt or capital structure to property values, the ability of corporate earning power to meet interest and dividend charges, the effect of the proposed new capitalization upon the company's prospective credit, and the desirable objective that new securities shall not by their terms or otherwise be deceptive to subsequent purchasers.

#### Determination of Value.

A prerequisite to the formulation of a fair and feasible plan of reorganization is the determination of the value of the debtor's enterprise for reorganization purposes. The Commission has consistently adhered to the position that, for reorganization purposes, the capitalization of reasonably prospective earnings is the most reliable method of valuation; that the value so found should be the controlling factor

<sup>6</sup> 308 U. S. 106.

<sup>7</sup> *In the Matter of Inland Power and Light Corporation*, Holding Company Act Release No. 2042.

in arriving at an appropriate capital structure for the reorganized debtor and should provide the basis of allocation of new securities among the debtor's creditors and stockholders. The position which the Commission has consistently urged with respect to valuations was fully sustained by the decision of the United States Supreme Court in *Consolidated Rock Products Co. v. DuBois*, decided March 3, 1941, in which the Commission participated as *amicus curiae*. The Court's opinion, per Douglas, J., contained the following controlling statement on the problem of valuation in reorganization proceedings:

"In the second place, there is the question of the method of valuation. From this record it is apparent that little, if any, effort was made to value the whole enterprise by a capitalization of prospective earnings. The necessity for such an inquiry is emphasized by the poor earnings record of this enterprise in the past. Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization. Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine qua non* to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule of *Case v. Los Angeles Lumber Products Co.*, *supra*. Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result.

"As Mr. Justice Holmes said in *Galveston, Harrisburg & San Antonio Ry. Co. v. Texas*, 210 U. S. 217, 226, 'the commercial value of property consists in the expectation of income from it.' And see *Cleveland, Cincinnati, Chicago & St. Louis Ry. Co. v. Backus*, 154 U. S. 439, 445. Such criterion is the appropriate one here, since we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties. It is plain that valuations for other purposes are not relevant to or helpful in a determination of that issue, except as they may indirectly bear on earning capacity. *Temmer v. Denver Tramway Co.*, 18 F. (2d) 226, 229; *New York Trust Co. v. Continental & Commercial Trust & Sav. Bank*, 26 F. (2d) 872, 874. The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations, or disaster, and if the allocation of securities among the various claimants is to be fair and equitable. *In re Wickwire Spencer Steel Co.*, 12 F. Supp. 528, 533; 2 Bonbright, *Valuation of Property*, pp. 870-881, 884-893. Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate. See Finletter, *The Law of Bankruptcy Reorganization*, pp. 557 *et seq.* But hardly more than that was done here. The Circuit Court of Appeals correctly left the matter of a formal appraisal to the discretion of the District Court. The extent and method of inquiry necessary for a valuation based on earning capacity are necessarily dependent on the facts of each case."

To illustrate various aspects of the fair and feasible plan which have arisen in cases in which the Commission was not required to file a for-

mal advisory report and to indicate the position of the Commission with respect thereto, a number of examples are given below.

In one of the proceedings in which the Commission participated during the past fiscal year, the debtor's only asset, an apartment hotel, had an estimated value considerably less than the amount of the first mortgage bondholders' claims. Nevertheless, a plan of reorganization proposed by the debtor provided for participation by both second mortgage bondholders and stockholders. It was proposed that a loan would be obtained, part of the proceeds of which would be used for improvements and the remainder to be distributed to bondholders on the basis of approximately 28 cents on the dollar. The preferred stock of the reorganized company would be divided equally between the first mortgage bondholders and the second mortgagees, while the stockholders would retain their present interests. The Commission successfully opposed the plan on the ground that it was unfair in recognizing junior interests for which there was admittedly no equity. The Commission also was of the opinion that the plan was not feasible since the value of the assets was probably less than the amount of the proposed new mortgage; furthermore, it seemed extremely doubtful whether, even after rehabilitation, the earnings would be sufficient to pay interest and amortization charges. Subsequently, the trustee proposed a plan which provided for complete elimination of all interests junior to the first mortgage bondholders. Under the trustee's plan the bondholders would have received all of a new issue of preferred stock and 40 percent of the new common. The remainder of the common stock was to be sold for cash to an experienced hotel operator. Although the Commission did not object to the trustee's plan, it made several suggestions with respect to minor modifications, most of which were adopted. Subsequently the plan was accepted by the bondholders and confirmed by the court.

In another proceeding in which the Commission is participating, the debtor carries on, directly and through a number of wholly-owned subsidiaries, the business of subdividing and developing real estate, operating hotels, cottages, a water supply company, a lumber and supply company, and owning and leasing farm properties, dam sites, and other properties. The debtor has outstanding in excess of \$800,000 principal amount of first mortgage bonds which are secured by certain of the debtor's properties and all of the outstanding shares of one of its subsidiaries. The debtor also owes approximately \$250,000 to a bank secured by certain other properties of the debtor and the shares of another of the debtor's subsidiaries, viz., a hotel subsidiary. All of the preferred and common stock of the debtor is closely held by persons who are also creditors of the debtor.

The trustee filed a plan of reorganization. The main features of this plan provided for the continued existence of the debtor and the organization of a new corporation which was to acquire all of the assets pledged as security for the first mortgage bonds. All of the common stock of the new corporation was to be distributed to the bondholders. A new loan of approximately \$195,000 was to be made by the bank to the new corporation, which loan was to be secured by a pledge of all of the bondholders' assets. Of the loan, \$120,000 was to be used to purchase furniture and equipment from the hotel subsidiary and the balance was to be used to pay all reorganization expenses, outstanding trustee certificates, all claims requiring payment in cash, and unsecured obligations of the hotel subsidiary. The entire \$120,000 secured by the hotel subsidiary upon the sale of the furniture to the new corporation was to be returned directly to the bank, \$30,000 by way of payment of a note to the debtor pledged by the bank and the balance by virtue of the hotel subsidiary's guaranty of the bank loan.

After careful analysis of all available information, the Commission came to the conclusion that the plan, on its face, was unfair as well as lacking in feasibility. In the first place it was the belief of the Commission that the plan, in essence, operated to improve the status of the bank claim at the expense of the bondholders. It appeared that two of the directors of the debtor were also directors of the bank. Under the plan, the bondholders were required to accept equity securities in a new corporation and pledge all the assets of the new corporation to secure a new loan of \$195,000 from the bank from which they were to receive no benefit and the necessity of which was not shown. Also, the bondholders were being foreclosed of any right to a deficiency claim against other assets of the debtor without any determination of the value of their security. The bank, on the other hand, which had a \$250,000 claim against the debtor, secured by a small portion of the assets, would, upon consummation of the proposed plan, have a \$325,000 claim, \$195,000 of which would be secured by a first lien against all of the property which now secured the bonds, and the balance of \$130,000 would be secured by all the property now securing its present \$250,000 claim.

Also under the plan, the present stockholders were to receive all of the stock of the debtor without any determination that there was any equity over the secured claims. Further, it appeared that the stockholders had obtained possession of approximately two-thirds of the bonds, at least a substantial portion of which had been acquired under circumstances which might afford substantial grounds for the subordination of the claims of such bonds to the claims of the public bondholders. In the opinion of the Commission, approval of any plan as fair before this question had been fully explored was unwarranted.

The Commission also noted that the trustee had failed to investigate causes of action available to the estate, based upon the possible violation of the trust indenture on the part of the directors and the indenture trustee with respect to partial releases of the security underlying the bonds which were in default. Further, in the opinion of the Commission, the plan was not feasible (1) because it appeared that both the debtor and the new corporation would begin operations with a large secured indebtedness and with no apparent source of income sufficient to meet the fixed charges on this indebtedness or to meet its payment at maturity; and (2) because it did not appear that either corporation would begin operations with sufficient working capital and since substantially all of the assets were to be pledged, there was little likelihood that either corporation would be able to later obtain funds for working capital.

The Commission's objections to the plan were incorporated into a memorandum which was filed in the proceedings. Also, counsel for the Commission participated at the hearing on the plan and presented the views of the Commission with respect to the plan in open court. In accordance with the position urged by the Commission the court disapproved the plan. A new plan is now in the process of being formulated.

In another case, the debtor owned a hotel which, on the basis of prospective earnings, had a value considerably less than the amount due on the first mortgage certificates. A plan was proposed which gave no recognition to any class below the first lienors. It called for an extension of the entire mortgage at a modified interest rate payable if earned. The property was to be administered by three trustees, the successor trustees to be appointed by the court.

The Commission was opposed to the trustee mechanism, urging instead a corporate arrangement which would, *inter alia*, increase certificate holders' control of their affairs. Also, it took the position that the plan was not feasible unless the proposed mortgage was reduced to a figure duly proportionate to the valuation.

Primarily as a result of informal conferences with the parties, the original plan was amended to eliminate these objectionable features. In the final plan, the bonds were extended 10 years, the new mortgage was 50 percent of the total face amount of the outstanding bonds, and a new corporation was provided as the vehicle. As a result of these major changes, the Commission did not oppose approval of the plan.

#### ADVISORY REPORTS ON PLANS OF REORGANIZATION

As has been pointed out, in order to be in a position to render the utmost assistance to the court with respect to the legal and financial problems arising in the course of the proceedings, the Commission undertakes its own comprehensive examination of the financial

condition of the debtor, including the factors bearing upon its earnings and valuation. Accordingly, when the proceeding reaches the stage of preparation and submission of plans, the Commission is in a position to discuss its views thereon with the parties and to present its recommendations on the plan in open court or, if required to do so, to submit a formal advisory report expressing its opinion with respect to the proposed plans.

The usual procedure in the reference of a plan to the Commission for such report is as follows: after the trustee has filed a plan a hearing is held at which the plan and objections thereto are considered. Also any other plans or amendments to the trustee's plan which may at that time be submitted by creditors, stockholders, or the debtor may be considered at this hearing. At this stage of the proceeding it is the concern of the attorneys representing the Commission to see that an adequate factual record is made to enable the judge to decide whether any one or more of the plans are worthy of consideration, and to supply the factual groundwork for the Commission's report. If the record develops inadequately, the Commission's attorneys endeavor to remedy the deficiencies either through the trustee's witnesses or by calling their own experts. Frequently, the Commission has cooperated with the appropriate parties in the preparation for such hearings, during which it goes over the matters necessarily to be considered, and aids in the formulation of the record. After such hearing, if the judge finds any one or more of the plans worthy of consideration, they are referred to the Commission, which then prepares and submits its report. If a plan is then approved by the judge as fair and equitable, and feasible, it is transmitted to the security holders for their acceptance or rejection, accompanied by a copy of the judge's opinion on the plan and a copy of the Commission's advisory report or a summary thereof prepared by the Commission. In this manner, the advisory report serves also to aid security holders in their decision to accept or reject the plan.

During the past fiscal year the Commission submitted formal advisory reports on five plans of reorganization. A brief summary of these reports follows:

*Mortgage Guarantee Company, Debtor, and Saratoga Building and Land Corporation, Druid Park Apartments Company, and Wyman Park Apartments Company, Subsidiaries.*—The business of the debtor and its subsidiary companies was investing in mortgages on real estate and selling guaranteed participations in these mortgages to the public. The debtor also acted as agent for the certificate holders in the collection of interest and in the performance of similar duties. Financial difficulties, which struck the debtor at the beginning of the depression, led to a voluntary plan of reorganization in 1933, the principal feature of which was a reduction in the interest received by the certificate

holders. In 1937, steps were taken toward a second voluntary plan. Inability to secure sufficient assents, however, led to abandonment of the 1937 plan and to the filing of the debtor's petition on September 16, 1939.

The reorganization was complicated by the fact that, during the years preceding the filing of the petition, the debtor, pursuant to the terms of the certificates, had foreclosed and taken title to many of the properties on which mortgage participation certificates had been sold. These properties, referred to as the debtor-owned properties, were treated differently in the final plan from other properties on which the mortgages had not as yet been foreclosed, referred to as the third-party mortgages. The first attempt at a plan of reorganization, formulated by the independent trustee, contemplated pooling all of the properties and mortgages and pledging them with the Reconstruction Finance Corporation as security for a loan, the proceeds of which would be used for distributions to the certificate holders. This plan failed, however, because of the decision of the Reconstruction Finance Corporation that the debtor did not have title to the properties. Another plan was then formulated by the trustee. In this plan the right to alter the liabilities of the debtor to the certificate holders was asserted only in connection with the so-called debtor-owned properties.

The debtor and its subsidiaries were clearly insolvent. The liability of the debtor on its guarantee of first and second mortgages exceeded by \$6,434,000 the appraised value of the properties which secured the mortgages. In addition, the debtor was liable on notes payable to the extent of \$335,000, and had sundry liabilities of \$87,000. As against liabilities of \$6,856,000 (exclusive of its liability on the guarantees covered by the appraised value of the properties) the debtor had free assets of only \$485,000.

This case reflected the value of continued discussion between the Commission and participants in the reorganization at every stage of the proceedings up to the final consummation of the plan. As originally submitted, the plan did not contain all of the safeguards which certificate holders eventually received, and did not fully comply with the principle that senior creditors are entitled to full recognition of their claims before junior creditors may participate. In frequent conferences with the trustee and with representatives of certificate holders, the Commission was able to obtain adoption of many suggested amendments. Changes suggested by the Commission to the trustee included drastic revisions of the clauses pertaining to the allotment of participation in the new company, sinking fund provisions, and control of the new company. These were adopted by the trustee and were filed by him as amendments to his plan prior

to the court's submission of the plan to the Commission for advisory report.

As finally submitted the compulsory features of the plan, i. e., its effect as binding the minority of creditors if two-thirds of them accepted it, applied only to certificate holders in the debtor-owned properties. A new company was set up, the stock of which was placed in a voting trust for 10 years. Three voting trustees were named, all of whom were independent of the debtor and were men of experience and standing in the real estate or related fields. The assets of the debtor were to be transferred to the new company. The activities of the new company were to be devoted to the liquidation of the properties for the benefit of the certificate holders, and to their management pending liquidation. An attempt was to be made to liquidate the properties within a 5-year period. Prior to liquidation of, and payment of the certificate holders in, any particular mortgage, interest at the rate of 4½ percent was to accumulate and be paid if earned. An additional 1 percent of interest was to accumulate, but was not to be paid until final distribution resulting from liquidation of each property. On vote of two-thirds of the certificate holders of each property, not only might the servicing of the property be transferred to an outside agency, but its sale at any price could also be compelled. A sinking fund was created out of which certificates might be retired. So far as free assets existed, they were to be devoted to payment of unsecured creditors, the largest part of whom were the certificate holders to the extent of their deficiency claims.

The Commission recommended acceptance of this amended plan, but suggested amendment of other provisions which granted participation to holders of certificates in third-party mortgages on a voluntary basis. Under the plan certificate holders in these mortgages might, by action of a majority, appoint the new company as their agent to service the mortgages and to take steps in their behalf. Such an action had no effect on any minority who might refuse to appoint the new company as their agency. In the event of foreclosure by the new company on their account, however, the assenters surrendered rights which they would have had upon foreclosure in the usual manner. The Commission, therefore, recommended amendment of this portion of the plan. The plan as submitted was approved by the court and submitted to the certificate holders:

*The Higbee Company.*—Under the plan proposed in this case the holders of the Senior Bank Indebtedness for their claim of \$591,930 received \$150,000 in cash and \$441,930 in notes bearing 4 percent fixed interest and maturing serially within 4 years. Holders of the Senior Rent Indebtedness of \$846,922 received an equal par value of 4 percent notes maturing in 7 years. Holders of the Junior Indebted-

ness, which aggregated \$1,951,727, received as a compromise \$600,000 in 4 percent 10-year notes and new \$1 par common stock at the rate of 1 share for each \$100 of the balance of their claim. They would thus receive a total of 13,517 shares, or about 51 percent of the total new common stock.

The holders of the First Preferred Stock, having a claim of \$1,139,900 principal and \$738,085 dividends, accrued to February 1, 1941, received new 5 percent cumulative \$100 par preferred stock for the par amount of their claim and one-third of the accrued dividends. For the balance of their accrued dividends, they received new common stock at the rate of 1 share for each \$100 claim, or an aggregate of 4,921 shares. Valuing the new common stock on the basis of the Commission's estimated valuation of the debtor's assets, as discussed below, the First Preferred Stock would receive a value of between \$1,915,000 and \$1,953,000 for its claim of \$1,877,985.

The holders of the Second Preferred Stock, having a claim totaling \$783,637, were given 1 share of new common stock for each \$100 due them. The 7,836 shares they would receive would have an aggregate value of between \$843,000 and \$902,000 on the basis of the Commission's valuation. The present common stock did not participate in the plan.

The debtor submitted no specific valuation in support of the plan, but in view of the capitalization proposed and the basis on which the new common stock was to be allocated, it was evident that a valuation of at least \$6,000,000 was presupposed. The Commission, using the 1941 fiscal year earnings of \$617,000 before Federal income taxes, less an adjustment of \$25,000 for executive salaries, concluded that this base of \$592,000 was a reasonable measure of the company's earnings for purposes of valuation. Capitalizing these earnings at a rate which seemed appropriate in the light of rates of capitalization applicable to comparable department stores and adding excess working capital to the result, the Commission determined that a value within a range of approximately \$6,100,000 to \$6,300,000 did not appear unreasonable. These figures compare with indebtedness and claims of preferred stockholders under the old capitalization totaling \$6,052,000. Under the proposed plan, debt and preferred stock would total \$3,274,752, leaving a substantial equity for the new common stock.

The plan is unusual in that it provides for the accumulation of dividends on the new preferred stock for a period of from 5 to 10 years. Usually such a proposal would not be considered feasible, but it was viewed as acceptable in this case because the accumulation will be due not to lack of earnings, but rather to a predetermined policy of applying earnings to payment of all outstanding debts as quickly as possible. No dividends are to be paid on the new common stock

until payment has been made in full of all notes and all accumulations of dividends on the new preferred stock.

The plan provided that holders of the new preferred stock, voting as a class, were entitled at all times to elect three members of the board of directors, holders of the 7-year notes one member, and common stockholders the remaining three. However, after the retirement of the 7-year notes, the common stockholders were to elect four members, a majority. In accordance with the recommendation of the Commission, the plan was amended to provide that, after retirement of the senior indebtedness, the preferred stockholders should elect a majority of the board of directors until all accumulated dividends on the stock have been paid, and at any time thereafter upon default of six quarterly dividends.

The major problem presented in this proceeding involved the proposed compromise of the junior indebtedness and its effect on the public investors—the two classes of preferred stockholders. This junior indebtedness consisted originally of a \$1,500,000 loan from The Cleveland Terminals Building Company, to enable Higbee to move into its new store. The Cleveland Terminals Building Company, which was controlled by the Van Sweringen Brothers, owned all the common stock of the debtor. After various intermediate transactions, the two notes evidencing this loan were purchased for \$600,000 in 1937 by a director of Higbee and an associate.

It has been contended that these notes should (1) be completely subordinated to claims of preferred stockholders or (2) be limited to \$100,000, the amount for which they were carried on the books of Midamerica Corp., which was an intermediate holder among whose officers and directors were the Van Sweringen Brothers, or (3) be allowed only in the amount paid by the last purchaser—\$600,000. Litigation of the issues presented by these contentions would have required the solution of many difficult factual and legal questions. In addition, if the disputed question of ownership of these notes were resolved in favor of certain of the claimants, the full amount of the notes together with interest might ultimately be determined to constitute a claim ahead of the preferred stock. The Commission, under the circumstances, was of the opinion that the proposed compromise could not be said to be unfair.

The compromise would relieve both classes of the old preferred stock of the possibility that a claim in excess of \$600,000 for the junior indebtedness would be allowed. On the other hand, if litigation were to result in eliminating the \$600,000 prior claim, their position would be improved. The Commission concluded, however, that even with elimination of these prior claims the First Preferred Stockholders claims in amount would be no larger than at present, and that it was questionable whether the value of the securities they would receive

in such event would materially exceed the provision made for them in the present plan. As to the effect on the Second Preferred Stock, which represented a residual claim in this case, the Commission concluded that the company's new common stock would have an asset value in excess of the rate at which it was to be allocated to the Second Preferred (one share for each \$100 claim), and that, considering all elements, the proposed compromise did not appear detrimental to the interests of this group.

The Commission, on March 20, 1941, filed its report approving the plan as amended. The court approved the plan on July 2, 1941.

*Atlas Pipeline Corporation.*—The trustee's plan in this case provided for the issuance of \$1,011,400 of 4½ percent first mortgage bonds; \$435,000 of 4 percent preferred stock; and \$100,000 of common stock with a par value of \$20. The first mortgage bondholders were to receive \$961,400 of the new 4½ percent first mortgage bonds, which in face amount corresponded to the principal amount of their claims plus interest. The remaining \$50,000 of the new bonds were subscribed by the American Locomotive Company under a guarantee by a Producers Group which controlled substantial oil production in the area. The Producers Group was to take the stock at cost plus interest over a period of 5 years. The second mortgage bondholders received the new preferred stock equalling one-third the amount of their claims without interest. Because of debtor's insolvency the common stockholders were eliminated. The new common stock was to be purchased by the Producers Group for \$100,000; and the common stock could not be divested of control for at least 3 years because of failure to pay preferred dividends. Further, the debtor agreed to purchase all crude oil from the Producers Group. The Producers Group was to advance short term secured credit during the life of the purchase contract up to \$200,000 if additional working capital was needed.

Under the plan complete control was given the Producers Group for 3 years. The first mortgage bondholders took a reduced interest rate, extended the maturity of their bonds, accepted a reduced sinking fund requirement, lost their conversion privilege, and gave up their lien on approximately \$150,600 in cash held by the indenture trustee. The second mortgage bondholders accepted 4 percent preferred stock having a par value equal to one-third the principal amount of their claims, and gave up their creditor position entirely.

From the Commission's investigation, it appeared that there was no adequate support for the estimated annual earnings or future economic life of the debtor; and financial judgment dictated a higher capitalization rate in arriving at going-concern value.

The Commission concluded that the plan was neither feasible, fair, nor equitable. The debtor's present liquidation value might exceed its value as a continuing entity, its earning prospects were uncertain,

and its remaining economic life limited by advancing obsolescence. The debtor would emerge from reorganization with an unsound and unbalanced financial structure. The new bond issue would represent 92 percent of what the Commission found the going-concern value to be and 65 percent of the total capitalization. The equity investment of the Producers Group on the other hand would amount only to 7 percent of the total capitalization and less than 10 percent of what the Commission found the going-concern value to be. In addition, the bondholders would place the fate of the corporation in the hands of the Producers Group under a contract of questionable benefit, and despite the conflicting interests of the Producers Group. The Commission concluded that the benefits to the bondholders were inadequate to compensate them for the risks involved and that the proposed plan created a situation similar to that condemned in *Taylor v. Standard Gas & Electric Co.*<sup>8</sup>

The Commission suggested three alternatives for the debtor: (1) if continued operation were found desirable, there was nothing to show that the debtor could not obtain the funds necessary, above the amount of its own earnings, from banks, etc. (therefore the contribution of the Producers Group was not shown to be essential); (2) the record showed interest in the debtor's property by other producers, and out of such interest a satisfactory plan might develop; and (3) if no reorganization could be effected on a fair and feasible basis, a liquidation of the enterprise offered brighter prospects than liquidation at the end of the company's relatively short economic life.<sup>9</sup>

*Ulen & Company.*—Both plans submitted in this case provided for the liquidation of the company's assets. The debtor had outstanding \$4,306,185, principal and accrued interest, of 6 percent debentures; an unsecured note of \$67,524, including accrued interest; two series of preferred stock; and some common stock. Thus the creditors' claims amounted to \$4,373,709. The trustee found the value of debtor's assets to be \$1,279,327; and the debenture holders' committee set it at \$2,969,350—both far below the amount of the creditors' claims.

The trustee's plan provided for the issuance of \$800,000 of 10-year 6 percent cumulative income debentures, and 400 shares of new common stock. Each general creditor, including debenture holders, would receive one \$200 income debenture, and one share of stock for each \$1,000 of principal claim. After payment of expenses, etc., all cash in the hands of the trustee would be distributed *pro rata* to the creditors in final settlement of their claims for interest. Unpaid interest on the new debentures would accumulate.

The debenture holder committee's plan differed in two important respects. Instead of income debentures, it provided for \$3,967,924.69

<sup>8</sup> 306 U. S. 307.

<sup>9</sup> The plan proposed by the trustee was approved by the court on July 16, 1941.

of unsecured liquidation certificates carrying interest at 6 percent, if earned. The second basic difference was that whenever the net proceeds from the liquidation of assets amounted to \$25,000, the board of directors was required to apply 75 percent of such proceeds to the retirement of liquidation certificates, either by purchase through tenders or in the open market, and only in the event that retirement of the liquidation certificates could not be effected through tender or purchase would resort be made to *pro rata* distribution.

Under both plans the holders of the present preferred and common stock were to receive no recognition.

The Commission found both plans fair in excluding stockholders from participation, and thought both plans sound in their underlying purpose to discontinue the business and liquidate. But on the score of feasibility it was pointed out that in order to avoid the issuance of deceptive securities, funded debt, even in a liquidation plan, should bear such a relation to the value and nature of the company's assets as to provide adequately for the payment of interest charges and the ultimate repayment of the principal. Largely due to the fact that many of debtor's investments were in foreign countries now involved in the war, any income therefrom was highly questionable. In the view of the Commission, no appellation of the new company as a Realization Corporation and no form of descriptive legend on the proposed securities would adequately offset the misrepresentation implicit in the promise of repayment of principal and the promise ultimately to pay interest, in light of the high degree of uncertainty attending these contingencies.

The Commission further noted that if the plan was to provide for any funded debt, the *pro rata* method of distribution provided for in the trustee's plan was preferable to retirement of "liquidation certificates" by purchase either through tender or in the open market as provided in the debenture holders' plan.

After the Commission had filed its advisory report the trustee filed amendments to his plan, in which petition he was joined by the proponents of the alternative debenture holders' plan. The amended plan<sup>10</sup> eliminated the provision for funded debt. The securities to be issued under the plan consist solely of about 400,000 shares of common stock, with a 10-cent par value, to be distributed to the debtor's general creditors, including its debenture holders, at the rate of 100 shares for each \$1,000 in principal amount of creditors' claims. The Commission approved the amended plan because, in providing for the issuance solely of common stock, it eliminated the unsound and misleading characteristics which would necessarily inhere in the issues of funded debt originally proposed in this case.

<sup>10</sup> On July 8, 1941, Judge Goddard approved the trustee's amended plan and disapproved the debenture holders' committee's alternative plan in accordance with the recommendation of the Commission.

*McKesson & Robbins, Inc.*—The debtor was engaged in the manufacture and Nation-wide wholesale distribution of drugs and drug sundries and liquor operating in 37 States and the Territory of Hawaii, with net sales averaging well over \$100,000,000 annually. Its president and active directing head for the decade from its incorporation until the filing of the petition for reorganization had been Phillip M. Musica, alias F. Donald Coster, who committed suicide a week after the commencement of the proceedings. Although Coster's notorious frauds and depredations had resulted in his withdrawal of approximately \$2,870,000 from the business and the inflation of reported assets by some \$21,000,000, the trustee's investigation disclosed that his fraudulent activities had been wholly confined to the crude drug department and to the Canadian subsidiary and did not pervade the other departments of the business.

The Commission became a party to the proceedings on December 8, 1938, the same day that the voluntary petition for reorganization was filed and William J. Wardell, the disinterested trustee, was appointed.

Extensive investigations of the debtor's affairs were undertaken by the trustee and his counsel and accountants, and detailed reports of their findings were distributed to the company's security holders and the parties to the proceedings in accordance with the provisions of Section 167 of the Act. The facts disclosed by these inquiries enabled the trustee to assert very substantial claims against the debtor's former directors, accountants, and others, and as a result more than \$2,500,000 in cash and property was recovered for the estate.

The submission of suggestions for plans of reorganization was invited by the trustee, and on November 7, 1940, the trustee filed his proposed plan of reorganization. From time to time during the interval between the filing of his plan and the court's submission thereof to the Commission for advisory report on February 20, 1941, numerous amendments were adopted by the trustee as the desirability therefor was disclosed.

The plan, as finally proposed, provided for the payment in cash in full of all priority debt. Interest on all other debt was also to be paid in cash, and the principal amount of such other debt was to be paid 40 percent in cash, 40 percent in new 15-year 4 percent sinking fund debentures, and 20 percent in new 5½ percent cumulative redeemable preferred stock. The plan provided also that the trustee was to procure an underwriting for the new debentures and new preferred stock otherwise issuable to creditors (to be underwritten by the trustee) if this were possible upon terms to net the estate the par or face value of these securities. In its advisory report the Commission pointed out that the plan would appear to require creditors to accept certain sacrifices (e. g., change of status from creditor to stockholder

with respect to 20 percent of their claims, an extension of maturity for 15 years of 40 percent thereof, and a reduction in the rate of return upon their claims), but that in the event of an underwriting the plan would nonetheless be fair to them since they would realize in cash the full value of their claims with interest. It was pointed out further in the report that even if no underwriting were possible, market conditions then prevailing indicated that the debentures and preferred stock provided for in the plan would sell at par or better, and that if such conditions continued to prevail without substantial change until confirmation of the plan, the package of securities and cash allocable to creditors would have an aggregate value equal to the full amount of their claims with interest, and that in that event, the plan would also provide full compensation to creditors and would be fair and equitable within the applicable judicial and statutory standards. The report contained the cautionary comment that there should be reserved for further consideration what changes would be necessary in the plan in order to give creditors full compensation for their claims, in the light of the sacrifices imposed upon them by the plan, in the event that market conditions at the time of confirmation of the plan would not permit creditors to realize the full value of their claims.

The new debentures and preferred stock were in fact successfully underwritten, and creditors were paid the principal and interest of their claims in cash in full.

The trustees' plan was predicated upon an over-all value of the debtor's estate of \$76,900,000, of which approximately \$16,900,000 was excess cash. After providing for the claims of creditors, an equity of approximately \$43,800,000 remained. Under the plan, this equity was capitalized by the issuance of 1,685,901 shares of common stock of a par value of \$18 per share. The preference shareholders were to receive about 81 percent of the new common stock, representing in terms of the trustee's valuation \$35,596,000. The Commission approved this allocation after concluding that the new securities were of a value commensurate with the interest of the preferred shareholders. The holders of the old common stock were allocated about 19 percent of the new common stock. This was fair since the class was to receive the full residual equity after no more than equitable provision was made for creditors and senior stockholders.

The Commission concluded that the new capital structure was sound, that the working capital appeared to be sufficient, and that the provisions respecting management and control were appropriate. Therefore, it found the plan to be both equitable and feasible, and recommended that it be approved. The plan was approved by the court. Subsequently, several slight modifications were ratified by the court to facilitate the underwriting of the securities.

In December 1938, the Commission undertook an investigation of the auditing practices followed by McKesson & Robbins and its accountants, and in December 1940, it issued its report thereon. In this report <sup>11</sup> the Commission concluded that the general adoption of changes in respect to the appointment of auditors and the determination and execution of the audit program would have a salutary effect upon auditing practice in the United States, and suggested specific procedures that appeared to have certain advantages over others that had been proposed.<sup>12</sup> Consistently with our general practice in cases under Chapter X counsel for the Commission participated in the preparation of the numerous documents required for the consummation of the plan and the launching of the reorganized McKesson & Robbins, Inc., and the corporate by-laws finally adopted with the approval of the court include provisions which carry fully into effect the program suggested by the Commission.

#### APPEALS

Although the Commission may not appeal or file any petition for appeal in a proceeding under Chapter X, it may appear in proceedings before the appellate court in the event that appeals are taken by other parties in cases in which the Commission is participating. Thus, during the fiscal year the Commission participated as a party appellee in 9 cases in the appellate courts. In 4 other cases the Commission participated in appeals in reorganization proceedings as *amicus curiae*. Of these 13 cases, 4 were before the Supreme Court of the United States and the remaining 9 were before the circuit courts of appeals. In 12 of the 13 cases the position urged by the Commission was upheld by the courts; in 1 case the court decided adversely to the position of the Commission.

Five of the appeals in which the Commission participated involved questions dealing with allowances, and in all of them the position urged by the Commission was sustained.

*In the Matter of Keystone Realty Holding Company.*<sup>13</sup>—In this case the district court, in a Chapter X proceeding, granted to an attorney for the debtor and an attorney representing a bondholder allowances out of the debtor's estate as compensation for services rendered in connection with a prior insolvency proceeding in the State court. On

<sup>11</sup> In the Matter of McKesson & Robbins, Inc.; Report on Investigation Pursuant to Section 21 (a) of the Securities Exchange Act of 1934.

<sup>12</sup> The Commission's suggestions are stated at pages 10 and 368, 369 of the Report.

Cf. recommendations of the American Institute of Accountants and of the New York Stock Exchange, Appendix A; and provisions of the English Companies Act, 1929 and Horace B. Samuel's proposed amendments to that Act, Appendix B. See also Samuel's discussion in *Shareholders' Money*, Sir Isaac Pitman & Sons, Ltd., London, 1933, at pp. 231-235, 315-321. For a recent adoption in the United States of the essential features of a program substantially in accord with that proposed in the text, see Section 32 (a) of the Investment Company Act of 1940.

<sup>13</sup> 117 F. (2d) 1003 (C. C. A. 3rd, February 24, 1941).

appeal from the orders granting these allowances, the Commission took the position that the District Judge had power under Section 258 to make allowances for services rendered in the prior proceeding but that the Judge abused his discretion in making such allowance at this particular stage of the proceeding. The court sustained the position of the Commission holding that it was an abuse of discretion for the district court to direct payment of these allowances, even though for completed work, where the ultimate success of the reorganization was doubtful and the total amount to be available for allowances was not known.

*In re Mountain States Power Co.*<sup>14</sup>—In this case the Circuit Court of Appeals for the Third Circuit affirmed the denial of compensation or reimbursement of expenses to a member of a committee, who was also a member of a brokerage firm which, during the pendency of the reorganization proceeding, purchased and sold securities of the debtor for its own account. The decision was predicated on the holding that, as to allowances to persons in a fiduciary or representative capacity who trade in securities of the debtor while acting in the proceeding, the law applicable to proceedings under Section 77B was similar to Section 249 of Chapter X, the latter being no more than a codification of the existing law. The circuit court of appeals also held that the allowances granted by the district court to certain other applicants were so inadequate as to constitute an abuse of discretion and ordered that the allowances to these applicants be increased.

*In the matter of Porto Rican American Tobacco Company.*<sup>15</sup>—In this case it was contended that since Section 206 of Chapter X accords the debtor the right to be heard on all matters arising in a Chapter X proceeding and Section 169 recognizes that the debtor may propose plans or amendments thereto and submit objections to plans, it is implicit in the statute that the debtor may be represented by an attorney who shall be compensated out of the estate whether or not his services were beneficial. The Circuit Court of Appeals for the Second Circuit rejected this contention, ruling that, in order to be compensable, services performed by the attorney for a debtor must be beneficial. Also, the court pointed out that where a trustee has been appointed by the court and the trustee has his own attorney, if an attorney for the debtor without prior court authority performs legal services which fall within the scope of the administrative duties of the trustee or his attorney, the attorney for the debtor must be regarded as a volunteer and even if his services have been beneficial, he may be denied compensation out of the estate.

*In the Matter of Postal Telegraph and Cable Corporation.*<sup>16</sup>—An individual employed, without court authority, by a committee to

<sup>14</sup> 118 F. (2d) 405 (C. C. A. 3rd, March 5, 1941).

<sup>15</sup> 117 F. (2d) 599 (C. C. A. 2d, February 10, 1941).

<sup>16</sup> 119 F. (2d) 861 (C. C. A. 2d, May 19, 1941).

investigate and study the debtor's lease situation, was denied compensation out of the estate for his services by the district court. On appeal from the denial of compensation, the Commission urged in support of affirmance of the district court order that the appellant was not entitled to compensation since he had failed to establish that his services were necessary, non-duplicative, and beneficial. The circuit court of appeals affirmed the order of the district court on the ground (1) that there was no clear evidence that the services were beneficial, and (2) that the services of the appellant in examining leases were administrative services such as the debtor in possession or the trustee was charged with the duty of performing in connection with the administration of the estate and that the appellant who acted without prior court authorization cannot recover from the estate for such services.

*In the Matter of Balfour Manor Apartments Company.*—An order was entered by the district court granting allowances. Subsequently the district court directed that a rehearing be held for the reconsideration of its prior order. Without making any mention of this order for rehearing, one of the applicants filed a petition for leave to appeal from the original order of the district court with respect to allowances. The petition was granted and the appeal allowed by the Circuit Court of Appeals for the Sixth Circuit on May 10, 1941. The Commission moved to dismiss the appeal on the ground that there was no final order from which an appeal would lie. On October 14, 1941, the Circuit Court of Appeals for the Sixth Circuit entered an order granting the motion of the Commission to dismiss the appeal.

*"Deep Rock Oil" cases.*—Three briefs were filed on behalf of the Commission in connection with further controversies which arose out of the same reorganization proceeding which was before the Supreme Court in the so-called "Deep Rock" case.<sup>17</sup> One of these briefs was presented to the Circuit Court of Appeals for the Tenth Circuit and the other two were presented to the Supreme Court. In the "Deep Rock" case, the Supreme Court reversed a decision of the United States Circuit Court of Appeals for the Tenth Circuit which had affirmed orders of the district court confirming a plan of reorganization for Deep Rock Oil Corporation. The Supreme Court disapproved the plan because of the participation accorded to the claims of Standard Gas & Electric Company, the parent of the debtor, Deep Rock Oil Corporation. The Court held that the abuses in the management of Deep Rock by Standard required that Standard's claim as a creditor be subordinated to the interests of the debtor's preferred stockholders. Upon the return of the case to the district court, Standard filed an amended claim and petitioned for its allowance. The court decreed that Standard's claim was subordinate to the claims

<sup>17</sup> *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307.

and interests of all other creditors and of the preferred stockholders. Since the value of the debtor's assets was less than the amount of these prior claims and interests, the court held that Standard's claim was not entitled to participation, whatever its amount. Hence the court refused to allow the amended claim. From this decree of the district court, Standard appealed to the circuit court of appeals, which affirmed the decree.<sup>18</sup> Standard then filed a petition for a writ of *certiorari* to review the decision of the circuit court of appeals. In the brief presented to the Supreme Court on behalf of the Commission in opposition to the petition for the writ of *certiorari*, it was urged that the district court properly construed the mandate of the Supreme Court and that its decree followed inevitably from the requirement of subordination directed by the Supreme Court and from the application to the case of well-settled principles of law. The Supreme Court denied Standard's petition for a writ of *certiorari*.<sup>19</sup> Thereafter, the district court approved the plan, which excluded Standard from participation, and after acceptance by the security holders, confirmed the plan on July 24, 1940. Standard appealed from the orders of approval and confirmation and the appeals were consolidated. The Commission and the other appellees filed a brief urging that the circuit court of appeals dismiss Standard's appeal or affirm the orders appealed from. The circuit court of appeals in a unanimous opinion affirmed<sup>20</sup> the orders of the district court. Again Standard petitioned for a writ of *certiorari* to review the decision of the circuit court of appeals. In the brief filed on behalf of the Commission, it was urged that the petition be denied on the ground that this second petition for a writ of *certiorari* was in effect an attempt to secure review by the Supreme Court of questions which the Court had refused to review when it denied the Standard's earlier petition for *certiorari*. On April 14, 1941, the Supreme Court denied the petition.

*In the Matter of American Fuel and Power Co., Inland Gas Corporation, Kentucky Fuel Gas Corporation.*—In this case the district court approved a proposed settlement whereby Columbia Gas & Electric Corp., the parent company, would surrender its bonds, debentures, and stockholdings of the debtor companies in exchange for a substantial cash payment and release from pending lawsuits brought by the trustee against Columbia for violation of the anti-trust laws. It was uncontroverted that the material facts of Columbia's misconduct as alleged in the anti-trust suits were provable, and although the district court assumed the truth of the allegations it approved the settlement on the theory that substantial doubt existed as to whether Columbia's securities might not nevertheless be entitled to parity treatment with those held by the public. On appeal to the Circuit Court of

<sup>18</sup> 113 F. (2d) 266 (C. C. A. 10th, June 29, 1940).

<sup>19</sup> Decided November 12, 1940.

<sup>20</sup> 117 F. (2d) 615 (C. C. A. 10th, January 13, 1941).

Appeals for the Sixth Circuit by two committees representing public investors, the Commission contended (1) that without regard to the adequacy of the assumed facts as a good cause of action under the anti-trust laws they were adequate to establish a breach of fiduciary obligations owing by Columbia to the debtors and other holders of the debtors' securities; (2) that on the basis of such assumed facts and under equitable principles announced by the Supreme Court in *Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307 (1939), *Pepper v. Litton*, 308 U. S. 295 (1939), and other recent cases, Columbia's claims were required as a matter of law to be ranked subordinate to other claims, in which event its claims would be admittedly worthless and their surrender would constitute no consideration for the settlement; and (3) that the proposed settlement should therefore have been rejected and the issue of subordination tried on the facts. In an opinion rendered August 15, 1941 the Circuit Court of Appeals, on a somewhat different rationale, reversed the order approving the settlement and directed the district court to reject all of Columbia's claims and interests which should be found to have been acquired in violation of the anti-trust laws.

In connection with appeals in four reorganizations, the Commission obtained leave to file briefs as *amicus curiae* because of the significance of the issues involved. Two of the briefs were presented to the Supreme Court and two to the circuit court of appeals.

*In the Matter of Julius Roehrs Company.*<sup>21</sup>—The debtor filed a petition under Chapter X. The district court, by order, directed the debtor to file its plan of reorganization within 5 days and to offer proof for the purpose of demonstrating its good faith and its ability to carry out its plan. The debtor filed a tentative plan of reorganization and a hearing was held. The court was not satisfied that the petition was filed in good faith and dismissed it. An appeal was taken by the debtor. Pursuant to leave granted by the circuit court of appeals, the Commission filed a brief as *amicus curiae* in which it urged that the district court was in error when it required the debtor to file its plan and prove its ability to consummate this plan as a prerequisite to approval of the petition. The circuit court of appeals ruled that the district court had applied an erroneous test of good faith, reversed the order dismissing the petition, and remanded the proceedings.

*In the Matter of 11 West 42nd Street, Inc.*<sup>22</sup>—This appeal raised a procedural question. Because the problem was of general application under Chapter X the Commission, although not a party to the proceedings below, obtained leave to submit a brief as *amicus curiae*. The Commission took the position that a debtor against whom an involuntary petition has been filed may not seek dismissal thereof by

<sup>21</sup> 115 F. (2d) 723 (C. C. A. 3rd, November 14, 1940).

<sup>22</sup> 115 F. (2d) 531 (C. C. A. 2d, November 25, 1940).

motion for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure, since that procedure is inconsistent with the procedural provisions of Chapter X which relate to summary determination of factual issues arising out of a petition for reorganization. The court ruled adversely to the position urged by the Commission.

*Case v. Jenney, In the Matter of Los Angeles Lumber Products Company, Ltd.*<sup>23</sup>—This controversy arose in the same proceeding which was before the Supreme Court in *Case v. Los Angeles Lumber Products Co., Ltd.*,<sup>24</sup> discussed in the Commission's Sixth Annual Report.<sup>25</sup> After the remand of the cause to the district court in conformity with the opinion and decree of the Supreme Court, a new plan of reorganization for the debtor was formulated and confirmed by the district court. Under this plan the assets of the debtor were to be transferred to a new corporation which would issue 859,628 shares of \$1 par value common stock. The stock to be issued was to be distributed only to bondholders of the debtor and represented the entire capitalization of the new corporation. Upon a finding that the debtor was insolvent, the stockholders of the debtor were excluded from all participation in the plan. Thomas K. Case, an appellant in *Case v. Los Angeles Lumber Products Co., Ltd., supra*, filed objection to the new plan. His objections were overruled. He then filed with the Supreme Court a motion for leave to file a petition for writ of *mandamus* or prohibition on the ground that the new plan was not fair and equitable and the order of the district court confirming it failed to comply with the mandates of the Supreme Court. The Commission presented to the Supreme Court a memorandum in opposition to the motion in which it took the position that the amended plan did not contravene the mandate of the Supreme Court. On October 14, 1940, the Supreme Court denied the motion.

*Consolidated Rock Products Co. v. DuBois.*<sup>26</sup>—The facts with respect to the prior proceedings in the district court and in the circuit court of appeals relating to this case were presented in the Commission's Sixth Annual Report.<sup>27</sup> The Supreme Court granted a petition for a writ of *certiorari* to review the decision of the circuit court of appeals reversing an order of the district court confirming a plan of reorganization of the debtor and its two wholly-owned subsidiaries. On March 3, 1941, the Supreme Court rendered its opinion affirming the decision of the circuit court of appeals. The Commission, as *amicus curiae*, submitted a memorandum urging that the petition for *certiorari* be granted, and a brief in which it urged the affirmance of the decision of the circuit court of appeals which had reversed the order confirming the plan of reorganization.

<sup>23</sup> 311 U. S. 612, October 14, 1940.

<sup>24</sup> 308 U. S. 106.

<sup>25</sup> Page 65.

<sup>26</sup> 61 S. Ct. 675 (March 3, 1941).

<sup>27</sup> Page 66.



## Part IV

# ADMINISTRATION OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The Public Utility Holding Company Act of 1935 deals with holding companies having subsidiaries which are electric utility companies or which are engaged in the retail distribution of natural or manufactured gas. The Act was passed for the express purpose of eliminating certain evils and abuses which the Congress had found to exist in connection with the activities of such companies, and was intended for the protection of both investors and consumers. It provides for the registration of holding companies; elimination of uneconomic holding company structures; supervision of security transactions of holding companies and their subsidiaries; supervision of acquisitions of securities and utility assets by holding companies and their subsidiaries; and the supervision of payment of dividends, solicitation of proxies, inter-company loans, and service, sales, and construction contracts. The Commission must pass upon plans for the reorganization of registered holding companies or their subsidiaries, and must require the geographic and corporate simplification of public utility holding company systems. The Commission does not have the power to regulate public utility rates.

### SUMMARY OF ACTIVITIES

The past fiscal year has witnessed important developments in both the activities of and the problems confronting the Commission in its administration of the Public Utility Holding Company Act of 1935.

Substantial advances have been made during this period in securing compliance by the major holding-company systems with the integration and simplification provisions of the Act. Further progress has also been achieved in improving the financial structure of companies in holding-company systems, as an incident to the exercise of jurisdiction over security issues and of control over dividend policies and intercompany payments. Other important developments have included the requirement of competitive bidding in connection with sales of securities subject to the provisions of the Act, and the requirements, pursuant to Section 13, that holding companies pay the entire salary expenses of such of their officers as are also officers of service companies and of operating companies. In addition, there has been complete revision of the rules and regulations of the Commission under the Act.

As of June 30, 1941, there were registered with the Commission, pursuant to the provisions of the Act, 147 public-utility holding

companies, the total consolidated assets of which amount to \$15,129,000,000. These 147 registered holding companies constitute 53 public-utility holding-company systems, which include 1,457 holding, subholding, and operating companies. Since the total assets of the privately owned electric and gas utility industry (including natural gas) are estimated to be approximately \$22,000,000,000, the assets of registered public-utility holding-company systems represent about 68 percent of the total private industry. Prior to the end of the fiscal year, the defense program had already reached the point where expansion of power supply facilities was recognized to be of vital importance. This aspect of the program has received increasing impetus in subsequent months. Our Commission has collaborated with other Government agencies interested in this program, our contribution being primarily related to the financial aspects of that portion of the program which involves new construction by registered holding companies and their subsidiaries.

The operating companies in registered holding-company systems constitute a large proportion of the industry affected by the program. Over 70 percent of the total additions to steam capacity included in recent estimates as to requirements for the years 1943 to 1946, inclusive, were tentatively assigned to the areas served by these companies. We have been closely following the plans for expansion of power supply facilities in an effort to determine the amount which the various companies subject to the Act may be called upon to spend for new construction; to determine how much cash individual companies and holding-company systems as groups can generate from their own operations, i. e., the sum of the earnings available after meeting their obligations to security holders and the non-cash items in their expense accounts, such as provisions for amortization and depreciation.

These studies make it possible to anticipate demands for raising additional capital and to study in advance the problems which this will involve. It is, of course, of paramount importance that funds be made available just as soon as called for by the construction program, but by advance planning, it should be possible to make a wise choice among alternative methods of financing with a view to preserving the financial integrity of the companies subject to the Act, keeping them in the best possible position to meet any future wartime demands, and leaving them in the best possible position to meet the shock of readjustment to a peacetime economy. With these considerations in mind, our studies are directed to the amounts which the individual companies and the holding-company groups could safely raise through bonds, short-term notes, and preferred stocks, and the balance that must be provided from some form of an equity investment.

Although there is necessarily some uncertainty as to the ultimate expansion of electric utility facilities, it does appear certain that, for

several years at least, increases in generating capacity will be limited only by the ability of manufacturers to produce the essential equipment. While a substantial portion of the new generating facilities presumably will be in hydroelectric projects financed by the Federal Government, the private electric utilities will be called upon to make capital expenditures not only for steam generating facilities, but also for related additions to transmission and distribution facilities.

The aggregate cost will be far in excess of what the utilities have been expending on new construction in recent years. In fact, during the years from 1933 to 1940, comparatively little new capital has been raised by the electric utility industry from the sale of securities. Construction expenditures have been financed in large part from earnings. This was possible partly because of the slowing up of the growth of power demand in the early years of the depression, and partly because construction in the years immediately preceding the depression had been in advance of immediate demands for energy. Both of these factors have diminished in importance in recent years and, when the demands of the defense program are added to the normal growth in power demand, it becomes clear that the industry is confronted with a problem of raising and conserving cash in an amount far in excess of what has been called for by the pre-war economy. Providing these facilities is of paramount importance and this, of course, means that such construction must be financed. This will prove no easy challenge—and it is possible that some Federal aid may be necessary.

As to the ability of the industry to meet this challenge, it must be remembered that in the heyday of the promotion of ever greater holding-company systems, the operating companies were bled. In many instances depreciation accruals were inadequate and capital was paid out as dividends in the guise of income, while at the same time the companies were subjected to ever increasing burdens in the form of debt and other senior securities and in some instances exorbitant or unearned charges for so-called service or management fees. Moreover, the complicated holding-company structure which was superimposed has proved ill-equipped to meet the needs of the subsidiaries for equity money. In some instances, despite the upward flow of dividends to holding companies, there are still large arrearages of dividends on holding-company preferred stocks which, until eliminated, are virtually an insuperable obstacle to holding-company financing.

As described elsewhere in this and in prior annual reports of this Commission, much progress has been made in clearing away the financial debris with which the Commission was confronted at the outset of its administration of the Act. Much, however, remains to be done. Our efforts during the prior year to get the operating subsidiaries of the holding companies in a position to finance defense

construction has related primarily to the following aspects of administration of the Act:

1. Enforcement of Section 11 (b) (1) to the end that there may be greater progress toward the integration of the industry along logical regional lines, and that managerial responsibility may gravitate away from one or two financial centers toward the territories served.

2. Elimination of unnecessary complications in the financial structure of holding companies, in accordance with Section 11 (b) (2), so as to remove present-day obstacles to the raising of additional capital. Compliance with the integration and corporate simplification standards of the Act are interrelated since, in many instances as the holding companies reconcile themselves to the narrowing of the area of their operations, they will find that the same transaction which accomplishes a divestment of a non-retainable subsidiary may also be a step in corporate simplification. For example, the holding company's interest in such a subsidiary may be exchanged for its own outstanding senior securities, or the cash proceeds from the sale of certain of their holdings can be used to reduce their top-heavy debt structures, or can be a basis for additional equity investment in other subsidiaries which require strengthening.

3. Increasing emphasis on requiring more adequate provisions for depreciation and more conservative dividend policies so as to preserve available cash in the operating companies, and to minimize the necessity to seek outside sources of additional capital. What, if any, change in emphasis may result from the transition from preparation for war to actual entry into the war cannot now be predicted. It would seem obvious, however, that there can be no slackening in the effort to put the industry in a financial position to meet whatever demands may be placed upon it. It is significant in that connection that in the first three weeks after the outbreak of war, a number of companies have been pressing forward to avail themselves of the machinery provided in the Act for effectuating voluntary compliance with the provisions of Section 11.

Each of the above aspects of Commission activity are discussed in separate sections of this report.

#### **INTEGRATION AND CORPORATE SIMPLIFICATION OF PUBLIC-UTILITY HOLDING-COMPANY SYSTEMS**

The past fiscal year has been one of very substantial progress in the geographical integration and corporate simplification of public-utility holding-company systems required by Section 11 (b) of the Public Utility Holding Company Act of 1935.

Although the statute was enacted by Congress in August 1935, the Commission was directed to enforce the integration and simplification provisions only "\*\*\*\*\* as soon as practicable after January 1, 1938." In the intervening period holding companies were given an oppor-

tunity to take voluntary steps to comply with Section 11, which opportunity was unfortunately neglected in favor of costly litigation directed against the constitutionality of the Act. After the termination of the period of litigation by the decision of the Supreme Court in March 1938, upholding the constitutionality of the registration provisions, the Commission gave all holding companies a further opportunity to submit to the Commission their plans for voluntary compliance. Most of the plans submitted, however, although helpful in some respects, amounted to little more than arguments attempting to justify the retention of the existing scattered holdings.

It finally became evident that compliance with the Act could be achieved only by the institution of affirmative proceedings, pursuant to the statutory direction in Section 11 (b). Accordingly in the spring of 1940, as reported in our last Annual Report<sup>1</sup> the Commission instituted integration proceedings with respect to nine major utility holding-company systems and corporate simplification proceedings with respect to three major systems. In the past fiscal year a number of additional proceedings were instituted principally to effect compliance with the corporate simplification standards of Section 11 (b) (2). The two classes of proceedings are interrelated, in that action taken to comply with the geographical standards may also be a step toward achieving corporate simplification, and steps taken in the direction of corporate simplification may serve to eliminate substantial problems which would otherwise require determination in proceedings under Section 11 (b) (1). At the close of the fiscal year, proceedings involving integration or corporate simplification, or both, were pending with respect to the 14 holding-company systems named below, which systems had consolidated assets aggregating \$10,219,000,000, or 67 percent of the consolidated assets of all registered holding-company systems:<sup>2</sup>

*Proceedings under Section 11 (b)*

System	Proceeding	
	Section 11 (b) (1)	Section 11 (b) (2)
Cities Service Power & Light Company .....	X	
Commonwealth & Southern Corporation (The) .....	X	X
Electric Bond and Share Company .....	X	X
Engineers Public Service Company .....	X	
General Gas & Electric Corporation .....		X
International Hydro-Electric System .....		X
Middle West Corporation (The) .....	X	X
Midland United Company .....		X
North American Company (The) .....	X	
North American Gas and Electric Company .....	X	X
Northern New England Company and New England Public Service Company .....		X
Standard Power and Light Corporation .....	X	X
United Gas Improvement Company (The) .....	X	
United Light and Power Company (The) .....	X	X
Total .....	10	10

<sup>1</sup> Page 14, et seq.

<sup>2</sup> The proceeding involving the United Corporation which is referred to below at page 84 was begun after the close of the fiscal year.

The heads of some of the largest holding-company systems have stated publicly to their security holders that the enforcement of Section 11 will not prejudice their interests. William G. Woolfolk, president of The United Light and Power Company, in April 1941, reported to his security holders:

"In the rearrangement of properties by way of compliance with the Act, we have noted no indication that the regulatory authorities will be other than helpful in protecting the investor, and out of what must now seem to you a complex and nebulous situation, your management foresees in the reasonably near future the emergence of a company which, though smaller perhaps, will be in every way creditable. To this end we are bending our every effort."

Leo T. Crowley, chairman of the board and president of Standard Gas and Electric Company, in a message to his stockholders, in March 1941 stated:

"The management of your Company has continued to devote its attention to the two major problems affecting the Company; namely, integration and recapitalization. The solution of these problems has been viewed not merely as a means of compliance with the requirements of the Public Utility Holding Company Act of 1935, with which they are so often associated in the public mind, *but also as a necessary and practical treatment of obvious corporate needs.* The two problems might well be classed as one in view of their equal importance from many standpoints. The method of solution of the first—integration—seems to present the only feasible way of meeting the second." (Italics supplied.)

A number of factors prompt increasing compliance with Section 11. There is an increasing necessity, largely rising out of National defense requirements, of securing funds for the financing of new construction. There are concrete indications that many holding companies, particularly in scattered systems, actually block needed operating company financing. Thus, holding companies, desirous of retaining control of operating companies, refuse to permit the operating company to issue common stock in situations where common stock can be sold on favorable terms and where further debt or preferred stock financing is inappropriate. Moreover, their policies of inadequate depreciation and excessive dividends have taken away many millions of dollars from operating companies which should have been used for new plant construction.

The difficulties of financing essential power expansion under present holding-company control—where the holding company is unable to raise the money itself and where its control of the operating company is an obstacle to the latter's financing—has thus accelerated a realization of the need for the severance of such control. An independent operating company is in a position to make its own decision as to its depreciation and dividend policies and as to the form of security most appropriate for the financing of its needs. It may issue common stock—a source of funds generally closed to the operating subsidiaries of holding-companies. Moreover, the remaining properties of the

holding-company system which may be retained under Section 11 frequently benefit materially from the sale of outlying system properties. Thus, the present emergency and the need for rapid expansion of the Nation's power resources have served to reinforce the desirability of a rapid compliance with Section 11.

There is also a growing recognition in financial circles and among investors that many holding companies are a source of economic loss to investors. Senior security holders in many holding companies—holders of debentures and preferred stock—especially have indicated their views in this respect and, in some cases, are organizing to protect their interests. Superfluous holding companies merely serve to reduce the return on the common stock investment in operating companies—the liberal holding company salaries, additional Federal and State taxes, and all the other heavy expenses of running the holding company, are items deducted before the investor in the holding company secures any return. Studies of independent statistical agencies indicate that the “breakup” value of many holding companies is greater than the present market value of their outstanding securities. In other words, the market appears to consider such holding companies (with their heavy expenses and taxes) and the holding-company management to be liabilities rather than assets.

That the provisions of Section 11 are not to be applied indiscriminately as a “death sentence,” but with full regard to the protection of investors, is well illustrated in the proceeding with respect to The North American Company system. While that proceeding was pending before the Commission for decision, North American Light & Power Company, a subholding company in The North American Company system controlling numerous subsidiary public-utility operating companies and a party to the integration proceeding, announced its intention to liquidate and dissolve. In a letter to its security holders, the company stated that such action was being taken in anticipation of the Commission's decision in the pending proceeding; that upon liquidation of the company its preferred stockholders would not receive their full preferential amount of \$152.50 a share, which included dividend arrears of \$52.50 a share; and that accordingly, the common stockholders would receive nothing. It was also stated that The North American Company, the top holding company, owning 44 percent of the preferred stock, 85 percent of the common stock, and 62 percent of the outstanding debentures, had indicated its intention to vote its shares in favor of the dissolution and liquidation which was proposed to be accomplished under the aegis of the Court of Chancery of the State of Delaware. The company did not propose to submit the plan of liquidation to the Commission as appeared to be required by the provisions of the Public Utility Holding Company Act of 1935.

The Commission informed the company of its doubts as to the propriety and validity of the contemplated procedure. After efforts to evolve a satisfactory solution failed, the Commission was forced to institute proceedings and enter an order forbidding The North American Company and North American Light & Power Company from taking steps to dissolve the latter except in accordance with appropriate orders of the Commission. In its opinion<sup>3</sup> the Commission stated that, in the integration proceeding pending before it for decision, there were numerous questions present involving North American Light & Power Company and its subsidiaries, as well as other subsidiaries of The North American Company, the proper disposition of which might be thwarted if the liquidation and dissolution of the company took place before such questions were decided. It was pointed out that in the case of a voluntary as well as an involuntary liquidation of a company in a holding-company system, or where the voluntary action was taken for the stated purpose of complying with the integration provisions of Section 11, the Commission was charged with specific administrative duties which were designed, among other things, to protect the scattered public security holders of the company against the concentrated power of a holding company possessing, as in the instant case, absolute voting control.

It was therefore the Commission's position that, before the company could dissolve and liquidate its assets in the manner proposed, Section 11 of the Public Utility Holding Company Act of 1935 required not only that the Commission be permitted to consider the effect of such action on the pending Section 11 (b)(1) proceeding, but also that it be permitted to determine whether the proposed manner of liquidation was fair and equitable to the security holders affected thereby; including a consideration under the applicable precedents of the treatment to be accorded The North American Company which, as a dominant stockholder of North American Light & Power Company, had acquired senior securities of the latter company at prices substantially below their face amount.

After the entry of the above order the companies would not assure the Commission that its order would be obeyed. Consequently, the Commission filed suit in the United States District Court of Delaware to insure compliance with its order. This suit is described on page 206. *infra*.<sup>4</sup>

The Commission's opinions during the past year have clarified most of the interpretative problems arising under Section 11 (b). The de-

<sup>3</sup> *In the Matter of The North American Company and its Subsidiary Companies*, Holding Company Act Release No. 2832.

<sup>4</sup> Since the end of the fiscal year, the defendants and the Commission have agreed to a postponement of the scheduled stockholders' meeting called for the purpose of authorizing the dissolution of North American Light & Power Company, in order to afford the parties an opportunity to discuss the possibilities of composing their differences.

terminations of the Commission, tentative and final, are discussed separately in relation to Sections 11 (b) (1) and 11 (b) (2):

**Section 11 (b) (1)—Integration.**

The opinion of the Commission in *The United Gas Improvement Company and its Subsidiary Companies*<sup>5</sup> clarified several important interpretative issues raised by the respondents. The Commission interpreted the portion of Section 11 (b) (1) relating to "interests in other businesses" and pointed out the specific statutory standards which holding companies must meet to retain interests in other businesses, including investment interests in utilities not subsidiaries of the holding company. The Commission also reaffirmed its earlier decision in *Columbia Gas & Electric Corporation*<sup>6</sup> that gas and electric utility companies cannot be considered as together constituting a "single integrated public-utility system" within the meaning of the Act. Thus a holding company must satisfy the requirements prescribed by Congress for the retention of *additional* systems if it desires to retain both an electric and gas utility system.

In a later decision in *The United Gas Improvement Company* proceeding<sup>7</sup> the Commission, having taken complete evidence as to the status of many of the scattered subsidiary utility properties and having given the companies concerned full opportunity to be heard, ordered the divestiture of such properties from the system. Despite the respondents' contention to the contrary, the Commission held that the statute permitted it to order such evolutionary adjustments prior to its final decision on the system or systems retainable; and that such progressive orders of divestiture resulted in the most expeditious solutions of problems arising under the Act and enabled a more orderly trial of the remaining issues with consequent savings in time and expense to the company and to the Government.

In a subsequent case, *Engineers Public Service Company and its Subsidiary Companies*,<sup>8</sup> the Commission's opinion settled the most important interpretative issue arising under Section 11 (b) (1). The company had contended that it was not precluded under clause (B) of Section 11 (b) (1) from having one integrated system in Virginia and States adjoining Virginia, and another in Texas and States adjoining Texas. Interpreting clause (B) in the light of its legislative history, and in the light of other provisions of the statute, the Commission concluded that additional systems are retainable under clause (B) only if they are located in the State or States in which the principal system operates or in States adjoining thereto.

<sup>5</sup> Holding Company Act Release No. 2692.

<sup>6</sup> Holding Company Act Release No. 2477.

<sup>7</sup> Holding Company Act Release No. 2913.

<sup>8</sup> Holding Company Act Release No. 2897.

The Commission further held in this case that it will require a complete disposition of all interests by a holding company in a controlled subsidiary and will not permit the holding company to retain a so-called "investment interest" through which the holding company might continue to exert influence.

**Status of Major Integration Proceedings.**

The following description of the status of the major integration proceedings instituted by the Commission indicates the extent of the progress made at the close of the fiscal year in complying with the requirements of Section 11 (b) (1).

*Electric Bond and Share Company.*—The Commission instituted Section 11 (b) (1) proceedings directed against the Electric Bond and Share system on February 28, 1940. The subsequent Section 11 (b) (2), or corporate simplification proceedings, indicated that progress in eliminating the innumerable corporate complexities of the system would facilitate securing compliance with the integration requirements of the Act. As a consequence, the integration proceeding has been held somewhat in abeyance pending progress in the corporate simplification proceedings.

During the year, National Power & Light Company, a major subholding company of the Electric Bond and Share system, filed with the Commission an application to exchange the common stock of Houston Lighting & Power Company for the outstanding preferred stock of National. This plan is advanced as a step in the prospective dissolution of National Power & Light Company, consonant with the objectives of the pending 11 (b) (2) proceeding.

*Cities Service Company and Cities Service Power & Light Company.*—In March 1940 the Commission instituted an integration proceeding against Cities Service Power & Light Company and its subsidiary companies. Extensive public hearings were held intermittently up to June 23, 1941, at which time the record was closed. The company has accepted the Commission's interpretation of Section 11(b) (1) (B) and is making no claim that it can retain control of more than one of its large group of properties.

On June 3, 1941 the Commission instituted a similar proceeding directed against Cities Service Company. Shortly thereafter, Cities Service Company and Cities Service Power & Light Company filed an application under Section 11 (e) covering a plan for the divestment of Cities Service interests in its principal utility holding company subsidiary. The plan calls for the organization of three regional holding companies, one owning the securities now owned by Cities Service Power & Light Company in the Rocky Mountain area, another owning the securities now owned by Cities Service Power & Light in Ohio, and a third owning the securities now owned by Cities Service Power & Light Company in midwestern and southwestern States. It is

proposed that the common stock in the three new regional corporations will be offered in exchange to holders of the preferred stocks of Cities Service Company. This plan is presently pending before the Commission for approval.

*The Commonwealth & Southern Corporation.*—The Commission instituted integration proceedings against The Commonwealth & Southern Corporation system on March 6, 1940. After the institution of the proceedings, the company requested the Commission to indicate its tentative views on the system's status under Section 11(b) (1). This request was granted and tentative views were released.

Because of the interrelationships of the geographical simplification requirements (in Section 11(b) (1)) and the corporate simplification requirements (in Section 11(b) (2)), the Commission, shortly after issuing the statement of tentative conclusions, instituted proceedings under Section 11(b) (2). In these proceedings the question was raised as to whether the holding company should not reduce itself to a single class of stock. Hearings proceeded in both cases. On June 20, 1941, the Commission, in an opinion holding that valuation testimony would not be received prior to determining whether a one-stock order should be entered, held that, under Clause (B) of Section 11(b) (1), the northern and the southern properties of The Commonwealth & Southern Corporation could not be retained in the same holding-company system. It is anticipated that after the decision on the one-stock order question, further hearings will be held and appropriate orders entered in the Section 11(b) (1) proceedings.

*Engineers Public Service Company.*—The Commission instituted integration proceedings against the Engineers Public Service system in February 1940. In response to a request by respondents for a tentative statement of the Commission's views as to the system's status under Section 11(b)(1), tentative conclusions were released by the Commission. Hearings were held and the Commission, shortly after the end of the fiscal year, issued its findings and opinion clarifying the status of the system under Section 11(b) (1).<sup>9</sup> The Commission determined that two subsidiaries of Engineers—Virginia Electric and Power Company and Gulf States Utilities Company—each constitute a single integrated public-utility system and that either of them may be retained by Engineers as its principal system under Section 11(b) (1). In deciding that Engineers could not retain both of these systems, the Commission made the important interpretative decision as to the scope of Clause (B) of Section 11(b) (1) which has been referred to above.

At the close of the fiscal year, the case was pending for the introduction of further evidence and resolution of the remaining issues.

<sup>9</sup> Holding Company Act Release No. 2897.

*The Middle West Corporation.*—The Commission instituted Section 11 (b) (1) proceedings on March 1, 1940 against The Middle West Corporation and its 49 utility subsidiaries, which operate electric facilities in 16 States and gas facilities in 12 States and 40 non-utility subsidiaries.

The integration hearings are now virtually completed. The answer filed by The Middle West Corporation in the proceedings proposed a "plan" for the retention of the system's southwestern and northern "groups" of properties and the disposition of approximately \$100,000,000 of miscellaneous scattered companies. The company's claim for retention of the widely scattered southwestern and northern properties is based upon the "two-area" construction of Section 11 (b) (1) (B) which has been rejected by the Commission as an improper construction of the Act.

During the past year or more, in compliance with Section 11 (b), Middle West has taken the following steps: It has disposed of its interests in Missouri Public Service Corporation; Central Power Corporation, its subsidiary, sold substantially all of its assets to a public power district; Northwestern Public Service Company, an indirect subsidiary, sold a portion of its assets to a public power district. Middle West also has a pending application to sell its interests in Albion Gas Light Company and Michigan Gas and Electric Company.

*The North American Company.*—The Commission instituted integration proceedings against The North American Company and its subsidiaries on March 8, 1940. Extensive hearings were held, and a full record was developed as to the operating characteristics and relationships within the holding-company system. The North American Company early conceded that it was necessary for it to dispose of its interests in the District of Columbia group of properties, controlled through its subholding company, Washington Railway and Electric Company. Consequently, North American has reduced its interest in these properties by paying out in common stock dividends participating units in its holdings in Washington Railway and Electric Company. North American has also liquidated some of its holdings in its subsidiary, Detroit Edison Company, by paying common stock dividends in Detroit Edison stock. The cash conserved as a result of paying dividends in kind has been used to retire holding company debentures and to make further investments in other operating properties.

The integration hearings were closed on April 15, 1941, briefs were filed, and arguments were held before the Commission on the remaining issues in the proceeding. The case is now pending before the Commission for decision.

*Standard Power and Light Corporation and Standard Gas and Electric Company.*—The Commission instituted Section 11 (b) (1) proceedings in regard to Standard Power and Light Corporation, Standard Gas and Electric Company, and their subsidiaries on March 6, 1940. The answer filed by Standard Gas and Electric Company indicated that Standard Gas proposed to take certain major steps in order to comply with the integration requirements of the Act. Thereafter, conferences were held between representatives of the company and the staff of the Commission in which the proposals of Standard Gas were thoroughly discussed. After these discussions, the Commission was advised by Standard Gas that it proposed to dispose of all of its interests except the common stock of Philadelphia Company, which operates in and around Pittsburgh, Pennsylvania.

Shortly thereafter, hearings were held on the issues of the case as framed by the Commission's Notice of and Order for Hearing and the Respondents' answer. In accordance with the position taken by the company, the Commission, shortly after the close of the fiscal year, ordered Standard Gas and Electric Company to dispose of all of its utility properties, with the exception of Philadelphia Company and its subsidiaries. The Commission concluded that the properties of Duquesne Light Company, a subsidiary of Philadelphia Company, constituted an integrated public-utility system within the meaning of Section 2(a) (29) (A), but the Commission made no finding as to the gas properties of Philadelphia Company and its subsidiaries and as to the Philadelphia Company's non-utility interests.<sup>10</sup> These matters are reserved for future hearings and decision.

*The United Gas Improvement Company.*—The United Gas Improvement Company controls approximately 38 utility subsidiaries which operate electric facilities in 10 States, gas facilities in 5 States, and approximately 41 non-utility subsidiaries.

The Commission instituted integration proceedings against The United Gas Improvement Company and its subsidiaries on March 4, 1940. Subsequently, the respondents requested the Commission to furnish them its tentative conclusions as to the system's status under Section 11 (b) (1). The Commission granted the request, and on June 18, 1941 issued its statement of tentative conclusions.

Following a tentative conclusion by the Commission that The United Gas Improvement Company could not retain its interests in the Connecticut Light and Power Company under the integration standards of the Act, The United Gas Improvement Company sold its stock holdings in the Connecticut Company in a successful offering to the public. Connecticut Light and Power Company, with consolidated book assets of \$118,916,972, constituted U. G. I.'s largest acknowledged subsidiary outside of the Pennsylvania area.

<sup>10</sup> Holding Company Act Release No. 2929.

On April 15, 1941, the Commission entered an order requiring that U. G. I. divest itself of certain scattered utility interests which it was found, on the basis of the record made, did not meet the standards of Section 11 (b) (1).<sup>11</sup> Thereafter, in response to a petition for rehearing filed by the company, the Commission suspended the effectiveness of the order requiring divestment. Additional evidence was introduced, additional briefs were filed, and further argument was held. The matter is presently pending before the Commission for decision.<sup>12</sup>

There is presently pending before the Commission for decision the question of whether The United Gas Improvement Company may retain its interests in the electric utility assets of Luzerne County Gas & Electric Corporation and the transportation assets of Connecticut Railway and Lighting Company. Further hearings will be held to obtain evidence as to the status of other outlying properties and investments.

*The United Light and Power Company.*—The Commission instituted integration proceedings directed against The United Light and Power Company system on March 8, 1940. Subsequent thereto, The United Light and Power Company and its subsidiaries requested that they be furnished with the Commission's tentative views with respect to what action the Commission tentatively believed would be required by Section 11 (b) (1) of the Act. On the basis of further examination of the problems of this holding-company system, the Commission concluded that achievement of the objectives of Section 11 would best be promoted by the taking of concurrent action under Section 11 (b) (2) requiring corporate simplification of holding companies. Such proceedings were therefore instituted, as a result of which an order was entered on March 20, 1941, directing the dissolution of The United Light and Power Company, the top holding company of the system, and the dissolution of United American Company, an intermediate holding company.

Subsequently, during June 1941 the Commission issued its tentative conclusions under Section 11 (b) (1) and consolidated the proceedings under Sections 11 (b) (1) and 11 (b) (2). After opportunity for hearing, a final order was issued under Section 11 (b) (1), directing the elimination from the holding-company system of a very substantial portion of its properties, including those operating in Michigan, Wisconsin, Ohio, West Virginia, and Texas. This order was based primarily on the applicability of Clause (B) of Section 11 (b) (1) to the entire system. The far-flung operations of the system could not, of course, be held to comply with the geographical limitations composed

<sup>11</sup> Holding Company Act Release No. 2692.

<sup>12</sup> On July 31, 1941, the Commission issued an order directing The United Gas Improvement Co. to dispose of its interests in outlying ice, cold storage, water, and certain inactive companies located in Arizona, Kansas, Kentucky, Missouri, Oklahoma, and Texas (Holding Company Act Release No. 2913).

by Congress under that clause and the order therefore required extensive dispositions of outlying properties of the top holding and subholding companies. The Commission also reaffirmed earlier opinions to the effect that a holding company must dispose of its "investment interests" in non-controlled public-utility companies where such interests are not reasonably incidental or economically necessary or appropriate to the operations of the system's integrated public-utility systems. Jurisdiction was reserved to determine issues remaining under Sections 11 (b) (1) and 11 (b) (2), among which questions are whether remaining properties can be kept under the provisions of (A) and (C) of Section 11 (b) (1).

**Section 11 (b) (2)—Corporate Simplification.**

*The United Light and Power Company*<sup>13</sup> involved a system containing 5 tiers of companies. It included 8 companies which were holding companies as defined in the Act and, in addition, had 23 operating subsidiaries rendering electric and gas service in 14 different States. One of the first problems as to compliance with Section 11 (b) (2) which the Commission considered was that of bringing the system into compliance with the "great-grandfather clause" which imposes a requirement limiting holding-company systems to not more than three tiers of companies, i. e., a holding company may not be the "parent" of a holding company which in turn is "parent" of another holding company. The Commission's order in this case directed the dissolution of two of the companies in The United Light and Power Company holding-company system. The two companies ordered dissolved were The United Light and Power Company, the top holding company, and United American Company, an intermediate holding company having no publicly-held securities. The selection of these two companies as the ones to be eliminated was based in part upon the fact that the degree of complexity as affecting particular classes of securities was the greatest at the top of the pyramid of holding companies involved, and in part upon the fact that the respondents themselves suggested a method, apparently in general accord with the statutory standards, which would bring about compliance with the statutory requirement by means of dissolving the top holding company. The Commission's order reserved jurisdiction to consider the taking of such further steps as might be appropriate to effect compliance with the corporate simplification requirements of the Act as applied to this holding-company system.

Subsequently, the proceedings were consolidated with others already pending under Section 11 (b) (1), which deals with geographical limitation of systems, and the issue was raised, among

<sup>13</sup> Holding Company Act Release No. 2923.

others, as to whether the holding-company system should eliminate all but a single holding company.<sup>14</sup>

An earlier proceeding, involving the corporate structure of *The United Illuminating Company*, resulted in the elimination of certain holding companies from the super-structure of that system. The United Illuminating Trust and the Illuminating Shares Company held the controlling stock of The United Illuminating Company. This voting trust had been created in 1930 for the purpose of retaining local control of the holding company. The Commission approved a plan providing for the termination of the trust and the return of the shares of The United Illuminating Company to their beneficial owners.<sup>15</sup>

During the year, proceedings were instituted against *General Gas & Electric Corporation* under Section 11 (b) (2).<sup>16</sup> This corporation is a holding company in the Associated Gas and Electric Corporation system and, either directly or indirectly through certain subholding companies, controls various utility properties scattered from Delaware to Florida. Shortly after the Commission's proceedings were instituted, the company filed a plan providing for various exchanges of stock and contemplating the subordination by Associated Gas and Electric Corporation of certain securities.

While these proceedings were pending the Commission entered an order approving one phase of the plan, the elimination of Southeastern Electric and Gas Company, a subholding company, by merger of that company into General Gas & Electric Corporation. The Commission's opinion<sup>17</sup> did not discuss the "great-grandfather clause" nor did it consider any problems presented under Section 10. The opinion held, however, that the Southeastern Electric and Gas Company performed no useful functions, required expenses of approximately \$10,000 per year, and might therefore appropriately be dissolved. Jurisdiction was reserved over various phases of the transaction, including accounting entries and the validity of open accounts and certain other obligations payable to the parent company, Associated Gas and Electric Corporation.

The elimination of companies to comply with Section 11(b) (2) is also involved in pending proceedings involving *The United Corporation*. That company is a holding company which has as direct subsidiaries The United Gas Improvement Company, Columbia Gas & Electric Corporation, Niagara Hudson Power Corporation, and Public Service Corporation of New Jersey. These, in turn, are all hold-

<sup>14</sup> While action with respect to the physical limitation of the holding-company system was taken shortly after the close of the fiscal year (*The United Light and Power Company*, Holding Company Act Release No. 2923), hearings have not been completed on the question of whether the holding-company system should be reduced to a single holding company.

<sup>15</sup> *The United Illuminating Company*, Holding Company Act Release No. 2245.

<sup>16</sup> Holding Company Act Release No. 2543.

<sup>17</sup> Holding Company Act Release No. 2757.

ing companies, some of which have subsidiaries which are holding companies. In March 1941, The United Corporation filed a plan under Section 11(e) which contemplated the gradual reduction of its utility holdings and, pending such reduction, the sterilization of voting rights, the discontinuance of interlocking directorships, and the termination of participation by the parent in transactions with its subsidiary companies. In order that consideration of the company's plan be accompanied by appropriate consideration of all relevant standards of Section 11(b) (2), the Commission, in setting the plan down for hearing, instituted proceedings under Section 11 (b) (2).<sup>18</sup> One of the principal matters raised for consideration under this section was as to the appropriate action to be taken to eliminate holding-company relationships so as to comply with the "great-grandfather clause."

Proceedings under Section 11(b)(2) were instituted against *International Hydro-Electric System* shortly before the beginning of the past fiscal year.<sup>19</sup> This system is a Massachusetts trust whose ownership of securities is limited to equities in certain other holding companies, among which are the New England Power Association and the Hudson River Power Corporation. Several of the subsidiaries of the New England Power Association in turn are holding companies.

When the proceedings were instituted, International Hydro-Electric System had outstanding large amounts of debentures, preferred stock, Class A stock, Class B stock, and common stock. All of the Class B and common stocks were owned by certain trustees, who held as trustees for the benefit of International Paper and Power Company and International Paper Company. On January 17, 1941 the Commission issued findings and an order pursuant to Section 11(b) (2).<sup>20</sup> The Commission found that the common and Class B stocks had no value and directed the trustees owning such stocks to cancel them. In response to a request that such stocks be permitted to be sold at public auction, the Commission held that such a sale would not be in the public interest since such securities definitely had no value. On June 16, 1941 the trustees turned in their Class B and common stocks for cancellation, thereby complying with the Commission's order.<sup>21</sup>

In proceedings involving *Northern New England Company* and its subsidiary holding company, *New England Public Service Company*, the Commission on May 2, 1941 entered an order directing recapitali-

<sup>18</sup> Holding Company Act Release No. 2907.

<sup>19</sup> Holding Company Act Release No. 2122.

<sup>20</sup> Holding Company Act Release No. 2494.

<sup>21</sup> Subsequent to the order of January 17, 1941, further proceedings have been had with respect to the International Hydro-Electric System. A voluntary one-stock plan for Massachusetts Power and Light Associates, a subholding company, was filed; because of inability to obtain consents, this plan was later withdrawn. Proceedings meanwhile have continued under Section 11(b) (2).

zation on a one-stock basis.<sup>22</sup> The order permitted as an alternative the liquidation of the company. This order was entered before the completion of valuation evidence and the Commission made no finding that the junior securities were without value, but concluded that a single class of stock was the only appropriate capitalization for this holding company in view of the unstable earnings record, the substantial debt and preferred stock of its utility subsidiaries, and the speculative character of other assets.

In Federal Water Service Corporation,<sup>23</sup> the company had outstanding debentures, four series of preferred stock, and Class A and B stocks. In addition, there were substantial arrears of dividends on the preferred stock as well as on the Class A stock, which had priority as to assets and earnings over the Class B stock. The capital of the company had been impaired to a substantial extent and under the State law current earnings could not be used to pay dividends until this impairment was eliminated. The plan presented by the management contemplated a statutory merger of the company with a parent company and wholly-owned subsidiary in accordance with State law, leaving the debentures undisturbed, but proposed to substitute a single class of par value common stock for the present shares, 95 percent of which was to be allocated among holders of the various series of preferred on the basis of their respective dividend preferences, and the remaining 5 percent to be distributed to holders of the Class A stock. No provision was made for the B stock.

The Commission unanimously held that although the company was not relying upon the machinery of Section 11 (e) for the effectuation of the plan, it was, nevertheless, to be considered in the light of the standards imposed by the Act for plans presented under Section 11 (e), namely, that it must be "fair and equitable to the persons affected."<sup>24</sup> The Commission was also in agreement that the Class B stock, which had no reasonable probability of receiving anything from the company under its existing capitalization, should not be permitted to participate in any manner in the plan. It therefore disapproved of a provision in the plan for a staggered board of directors designed to continue in control in management to some degree identified in interest with the Class B stock. A difference of opinion

<sup>22</sup> *Northern New England Company et al.*, Holding Company Act Release No. 2737.

<sup>23</sup> Holding Company Act Release No. 2635.

<sup>24</sup> The majority opinion pointed out that the language of Section 7 (d) (6), which requires consideration of the question whether "the terms and conditions of the issue or sale of the security are detrimental to the interest of investors," while not identical with the standard of "fair and equitable" contained in Section 11 (e), means substantially the same thing in a situation where it is apparent that reorganization is necessary to comply with Section 11 (b) (2) of the Act and the plan before the Commission is evidently designed to effect compliance therewith. Commissioner Healy expressed the view that the designation by the applicant of the sections of the Act relied upon was inconclusive. He pointed out that the applicant was presenting a plan of the type described in Section 11 (e) of the Act; that is, for "action \* \* \* for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b)." Accordingly, he concluded that it must be appraised in the light of the standards which Congress had prescribed for such plans, i. e., the "fair and equitable" standard.

was expressed, however, with respect to the continuing interest of the Class A stockholders under the plan by reason of the allocation to them of new common stock.

Both the majority and dissenting opinions considered the application of the recent decision of the Supreme Court in the Los Angeles Lumber and Consolidated Rock cases,<sup>25</sup> which had held that the "fair and equitable" standard prescribed by Congress as applicable to plans of reorganization under Section 77B or Chapter X of the Bankruptcy Act, had the same meaning as had been developed in connection with that phrase in the equity receivership cases, and that that standard requires full recognition of liquidation priorities. Section 11 (c) also expressly prescribes the "fair and equitable" standard as applied to plans for compliance with Section 11 (b) of the Act, but the majority of the Commission held that this standard does not have the same application in the setting of a plan to comply with Section 11 where, as contrasted with the typical equity receivership or bankruptcy organization, liquidation of the company is not the alternative to reorganization. The majority concluded that on the basis of the pre-reorganization capitalization, the Class A stockholders of Federal had a reasonable, though remote, expectation of participating in future earnings and that, on this basis, it was "fair and equitable" to give them a continuing interest in the corporation in the comparatively small amount provided in the plan. It recognized, however, that the earnings prospects for Federal were not such as to warrant the finding of a present value for its properties equal to the full amount of the prior claims of the preferred stockholders on a liquidation basis.

Commissioner Healy dissented on the ground that, since a reorganization was legally compulsory under Section 11 (b) (2), rights to participate should be determined in the light of the respective contract rights to priority in the event of liquidation. On the basis of this reasoning and of his analysis of the facts, he concluded that any allocation to the Class A stock would be unfair. The same analysis led to a disapproval of the treatment of the various series of preferred stockholders, since the allocation was based on the relative dividend preferences and did not take into account their respective rights to priority on liquidation.

Another aspect of the decision, on which there was no difference of opinion, limited to cost the participation accorded to securities purchased by the management while the reorganization proceeding was pending before the Commission. Since the close of the fiscal year an appeal has been taken by those whose participation was so limited.

<sup>25</sup> *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (1939); *Consolidated Rock Products Co. v. Du Bois*, 61 S. C. 675 (1941).

Proceedings under Section 11 (b) (2) were instituted against *The Commonwealth & Southern Corporation*,<sup>26</sup> which company is a large holding company owning the equities of various operating companies. The order instituting the proceedings required the company to show cause why it should not reduce itself to a single class of stock.

On the basis of a showing as to the underlying facts concerning the holding-company system, the Commission held that expert evidence as to valuation of the company's assets was immaterial and that such evidence would not be permitted on the issue of whether a one-stock structure was the appropriate structure for this company.<sup>27</sup> One of the factors considered by the Commission in its opinion was the company's status under Section 11 (b) (1). The Commission indicated that a one-stock capital structure might be particularly appropriate or even necessary where, as it appeared here, the company must dispose of substantial amounts of assets in order to comply with that section. After this ruling the hearing proceeded on the issue of whether a one-stock order should be entered. At the close of the fiscal year, the matter was pending.

A number of pending proceedings under Section 11 (b) (2) involve the issue of possible subordination of the debt claims of a parent holding company against its subsidiary to the rights of the public holders of the securities of the subsidiary. These cases are discussed in a subsequent section of this report, entitled "Protection of the Financial Integrity of Utility Companies."<sup>28</sup>

Tables 43 to 45 of Appendix II, pages 308-309, indicate the number of applications under Sections 11 (e), 11 (f), 11 (g), and 12 (e), relating to plans for the simplification and reorganization of registered holding companies or their subsidiaries, and applications under Section 11 (f) and Rule U-11F-2, relating to fees and expenses, received and disposed of during the past fiscal year.

#### PUBLIC UTILITY FINANCING

##### Statistics.

During the fiscal year ended June 30, 1941, 125 applications or declarations filed by registered public-utility holding companies and their subsidiaries were declared effective pursuant to Sections 6 and 7. These effective filings aggregated \$1,065,893,281 in principal amount, compared with \$1,002,051,051 for the preceding year. This brought the total of new securities issued since the effective date of the Act, December 1, 1935, to \$3,951,825,783. Sixty-five filings were pending at the end of the fiscal year.

The following table indicates the number of applications and declarations under Sections 6 and 7, relating to issues of securities, received and disposed of during the year ended June 30, 1941:

<sup>26</sup> Holding Company Act Release No. 2679.

<sup>27</sup> *The Commonwealth & Southern Corporation*, Holding Company Act Release No. 2631.

<sup>28</sup> Page 102, *infra*.

*Applications and declarations under Sections 6 and 7*

	Number pending June 30, 1940	Number filed	Number approved	Number withdrawn or dismissed	Number denied	Number pending at close of fiscal year
To June 30, 1940		533	420	54	2	57
Filings for the fiscal year ended June 30, 1941:						
Section 7 issues	24	• 99	63	20	1	39
Section 7 assumptions of liability	4	11	8	2	1	4
Section 7 alteration of rights	8	25	24	5	0	4
Section 6 (b) issues	20	63	62	2	2	17
Section 6 (b) assumptions of liability	1	2	1	1	0	1
Total for fiscal year	57	• 200	158	30	4	65
Grand total		733	578	84	6	

• Three reopened.

The past fiscal year's effective filings, some of which covered more than one security issue, consisted of the following:

*Effective applications and declarations under Sections 6 and 7—By type of issue*

Type of issue	Number of issues	Amount	Percent
Mortgage bonds	55	\$629,860,423	59.1
Debenture bonds	3	12,700,000	1.2
Notes	48	104,093,457	9.7
Preferred stock issues	19	178,806,100	16.8
Common stock issues	43	140,433,301	13.2
Total	168	1,065,893,281	100.0

These securities, in the amounts indicated, were issued for the following purposes:

*Effective applications and declarations under Sections 6 and 7—By purpose of issue*

Purpose	Amount	Percent
Refunding	\$853,432,439	80.1
Reorganization	200,000	
Exchanged for other securities	115,140,070	10.8
Acquisition of property	6,352,000	.6
Miscellaneous	19,025,212	1.8
New financing	71,743,530	6.7
Total	1,065,893,281	100.0

It was proposed to market or dispose of these securities in the following manner:

*Effective applications and declarations under Sections 6 and 7—By method of disposal of issue*

Method	Amount	Percent
By underwriters	\$537,005,093	50.4
By private placement	316,637,982	29.7
To parent or affiliates	79,983,034	7.5
Through other channels	132,267,172	12.4
Total	1,065,893,281	100.0

**Standards of the Act.**

Before securities of registered public-utility holding companies or their subsidiaries can be issued they must meet the standards of Section 7 or be exempted pursuant to Section 6(b).<sup>29</sup> The Commission, through formal orders with conditions attached or through informal conferences, which the companies frequently request, has continued to strengthen the terms of the issue to the point where investors and consumers receive the protection intended by the Act. In these meetings, sometimes extending over a considerable length of time, the weak points of the issuer and its securities are carefully canvassed and adequate safeguards agreed upon. Changes, such as increased maintenance and depreciation charges, restrictions on dividends, greater voting rights, limitations as to the future issuance of securities having a preference over the proposed issue, elimination of conflicts of interests of indenture trustees, restatement of certain accounting items, and similar matters, are frequently made. It should be noted that the statute and the precedents set by the Commission in earlier cases have greatly changed the type and character of the financing plans now being filed with the Commission.

From November 1, 1935, to June 30, 1941, the Commission has granted 186 applications for exemption under Section 6 (b). It has been the Commission's policy to review a Section 6 (b) application with the same care as a declaration under Section 7. Bond indentures and preferred stock contracts of exempted securities must meet the same standards, with respect to protective covenants, as securities issued under Section 7. The significant difference between the power which the Commission has exercised under the two sections is that in Section 6 (b) cases the Commission has never imposed conditions preventing the issuance of securities in the amount and type approved by the State Commission.

When, however, it appears that a proposed debt issue in a Section 6 (b) case is excessive or that there is an insufficient equity "cushion" under the senior securities, including preferred stock issues, it is the Commission's policy to impose conditions which will improve the company's financial structure. Among the conditions imposed which related to matters other than fees and commissions there were the following general types:

- (a) No dividend shall be paid on common stock or in excess of a specified amount without Commission approval.
- (b) No dividend shall be paid on common stock if common stock and surplus fall below a stated minimum.
- (c) No dividend shall be paid on common stock except out of earned surplus accumulated after a specified date.

<sup>29</sup> For a distinction between the Commission's powers under these two sections, see concurring opinion of Commissioner Healy, *West Penn Power Company*, 7 SEC 69, 90. See also *Dayton Power and Light Company*, 6 SEC 787.

(d) No dividend shall be paid on common stock unless earned surplus after such dividend declaration is equal to or greater than a fixed sum plus a specified annual amount.

(e) No dividend shall be paid on common stock and no common stock shall be repurchased unless a stipulated amount has been set aside for depreciation and maintenance or any deficiency therein has been frozen in the surplus account.

(f) Reduction or prohibition of the payment of interest or principal on system advances; reduction of the amount of fees and commissions to be paid in connection with the financing.

#### Utility Bond Issues under Section 7.

In passing upon applications and declarations to issue securities, close scrutiny is given to the ratio of bonds, or of bonds and preferred stock, to total capitalization and to net tangible property, and to the relation between "earning power" and fixed charges and preferred dividend requirements. In no case has the Commission permitted the issuance of fixed interest-bearing obligations when it has felt that fixed charges are inadequately covered.

In cases where it appeared that a declaration for the issuance of securities would result in an excessive amount of funded debt the Commission, until recently,<sup>30</sup> was inclined to make a distinction between refunding and new money issues.

In the *El Paso* case, decided February 4, 1941, the Commission took occasion to reverse its previously indicated policy with respect to refunding issues as contrasted with new money issues in the following words:

"In order that future applicants presenting declarations for refunding of outstanding senior securities may be fully forewarned of the problem and be prepared to meet it we take this occasion to announce our future general policy as follows: A refunding of outstanding senior securities where the issuer has a high ratio of debt to net property or where the security issue does not fully meet the standards of Section 7 (d) will not be permitted effectiveness *merely* because it is a refunding. Such effectiveness will be permitted only where it appears that the circumstances are so unusual and extraordinary as to justify a departure from the general policy announced. Even in such cases the applicants should else be prepared to have included in their refunding operations measures definitely providing for a reduction of the ratio of debt to net property and of debt to total capitalization to a reasonable level."

The Commission deemed the matter of such importance that it attached to its opinion in the *El Paso* case an appendix giving comprehensive reasons for its changed policy. Referring to its former policy, the Commission said:

"Several opinions of the Commission and of individual Commissioners have in the past stated that our policy was to apply the standards of Section 7 (d) less

<sup>30</sup> See appendix to the *El Paso* opinion, Holding Company Act Release No. 2535. See especially concurring opinion of Chairman Frank in the *Southwestern Gas and Electric Company* case, 6 SEC 822.

strictly to refunding issues than to issues for new money. While such statements have been largely predicated on special circumstances appearing in the cases wherein the statements were made, it is apparent that reliance has been placed upon them as authority for the general proposition stated."

It was pointed out that, although Section 7 (c) (2) (A) of the Act provides for flexibility as to the *type* of securities which may be issued in refunding cases, no such differentiation or exemption is provided with respect to the application of the standards of Section 7 (d).

The Commission originally made this distinction on the assumption that

"any improvement of a bad financial structure is necessarily a step in the right direction, and that the issuer should be permitted to take steps in the right direction, even though his proposals stop short of the point where the resultant financial structure is consistent with sound finance and the objectives of the Act. Most of the refunding issues which have come before the Commission have involved proposals to take advantage of declining interest rates and to substitute low coupon bonds for those originally issued at a higher rate. Interest savings have been substantial, and consequently there have been such improvements in the ratio of earnings to fixed charges as to present a better picture with respect to the new bonds being 'reasonably adapted to the earning power of the declarant.' In addition, indentures have been modernized, possible conflicts of interest affecting indenture trustees have been eliminated, and similar improvements made in miscellaneous terms and conditions of the securities. Without attempting to minimize the extent of the improvements in the financial condition of the issuer and the protection for investors which may have resulted, it is, nevertheless, the Commission's conclusion that it may have frequently fallen short of giving full effect to the intention of Congress, to the extent that it has permitted refundings without requiring them to fully measure up to the standards of Section 7 (d).

"Aside from the statutory provisions, the wisdom of identical treatment of new money issues and refunding issues is indicated also from the practical point of view. Where corporate debt is excessive and the refunding is accomplished through the sale of new long term obligations, the issuer perpetuates the two attendant major perils—the necessity of paying it off at some date in the future, and the necessity of meeting fixed charges in the meantime."

It should be emphasized that the El Paso decision stated a general ideal or objective, that refunding issues which fail to meet the standards of Section 7 (d) will not be approved *merely* because they are refundings.

A recent interesting case which illustrates the work of the Commission with respect to improving the financial structure of companies issuing securities is that which involved the refinancing of *The Commonwealth & Southern Corporation* and its subsidiary, *Georgia Power Company*.<sup>31</sup> Originally, the parent company, which held \$34,000,000 of 5 percent bonds of its subsidiary, planned to resell them to insurance companies along with \$17,000,000 2½ percent 10-year installment notes to 5 New York banks to retire its outstanding funded debt amounting to nearly \$52,000,000. In discussions, it was pointed out

<sup>31</sup> Holding Company Act Release No. 2586.

to the management that the sale of these bonds would have the effect of freezing the outstanding bonded debt of the subsidiary, at approximately \$125,000,000 which, in the staff's opinion, was greatly in excess of the amount which could safely be supported by its assets. After further discussion, the management decided to proceed immediately with the refunding of the \$125,000,000 of Georgia Power Company bonds. This refunding was consummated by a private sale to 27 insurance companies of \$101,000,000 of 3½ percent mortgage bonds, together with \$13,500,000 of 2½ percent 8-year installment notes sold to banks.

Before declaring the application effective, the Commission discussed with the Georgia Power Company the desirability of making a thoroughgoing readjustment of its accounts. As a result, among other things, the operating company eliminated write-ups in its property account aggregating over \$32,000,000; restated its preferred stock at its liquidating value of \$100 per share (its stated value averaged \$86); increased its depreciation reserve by \$13,000,000; reduced the stated value of its common stock from \$35 to \$22 per share; charged unamortized debt discount and expense of \$5,000,000, attributable to the refunded bonds, against earned surplus; and consented to a condition restricting dividends to earnings accumulated subsequent to December 31, 1940.

On a *pro forma* basis, funded debt amounted to 53 percent, preferred stock 21 percent, and common stock equity 26 percent, respectively, of total capitalization. The total of the new bonds and notes represented 53 percent of the utility's net property after the write-downs referred to above, but without adjustment for estimated remaining intangibles. The Commission noted that the *pro forma* property account was still substantially in excess of original cost of its utility plant, which was being reclassified in accordance with the uniform system of accounts of the Federal Power Commission. Depreciation accounting, however, had superseded retirement accounting and the provisions for this expense had shown considerable improvement during the last 4 years. The Commission declared that the sinking fund provisions of the bonds and the retirement of the installment notes would rapidly improve the capital structure of the company. It was noted that there had been a marked upward trend in earnings and that the total fixed charges and preferred stock dividend requirements were earned on a *pro forma* basis 1.60 times.

The parent company made a capital contribution to the subsidiary totaling \$18,500,000, which consisted of \$14,337,319 of its portfolio bonds and all of its holdings of preferred stock which cost \$4,162,681. The Commonwealth & Southern Corporation then eliminated its own funded debt amounting to \$51,857,500. The funds for this purpose were obtained as follows: from the corporation's cash account

(\$16,500,000), in payment of the remaining Georgia Power Co. bonds in its portfolio (\$18,493,122) and from the proceeds of an issue of 10-year installment notes (\$17,000,000). It was found that the *pro forma* debt of the parent company was reasonable in proportion to its total assets and that the fixed charges were amply covered. It was also found that the issuance of the short-term notes would not be a hindrance to compliance with Section 11. The transactions covered by these applications were beneficial and constructive to The Commonwealth & Southern Corporation, as well as to the Georgia Power Company.

In June 1941, the Commission authorized the *Philadelphia Company*, a registered holding company and a subsidiary of *Standard Gas and Electric Co.*, to issue \$48,000,000 collateral trust bonds, \$12,000,000 collateral trust serial notes (due 1942-1952), and not to exceed 413,794 shares of common stock (to be sold to its parent at \$7.25 per share), for the purpose of refunding outstanding bonds amounting to \$60,000,000 at a call premium of \$3,000,000. Philadelphia Company's principal investment is in the common stock of *Duquesne Light Company* and the *Pittsburgh Railways Company*, which is in the process of reorganization under Section 77B.

In 1939, anticipating the necessity of creating a reserve to absorb the depreciation of its investment in the Railways Company; Philadelphia Company applied for approval of a reduction in the stated value of its common stock and the creation of a revaluation reserve amounting to \$23,000,000. The Commission granted the application although it expressed "doubts of the adequacy of the revaluation reserve."<sup>32</sup>

In its opinion<sup>33</sup> on the refunding program, the Commission noted that the transactions "are not without their difficulties" for "in relation to the book values of the properties of the system, with adjustment for write-ups and deficiencies of depreciation reserves, as well as unrealized depreciation in the Railways, the debt initially is higher than we should like to see it." In approving the transactions<sup>34</sup> the Commission noted, however, that the provisions for debt retirement and for increasing the amortization reserve were quite drastic and gave evidence of a "bona fide endeavor to rectify a top-heavy structure as rapidly as circumstances permit."

On October 2, 1940, Northeastern Water and Electric Corporation,<sup>35</sup> a registered holding company and an indirect subsidiary of *Associated Gas and Electric Corporation* in bankruptcy proceedings, filed an application to purchase *Union Water Service Company*. The company declared that it regarded the acquisition of the Union properties as an

<sup>32</sup> 6 SEC 752. See Sixth Annual Report, pp. 32 and 33.

<sup>33</sup> Holding Company Act Release No. 2816.

<sup>34</sup> Commissioner Healy dissented without opinion.

<sup>35</sup> Holding Company Act Release No. 2314.

anticipatory investment of the proceeds of the sale of certain electric properties in Ohio. The applicant further stated that it was engaged in negotiations looking toward the complete severance of *Northeastern* from the *Associated* system.

The consolidated *pro forma* balance sheet showed that funded debt and minority interest represented 41 percent of the total capitalization, while preferred stocks represented another 46 percent, and the common stock the balance. Furthermore, senior securities (debt and preferred stock) represented 86 percent of the net book fixed capital. When write-ups were eliminated these securities represented 113 percent of the net fixed capital. When, however, preferred stock investments in nonsubsidiaries were added to the adjusted property account, the common stock equity appeared to be 7.50 percent.

In reviewing the declaration in the light of the standards of Section 7 (d), the Commission noted that *Northeastern* was one of a tier of four holding companies and that control was exercised through a disproportionately small investment in the common stock. Earlier assurances that *Northeastern* would promptly liquidate its electric properties had not been fulfilled. The Commission found that, on a corporate basis, prospective earnings of the company would not be adequate to pay interest charges; sinking fund requirements, and preferred stock dividend requirements during the next 3 years. The Commission also noted that the preferred stock of *Northeastern* represented the investment made by bondholders in a predecessor company which was reorganized less than 6 years before. In approving the declaration, however, the Commission pointed out that there were off-setting factors: (1) the issuance of common stock at this time was precluded by the complexity in the financial structure of the corporation; (2) even if *Northeastern* is not able to obtain cash from the sale of its Ohio properties during the next 3 years, nevertheless, its anticipated earnings on the corporate basis would suffice to pay the interest and liquidate the principal of the note and to make possible the payment of full dividends on the preferred stock for 2 of the 3 years and a portion of the third—provided that no dividends are paid on the common stock.

The Commission permitted the declaration to become effective only upon condition that no common stock dividends be paid until the retirement of the note and that the declarant file a stipulation that, if the electric properties were not disposed of within 6 months, the company will consent to the entry of an order by the Commission pursuant to Section 11(b) (1) requiring their disposition.

In replying to argument of counsel that the condition restricting the payment of dividends constituted "an unwarranted intrusion on managerial discretion", the Commission stated that the Public Utility

Holding Company Act of 1935 was intended to restrict transactions proposed by management which did not meet the prescribed standards, and that the Commission was bound to carry out the mandate of the statute. The Commission's "statutory powers and duties under Sections 7 and 10 \* \* \* are in no way diminished by the fact that Northeastern is controlled by the *Associated* trustees who, in turn, are subject to the supervision of the Bankruptcy Court." This was admitted by counsel for the trustees of the insolvent parent. As a reply to the contention of counsel, the Commission set forth, at length in an appendix, some of the reasons which prompted Congress to enact the statute.

#### Debt Retirement Policies.

As a remedial measure designed to conform top-heavy corporate structures to statutory standards where the ratio of debt to net property is excessive, the Commission has frequently required issuers to follow some systematic debt reduction plan. Several methods of providing for gradual debt reduction have been utilized. In some instances, conditions have been attached requiring that the interest savings from refunding or a certain amount of net earnings be reserved to redeem outstanding debt. In other instances, the Commission has required the inclusion of sinking fund provisions whereby the issuer agrees to devote annually a stated amount to retirement of bonds or to property additions. In still other instances, the objective of debt reduction has been achieved by means of serial financing.

The Commission has referred to the need of debt amortization as follows:

"Too many utilities regard their debt as perpetual and make no adequate provision for its ultimate liquidation.<sup>36</sup> There appears to be an abiding faith in the permanency of existing generating and transmission facilities, although it is well known that rapid scientific progress might change the methods of the power industry overnight. A similar optimism once prevailed in the street railway industry: 'As late as 1921 an investment banker wrote—"Sinking funds are found in some of the earlier street railway mortgages, but the present tendency is to omit them, on the theory that a street railway is permanent property and not of a wasting character where sinking funds are essential to reduce the debt as the assets are diminished." ' ' <sup>37</sup>

#### Equity Financing.<sup>1</sup>

As a corrective measure, the Commission is becoming more insistent that, wherever possible, more common stock financing be done to

<sup>36</sup> In this connection it is noteworthy that as a result of numerous recent refundings, it is estimated that some \$3,656,200,000 of debt (or well over one-half of the total fixed debt of the utility industry) falls due in the decade from 1961 to 1970. Moreover, it is estimated that \$2,543,500,000 of funded debt (or almost 40 percent of the total) falls due in the five years from 1965 to 1969. Experts have suggested that this may constitute an unique concentration of maturities and a possible future source of trouble to the utility industry. 21 *Savings Bank Journal* (May, 1940) 40.

<sup>37</sup> Appendix, *El Paso Electric Co.*, Holding Company Act Release No. 2535.

improve the capital structure of those companies which have a high ratio of bonds to (a) "capitalization" and (b) net property, adjusted for write-ups. All too frequently holding companies and their subsidiaries have been so overburdened with senior securities that they are unable to sell common stock to the public without a thoroughgoing recapitalization.<sup>38</sup>

In a number of instances, however, the Commission, in passing upon declarations before it, has required companies to take action to increase the ratio of equity to senior securities.<sup>39</sup>

One method of increasing common stock equity has been to require the conversion of open accounts, bonds, or preferred stock held by the parent company into common stock of its subsidiary.<sup>40</sup> When the *Appalachian Electric Power Company*<sup>41</sup> refinanced its bonds and preferred stock, its parent, *American Gas and Electric Company*, made a \$30,670,000 capital contribution to its subsidiary. This was accomplished by converting an open-account advance and preferred stock into capital surplus, with the further provision that \$22,500,000 of that amount would be placed in an appropriate reserve account to be available for possible adjustments to fixed capital accounts and the depreciation reserve account. The principles of the *Deep Rock* case<sup>42</sup> established by the Supreme Court of the United States have given considerable impetus to the conversion of senior security holdings into common stock. This case is discussed at p. 105 of this report.

A number of holding companies have increased their equity investments in their subsidiaries either by outright cash contributions or the purchase of additional common stock. Although the aggregate amount has not been large, there has been a substantial increase in the number of such instances since June 30, 1940.<sup>43</sup>

#### Mortgage Indenture.

Since the mortgage indenture is one of the principal instruments of utility finance, the Commission has long desired to secure a greater degree of uniformity and simplicity in its covenants. To that end the Commission is now making a study of the provisions of a large number of existing utility mortgage indentures.

Wherever possible the Commission has sought to limit funded debt to 50 percent of the net fixed assets. In passing upon this relationship

<sup>38</sup> See, for example, the conclusion in report of Public Utilities Division entitled "Dividend Status of Preferred Stocks of Registered Public Utility Holding Companies and Their Electric and Gas Utility Subsidiaries as of December 31, 1938."

<sup>39</sup> See appendix, *El Paso Electric Company*, Holding Company Act Release No. 2535.

<sup>40</sup> See *Public Service Co. of Colorado*, 5 SEC 788; *Gulf Public Service Company*, Holding Company Act Release No. 2253; *East Tennessee Light & Power Co.*, Holding Company Act Release No. 2344. See also *Georgia Power Company* financing, p. 93, *supra*.

<sup>41</sup> Holding Company Act Release No. 2430.

<sup>42</sup> *Taylor v. Standard Gas and Electric Company*, 306 U. S. 307 (1939).

<sup>43</sup> See, for example, *Union Electric Company of Missouri*, Holding Company Act Release No. 2780; *The Ohio Power Company*, Holding Company Act Release No. 2660; *Wisconsin Public Service Company*, Holding Company Act Release No. 2550; *Lake Superior District Power Company*, Holding Company Act Release No. 2528; *Missouri General Utilities Company*, Holding Company Act Release No. 2661.

consideration is given to the existence, if any, of write-ups which may be included in the property account. In general, the issuance of additional bonds is limited to 60 percent of the cost or fair value, whichever is less, of net additions to fixed property. This higher ratio for bonding additions is sanctioned to give greater flexibility under the indenture to meet unforeseen future conditions.

The Commission has been careful to see that each mortgage indenture has adequate maintenance and replacement provisions to insure, as certainly as possible, that the net value of the property securing the mortgage will not decrease and thereby diminish the security of the outstanding bonds. Furthermore, the sum specified in the indenture for maintenance and replacement must annually be accounted for to the trustee. Since the enactment of the Trust Indenture Act of 1939, the trust indenture provisions of all utility bond issues must meet the standards of that Act with respect to the duties, responsibilities, and the rights of the trustee.

#### **Preferred Stock Protective Provisions.**

In order to protect preferred stockholders more adequately the Commission has insisted upon an increasing number of safeguards. These have to do primarily with voting privileges. The Commission now insists that in order to meet the standards of the Act, preferred stock, as a class, must have the right to elect a majority of the board of directors upon accumulation of six quarterly dividend arrearages.<sup>44</sup>

Furthermore, the Commission has insisted that the assent of a specified majority of the preferred stock voting as a class shall be necessary before certain corporate actions may be taken which may affect the rights, privileges, or priorities of the preferred stockholders, such as issuing additional senior securities or effecting a merger or consolidation.

#### **COMPETITIVE BIDDING**

On April 7, 1941, the Commission adopted Rule U-50, under the Public Utility Holding Company Act of 1935, requiring competitive bidding in the sale of securities by registered public-utility holding companies and their electric and gas utility subsidiaries.<sup>45</sup> The rule, applicable both to new security issues and to the sale by holding companies of portfolio utility securities, prescribes public invitation of sealed bids. Certain transactions are specifically exempted, including securities sold for less than \$1,000,000; securities issued *pro rata* to existing security holders pursuant to any preemptive right or privilege or in connection with any liquidation or reorganization; and loans of a maturity of 10 years or less, where the lender is a moneyed institution not purchasing for resale, and no finder's fee or other negotiation

<sup>44</sup> *The Ohio Power Company*, Holding Company Act Release No. 2660; *Luzerne County Gas and Electric Corporation*, Holding Company Act Release No. 2784.

<sup>45</sup> Holding Company Act Release No. 2676.

charge is to be paid to any third person. In addition, there is a general provision for exemption from competitive bidding by order of the Commission.

Prior to the adoption of Rule U-50, the customary method of selling utility securities involved a sale by the issuing corporation to an underwriting syndicate at a price determined by private negotiation with the principal or so-called originating underwriter. It was an established policy of investment bankers not to compete among themselves for the securities business of any issuer which had a continuing investment banking relationship with a particular firm. Similarly, with very few exceptions, the issuing corporation made no attempt to seek competitive bids or to "shop around" for better terms than those offered by its customary banker. In some cases, moreover, there was a clearly traceable affiliate relationship, sometimes extending over a considerable period of time, between the originating underwriter and the issuer. In fact some of the underwriters had been promoters of some of the major holding company systems. As a result of these conditions there was a definite absence of free market competition in the underwriting of utility security issues. Fortunately, the provisions of the Public Utility Holding Company Act of 1935 provided ample authority for meeting the problem.

Section 1 of the Act enumerates various abuses and evils which gave rise to the need for control of public-utility holding companies and their subsidiaries, including those which occur when public utility companies enter into transactions in the "absence of arm's-length bargaining" or where there is "restraint of free and independent competition." In addition to the provisions which are aimed at the maintenance of competitive conditions, the Commission was given very special authority over dealings with "affiliates." In fact, the Commission's first approach to the problem of maintaining arm's-length bargaining in the issuance and sale of public-utility securities was evidenced by an attempt to control relations of holding company systems with investment banking affiliates.

Early in the administration of the Act, the Commission was confronted with security transactions in which there was serious question whether the negotiations were conducted at arm's-length. The Commission eventually concluded that it was necessary to establish a procedure to cope with the problem of affiliation in security issues. Accordingly, in December 1938, it adopted Rule U-12F-2 which prohibited, with exceptions, the payment of any underwriter's fee by registered holding companies or subsidiaries thereof to any affiliate unless the affiliate had been awarded the securities as the most favorable bidder in open competition. One of the exceptions was that an affiliate might act as an underwriter without competitive

bidding if its participation did not exceed 5 percent of the total offering and its fee was computed at the same rate as that of other underwriters having a similar participation. The theory of this exception was that with their participation so limited investment bankers would no longer find it worth while, and therefore would cease, to dominate the securities transactions of the companies with which they were affiliated.

The Commission's experience with Rule U-12F-2, however, was that, despite the fact that their participation was so limited, affiliated investment bankers continued to negotiate, as managing underwriters, the securities transactions of the companies with which they were affiliated. Significantly, during the 2 years that Rule U-12F-2 was in effect no use was made of the competitive bidding procedure it provided. Thus, the attempt to assure competitive conditions and arm's-length bargaining in the issuance and sale of securities by companies subject to the Act was defeated because affiliated investment bankers, whatever their incentive may have been, continued to use their position of superior advantage to dominate such transactions.

It was claimed, moreover, that Rule U-12F-2 was burdensome and costly to issuers and underwriters alike because prolonged investigations and hearings were found necessary in many cases to determine whether, under the Act, an underwriter and an issuer were affiliated within the meaning of Section 2 (a) (11) (D) and the corresponding standard imposed in the rule. The Commission recognized that these hearings were not only costly and time consuming for the parties, but presented for decision complex questions of fact. Thus it examined and re-examined the record in the *Dayton Power & Light Company* case,<sup>46</sup> decided in March 1941, to avoid any possible unfairness in drawing inferences from the details of a large mass of evidence adverse to the investment bankers there involved; and the delay and suspense, necessarily incident to that careful scrutiny, had occasioned further criticism of Rule U-12F-2.

The Commission's realization of the shortcomings of Rule U-12F-2 led, in February 1940, to the solicitation of suggestions as to the method by which it might "best insure the reasonableness of fees and commissions and the fairness of the terms and conditions of any proposed issue and sale of utility securities." It also instructed its Public Utilities Division to make a full study of the problem and, more than a year ago (February 29, 1940), a letter was written to each holding-company system subject to the Act, as well as to State commissions, investment bankers, and securities dealers throughout the country. It was stated in this letter that competitive bidding and "shopping around" had been suggested as possible ways of meeting

<sup>46</sup> Holding Company Act Release No. 2654.

the problem. Many replies were received, but after careful consideration and discussions with representatives of the Investment Bankers Association, the National Association of Securities Dealers, Inc., and others, it appeared that none of the suggestions received in response to that inquiry, other than competitive bidding, gave promise of effectively achieving the desired results. Then, in a report to the Commission dated December 18, 1940,<sup>47</sup> the Public Utilities Division formally recommended the adoption of a competitive bidding rule. Copies of that report were distributed to registered holding companies, State and Federal regulatory bodies, and to a broad list of investment bankers and dealers, both directly and through the Investment Bankers Association and the National Association of Securities Dealers, Inc. In distributing the report, written comments were invited, following which numerous responses were received. The Commission then called a public conference to consider the recommended rule and public discussion continued for 4½ days. The conference was attended by approximately 200 persons from every part of the country, including two members of Congress, investment bankers, securities dealers, and representatives of other governmental agencies. Four members of the Commission were present at all times. All shades of opinion, *pro* and *con*, were expressed on the question, both in the written responses and at the conferences.

After weighing the evidence and considering all aspects of the problem, the Commission concluded that there was no way short of competitive bidding that would afford it satisfactory means of determining the reasonableness of spreads or the fairness of prices, assure disinterested advice in financial matters to the companies concerned, and effectively control their dealings with affiliates.<sup>48</sup>

In connection with hearings on the rule, there was considerable emphasis upon the difficulties of investment bankers, particularly the small local dealers, in making enough money to keep them in business under present day conditions of the financial markets. It was urged that competitive bidding might result in a further shrinkage of income for the small firms. The Commission indicated its concern with the problems of the local dealers. However, it appeared that these difficulties had developed to an acute degree during a period when competitive bidding was the exception rather than the rule. The small dealers had no assurance of obtaining an adequate share of negotiated issues or a fair division of the gross underwriting spread. Moreover, there had been a growing practice of direct sales by issuers to insurance

<sup>47</sup> "The Problem of Maintaining Arm's-Length Bargaining and Competitive Conditions in the Sale and Distribution of Securities of Registered Public Utility Holding Companies and their Subsidiaries."

<sup>48</sup> "Statement of the Securities and Exchange Commission upon the promulgation, under the Public Utility Holding Company Act of 1935, of Rule U-50, requiring competitive bidding for securities of registered public utility holding companies and their subsidiaries"—Holding Company Act Release No. 2670.

companies, which gave no opportunity to the investment banking industry at large to earn commissions, although there might be payment of so-called "finders' fees" to a few investment banking firms who act as intermediaries in conducting the negotiations with the insurance companies. Among the factors which appear to have led to the growth of private placements and consequent elimination of the investment banking function in the distribution of securities, is the fact that insurance companies can give a "firm commitment" while proceedings for approval of the regulatory authorities are pending whereas investment bankers are unable to make a firm commitment until immediately before public offering. Another factor has been the fact that direct sales to insurance companies do not require registration under the Securities Act, since they do not involve a "public offering." These competitive advantages of the insurance company over the investment banker are eliminated under competitive bidding, since there is a preliminary approval by the regulatory authorities prior to the invitation for competitive bids and since registration under the Securities Act is necessarily involved. One further competitive advantage of the insurance companies is that they are buying for their own investment and not for resale. This advantage remains unaffected whether or not competitive bidding is resorted to.

Since Rule U-50 became effective there has been active competition between investment bankers, both in the formation of groups to bid on new issues (frequently without relation to past affiliations) and in the tendering of bids. The insistence upon competition in the sale of this particular kind of merchandise follows the traditional American pattern of the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, all of which aim to preserve competition and to keep that competition fair. These laws, backed by both major political parties, are among the foundation stones of our democratic system of capitalism. Rule U-50 is not merely a matter of business procedure. Ours is a system of free enterprise and when practices are allowed to develop which eliminate or suppress competition, the very fundamentals of that system are endangered. The liberating influence of this competitive bidding rule will foster free enterprise and competition in a field which has long been characterized by concentration of the management and underwriting of new securities in the hands of a few firms.

#### **PROTECTION OF THE FINANCIAL INTEGRITY OF UTILITY COMPANIES**

Since impairment of the financial integrity of utility companies inevitably leads to poor public service and to falling security values, measures designed to protect the financial strength of utility companies are of the utmost importance to consumers as well as to in-

vestors. Therefore, Section 12 (c) of the Act prohibits the payment of any dividend in contravention of a regulation or order of the Commission deemed necessary or appropriate to protect the financial integrity of companies subject to the Act; to safeguard their working capital; to prevent the payment of dividends out of capital or unearned surplus; or to prevent circumvention of such rules or orders. To implement the statute, rules have been promulgated which prohibit the declaration of dividends out of capital or unearned surplus without approval of the Commission.

On account of the large fixed investment in the utility industry in relation to its operating revenues, depreciation accruals constitute an important part of total operating costs. If the amount of depreciation is underestimated and an inadequate allowance therefor is charged as expense, there results an overstatement of net income available for fixed charges and for the payment of dividends. Not alone does it result in a distorted income statement, which may be misleading to investors, but if the overstated earnings are paid out as dividends and that policy is continued, it may cause an impairment of the capital of the company and jeopardize its financial integrity. The failure to charge adequate depreciation expense also results in a deficient depreciation reserve and, as a consequence, the net book value of the company's assets is correspondingly overstated. This, likewise, is misleading and may cause investors to believe that the company's capital structure as related to net property values is sounder than it actually is.

To date, the Commission's supervision over the dividend and depreciation policies of utility companies to prevent impairment of working capital and maintain financial integrity has been limited chiefly to the individual cases which come before it in connection with security issues. In passing on proposed security issues, the Commission has not infrequently imposed conditions restricting the payment of common stock dividends where such action was necessary to protect the interest of investors or the financial integrity of the company.

It has been the Commission's practice in difficult cases involving the adequacy of depreciation to supplement its analysis of financial statements by engineering field investigations. The results of these investigations indicated the desirability of undertaking a general survey of the dividend and depreciation policies of the utility companies subject to the Act. Such a survey was made on the basis of figures supplied by the companies and the results were published in August 1940, in a report entitled "Financial Statistics for Electric and Gas Subsidiaries of Registered Public Utility Holding Companies, 1930-1939."<sup>49</sup>

<sup>49</sup> A later edition of this report, covering the period 1930-1940, was issued in August 1941.

These reports showed that there was a marked discrepancy between the depreciation charges which companies were allowed to deduct for the purpose of computing their Federal income tax returns and the depreciation expense which they actually recorded on their books. Thus, for the 10-year period 1930-1939, 168 operating companies, with aggregate assets of nearly \$8,000,000,000, were allowed depreciation deductions for Federal income tax purposes in the amount of \$1,772,904,000, although the depreciation expense charged against income on their books aggregated only \$1,153,960,000. After their income accounts were adjusted by the amount of the excess of depreciation allowed for income tax purposes, it was found that 113 of these 168 companies had paid out as dividends \$348,777,000 more than they actually earned during the 10-year period.

In the last few years there has been considerable improvement in the depreciation policies of the utility companies, particularly since 1937 when the Federal Power Commission and most of the State utility commissions prescribed depreciation accounting for electric utilities in place of retirement accounting, which had been in general use prior to that time. But the Commission's studies indicate that the depreciation charges of a large number of companies continue to be inadequate.

Early in July 1941, the *Philadelphia Electric Company*, a subsidiary of The United Gas Improvement Company and The United Corporation, agreed to make substantial revisions in its depreciation practices.<sup>50</sup> The company has tentatively agreed, pending completion of its property studies, not to use \$10,000,000 of its earned surplus existing December 31, 1940, for dividend distributions; to increase its annual accruals from current earnings for depreciation purposes to not less than \$7,000,000 beginning January 1, 1941 (accruals for 1940 amounted to \$5,870,000); and to diligently pursue its present studies on the cost and probable useful lives of its utility assets. Representatives of the Pennsylvania Public Utilities Commission contributed materially to the resulting cooperative adjustment of the company's depreciation and dividend practices. Close cooperation with State commissions on such matters is an established policy of this Commission.

Closely related to the problem of dividend payments is that of payments on what purport to be debt claims of parent holding companies. In prior years it had been the practice of many holding companies to force their subsidiaries to declare dividends on the basis of the entire book earnings (which may or may not have represented actual earnings), regardless of the availability of cash to pay such dividends. The dividends so declared were not in fact paid—except as a matter of bookkeeping entries or formal payments. The sums

<sup>50</sup> Holding Company Act Release No. 2891.

involved were loaned back to the subsidiaries, frequently at high rates of interest. Open accounts between the parent holding company and its subsidiaries involved a great number of such "advances" in respect to dividends, as well as numerous other questionable inter-company transactions not conducted at arm's-length. Sometimes the balance remained an open account, sometimes part of it was the consideration for the issuance of additional common stock to the parent holding company, and sometimes for the issuance of senior securities. In some instances there was a time lag but an essentially similar relationship between the "milking" of the subsidiary and the creation of a debt claim in favor of the parent holding company. Having launched the subsidiary with an unbalanced security structure or drained it of cash, it became necessary for the parent company to come to its rescue with financial aid in the form of a loan or the purchase of senior securities.

An intercompany claim of this character came before the Supreme Court in 1939. *Taylor v. Standard Gas & Electric Company*,<sup>51</sup> involved a reorganization plan under Section 77B of the Bankruptcy Act for Deep Rock Oil Company, one of the non-utility subsidiaries of Standard Gas & Electric Company. The parent holding company had filed a claim arising out of an open account against Deep Rock, in the amount of \$9,000,000, which was subsequently allowed in the compromised amount of \$5,000,000. It was assumed that the \$5,000,000 figure represented a valid consideration received by Deep Rock from Standard. Nevertheless, the Supreme Court held that the equities of the situation required complete subordination of this debt claim to the claims of the publicly-held preferred stock of Deep Rock, and for that reason disapproved "lower court decisions approving as 'fair and equitable' a reorganization plan" which did not provide for such subordination. Among the factors stressed was the domination of the management of Deep Rock by Standard; the responsibility of Standard for a capitalization, top-heavy with debt; cash advances to permit dividends not warranted by earnings; misrepresentations in connection with the sale of securities; charging 7 percent interest, compounded monthly, on the open account; management fees; and miscellaneous other abuses, as to which the Court stated:

"It is impossible within the scope of this opinion, to tell the numerous other transactions evidenced by the books of the two companies, many of which were to the benefit of Standard and to the detriment of Deep Rock. All of them were accomplished through the complete control and domination of Standard and without the participation of the preferred stockholders who had no voice or vote in the management of Deep Rock's affairs. \* \* \* It is impossible to recast Deep Rock's history and experience so as even to approximate what would be its financial condition at this day had it been adequately capitalized and independently managed and had its fiscal affairs been conducted with an eye single to its own interests."

<sup>51</sup> 306 U. S. 308.

The decision in the Deep Rock case is merely an illustration of the traditional equitable principle that directors and controlling stockholders are held to a strict fiduciary standard in dealing with their corporation. This was pointed out by the Court in the subsequent case of *Pepper v. Litton*,<sup>52</sup> in which the Court stated that, in scrutinizing such dealings, "the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain. If it does not, equity will set it aside." This arm's-length bargaining test closely parallels the standards applicable under the Public Utility Holding Company Act of 1935 to intercompany transactions and to other transactions between affiliates.<sup>53</sup> Accordingly, the effect of these recent decisions of the Supreme Court has been to emphasize the importance of Commission scrutiny under the Act of the many debt claims of the registered holding companies against their subsidiaries.

The problem may arise in connection with the Commission's approval of a reorganization plan under Section 11 (e) or Section 11 (f) of the Act. Mountain States Power Company,<sup>54</sup> referred to in the Commission's annual report for the year ended June 30, 1939,<sup>55</sup> was a case involving a plan of reorganization for a company which was the subject of reorganization proceedings under Section 77B of the Bankruptcy Act. The plan was approved by the Commission under Section 11 (f). The equities in favor of subordination did not appear to be as strong as those involved in the Deep Rock case and the Commission approved a compromise settlement which gave the preferred stockholders partial priority over the parent company's debt claim.

Shortly after the close of the past fiscal year,<sup>56</sup> the Commission approved, under Section 11 (e) of the Act, a plan of corporate simplification for *Derby Gas & Electric Corporation*, a subsidiary holding company in the Ogden Corporation holding company system.<sup>57</sup> Derby had outstanding a \$5,000,000 open account claim held by Ogden, preferred stock, of which 14.7 percent was held by Ogden and the balance by the public, and common stock all held by Ogden. The preferred stock held by Ogden had been purchased at a substantial discount by a wholly-owned subsidiary of the parent holding company at a time when reorganization proceedings were pending before

<sup>52</sup> 308 U. S. 295. See also *Consolidated Rock Products Company v. Du Bois*, 61 Sup. Ct. 675, 85 L. Ed. 603 (1941).

<sup>53</sup> "Absence of arm's-length bargaining" and "restraint of free and independent competition" are linked together in Section 1 (b) of the Act, as among the evils in the holding company field which the Act was expressly designed to eliminate. Section 2 (a) (1) (D) makes the possibility of "absence of arm's-length bargaining" a basis for imposing affiliate obligations, and Section 12 (f), among others, provides for the regulation of transactions between companies in the same holding company system and between other affiliates with a view to the "maintenance of competitive conditions."

<sup>54</sup> 5 SEC 1.

<sup>55</sup> Page 73.

<sup>56</sup> July 12, 1941.

<sup>57</sup> Holding Company Act Release No. 2375.

the Commission. The subsidiary company had called for retirement in advance of maturity its outstanding funded debt. This was done in contemplation of a refunding operation but without making definitive arrangements, including securing Commission authorization, for the new issue. Later, the refunding was abandoned, and the funded debt paid off out of the proceeds of a demand advance from the parent which carried interest at the same rate as that on the retired funded debt. The plan provided for a cash payment to the parent out of the proceeds of a new issue of debentures in the amount of \$2,750,000 on account of its \$5,000,000 claim. The plan also provided for a single class of stock which was divided between the parent holding company and the public holders of Derby's preferred stock. The basis of division recognized that the open account claim might be, to a certain extent, vulnerable under the strict standards applicable to intercorporate dealings. The Commission approved this aspect of the plan as fair and equitable on the ground that the circumstances did not appear to require subordination of the parent company's claim within the so-called Deep Rock doctrine and that, in any event, the plan might be justified as a fair compromise of the issues involved.<sup>58</sup>

Problems as to the status of debt claims of parent holding companies against their subsidiaries are also involved in a number of pending Section 11 proceedings. Thus, plans of reorganization filed under Section 11 (e) of the Act by Interstate Power Company and North Shore Gas Company proposed settlements of such issues. The Commission itself has raised the issue as to the status of parent holding company debt claims in a number of proceedings instituted pursuant to Section 11 (b) (2) of the Act, notably those involving United Gas Corporation, Florida Power & Light Company, and Pennsylvania Power & Light Company in the Electric Bond and Share system.

Occasionally such questions come before the Commission as an incident to passing on proposals to issue new securities to refund outstanding debt of a subsidiary company where part of the issue is held by the parent. An example is the refunding program of *Georgia Power Company*, a subsidiary of The Commonwealth & Southern Corporation, which was carried out early in 1941.<sup>59</sup> During the years from 1930 to 1938, Georgia Power Company paid very substantial dividends to its parent company. Much of this money was needed, however, for construction purposes, and the parent company, therefore, made open account advances to its subsidiary company. These advances carried interest rates of 5 and 6 percent. From time to

<sup>58</sup> The Supreme Court decisions recognize the fact that a reorganization plan may embody fair and appropriate compromises of disputed contentions. Cf. *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (1939); *Consolidated Rock Products Co., v. Du Bois*, 85 Law Ed. 603, 610 (1941). The Commission disapproved the plan insofar as it contemplated realization of a profit on the preferred stock of Derby purchased by a wholly-owned subsidiary of the parent holding company at a time when reorganization proceedings were pending. Subsequently the plan was approved after the filing of an amendment designed to meet this objection.

<sup>59</sup> Holding Company Act Release No. 2586.

time the parent company caused Georgia Power Company to issue additional first mortgage bonds which would then be transferred by Georgia Power Company to its parent company in payment of the open account. By the end of 1938 The Commonwealth & Southern Corporation had accumulated in this manner approximately \$34,000,000 of first mortgage bonds of Georgia Power Company. The remainder of such bonds, aggregating an amount of approximately \$90,000,000, were outstanding in the hands of the public.

In connection with the refunding program of Georgia Power Company, which has been discussed in a previous section of this report,<sup>60</sup> The Commonwealth & Southern Corporation was induced to convert into common stock a substantial portion of its investment in Georgia Power Company represented by these bonds. Similar conversion was made with respect to certain preferred stock of the operating company owned by the parent holding company. The parent company was permitted, however, to withdraw in cash a portion of its investment by use of money obtained from the sale of the new refunding bonds.

Passing on any particular intercompany claim, whether in connection with a refunding issue or as incident to the approval of a plan of reorganization or recapitalization, frequently requires not merely the scrutiny of a single transaction, but the review of a course of dealings over a period of years which involves a multitude of separate transactions. This is necessarily a time consuming process and may give rise to substantial difference of opinion as to a great many issues of law and fact. It is not feasible to deal with more than a limited number of such cases at any one time and the problem is, therefore, to select the most pressing cases for immediate attention.

On April 16, 1941, there was submitted to the industry for comment a proposed rule which would suspend payments to the parent holding company on all debt claims owed by subsidiaries who are in arrears as to their publicly-held preferred stock until the Commission should have an opportunity to consider the status of the debt and to enter an appropriate order under the applicable provisions of the Act. Later, a public conference was held with respect to the proposed rule.

In support of the proposed rule, it was urged by Commission counsel that the rule was designed to bring before the Commission for determination issues of considerable importance to the various classes of security holders affected; that the Commission would have jurisdiction to pass upon the propriety of making payments on any such claims under Sections 12 (c) and 12 (f) of the Act; and that debt claims of the parent holding company are most likely to require careful scrutiny in those instances where the subsidiary against whom the claim is pressed is in arrears as to its preferred dividends. Counsel for preferred stock-

<sup>60</sup> Page 93, *supra*.

holders of one of the subsidiary companies which would be affected by the rule also urged its adoption.

On the other hand, vigorous opposition was expressed on behalf of counsel for one or two holding-company systems. Those opposed argued that the Commission had no jurisdiction to pass on such intercompany claims, and also urged that the rule was not adapted to singling out the type of cases in which the Commission would be justified in requiring the suspension of payments pending scrutiny of particular claims. The adoption of a rule dealing with this subject was still under consideration at the close of the fiscal year. However, the discussions with respect to the rule had served to focus attention upon many of the most critical situations involving such intercompany claims and, in the meantime, the Commission has instituted proceedings by order to inquire into a number of these intercompany claims.<sup>60a</sup>

Tables 46 and 47 of Appendix II, page 309, indicate the number of applications under Section 12 (c) and Rules U-12C-2 and U-12C-3, relating to the payment of dividends out of capital or unearned surplus, and applications under Section 12 (c) and Rule U-12C-1, relating to the acquisition of securities by the issuer, received and disposed of during the past fiscal year.

#### PROGRESS IN SERVICE COMPANY REGULATION

Distinct progress in the administration of service, sales, and construction contracts pursuant to Section 13 of the Act was recorded during the past fiscal year. Section 13 was enacted primarily to prevent holding companies or their dominated service companies or allied interests from mulcting their controlled utility companies through the guise of service fees or other unearned charges. Consequently, registered holding companies are prohibited by Section 13 (a) from servicing for a charge their associate public-utility or service companies except under special or unusual circumstances. Equally important are the provisions of Section 13 that such contracts as may be performed by system companies for their associates shall be performed efficiently and economically and for the benefit of the serviced

<sup>60a</sup> On January 21, 1942, the Commission announced that in the light of its experience in dealing with such problems by order, it is presently of the opinion that it is undesirable to have a general rule covering payments of both principal and interest and of the broad scope proposed, although further study may lead to the conclusion that there is some room for the exercise of the rule-making function within this field. The method of proceeding by order permits a greater flexibility in selecting the most pressing problems for immediate attention, and in many instances permits the problems of the intercompany claims to be dealt with, as an incident to proceedings under Section 11 (b) (2) of the Act, more economically than in the type of proceedings which might be precipitated by such a rule. The failure of the Commission to adopt the proposed rule should not be construed as accepting any of the legal arguments urged in opposition to the rule. In fact, the determination of the Commission to proceed by order necessarily assumes that the Commission regards the matter of taking action with reference to such intercompany claims as within its statutory powers under the Act, the choice between proceeding by rule or by order being dictated largely by considerations of an administrative character. See Holding Company Act Release No. 3221.

company and the cost fairly and equitably allocated.<sup>53</sup> The Commission has enforced these provisions by rules and regulations and by proceedings pursuant to the Act.

Intrasystem service, sales, and construction contracts are performed primarily by either actual or subsidiary service companies, but so-called cross-servicing between operating companies in the same system is permitted to a certain limited extent. While there are certain technical differences in regard to the qualification of these two types of service companies, the basic requirements as to the standards and methods of operations by such companies are, for all practical purposes, similar. Regulation of intrasystem service arrangements involves, first, the qualification of the mutual and subsidiary service companies, and second, the more important function of continuing supervision of the actual operation of the servicing relationships. The first phase of this regulation, which has been discussed in prior annual reports of the Commission, is now largely completed, except for a small number of new filings during the fiscal period and certain other cases which had presented unusual difficulties. There has accordingly been a shift in emphasis to the matter of supervising the actual operations of the arrangements previously passed on by the Commission.

One of the statutory requirements is that the servicing activities must be for the benefit of the companies receiving the services. This excludes service activities which are primarily in the interests of the holding company, that is, activities designed to protect its investment and which enable it to control the operations of its subsidiaries. Apparently, there has been a tendency to shift holding company expenses to the operating companies through the vehicle of common officers and employees. Thus, part of the salary cost and related expenses of running the holding company and exercising control over its subsidiaries, appears either as an operating expense of the service company, which is in turn charged to the operating subsidiaries in the system, or is directly charged to the operating companies, depending upon whether these common executives are on the pay roll of the service company or on the pay roll of the operating companies. In either event the ultimate charge may be borne in part by the consumer and in part by the public holders of securities of the operating companies, while the holding company escapes its fair share of the burden.

Some indication of the sums involved in certain of these situations is presented in the tabulation below. While total service company fees are used, salaries on the average comprise 60 percent to 70 percent of these fees. A considerable portion of such salaries is paid to high salaried executives and supervising personnel. The holding companies referred to had limited staffs, if any, of their own. In practically all instances where such staffs did exist, a portion of their salaries was paid by the service company and charged to the operating

companies. In contrast, most operating companies in the systems illustrated have well-paid, full time operating personnel resident on the properties.

As will be observed, the bulk of the service company fees are charged to the operating companies, while the holding companies themselves pay an insignificant amount for the cost of determining policies and administering and protecting investments, in many instances aggregating hundreds of millions of dollars and producing tens of millions of dollars in gross revenues.

*Service company fees—Sums involved in certain situations*

	Fees paid by all system units	Fees paid by holding companies	Gross operating revenues of system	Fees in percent of gross	Holding company fees in percent of total
American Gas and Electric Service Co. ....	\$2,477,631	\$209,821	\$86,348,350	2.87	8.47
Columbia Engineering Corporation.....	1,664,278	363,571	109,817,602	1.52	21.84
Commonwealth & Southern Corporation...	2,313,447	361,450	155,225,767	1.62	14.37
Ebasco Services, Inc.....	3,275,572	100,634	300,258,322	1.09	3.07
Engineers Public Service Co., Inc.....	361,414	65,389	57,196,379	.63	13.09
Middle West Service Co.....	600,482	99,643	88,860,361	.68	16.59
New England Power Service Co.....	3,796,342	212,855	65,413,591	5.80	5.61
Atlantic Utility Service Corporation.....	1,994,358	401,638	154,715,554	1.29	20.14
Total.....	16,685,524	1,815,001	1,017,835,926	1.63	10.88

The personnel, involved in the situations described above, holding interlocking positions, supervise, if indeed they do not direct, the day to day operations of the system operating companies. Obviously, the question is where do their duties and responsibilities to the holding company end, and where do their duties and responsibilities to the operating companies begin. Needless to say, these problems require careful consideration and case studies in each instance, since operating conditions and service requirements vary in each system.

In a series of proceedings initiated in the past fiscal year, as well as in connection with the consideration of a case which had been pending for some time, the Commission dealt with this apparent shifting of holding company expenses to the operating companies. In essence the condition confronting the Commission in these cases, in greater or lesser degree and in one form or another, was the use by the holding company of common officers and employees between it and the service company to supervise in its own interest daily operations of the operating companies and the passing on to those companies of the major portion of the cost of such supervision. The questions at issue were whether or not it was possible to allocate such expenses between the holding company and operating companies "fairly and equitably" pursuant to the requirements of Section 13 (b), and whether, in effect, the holding company was not in reality rendering services for a charge to its operating subsidiaries in contravention of Section 13 (a).

In its opinions with respect to these cases, the Commission laid down the broad principle that compensation and collateral expenses of all holding company officers, directors, and employees must be borne directly by such holding companies and could not be shared with their controlled service companies and thus passed on to the operating companies. In other words, the Commission has taken the position that operating companies should not be asked to pay the cost of the control activities of the holding company.

Since these three cases constituted a landmark in the administration of Section 13, it may be desirable to refer to them briefly.

In the case of Ebasco Services, Incorporated,<sup>61</sup> the system service company of Electric Bond and Share Company, it appeared that six of Bond and Share's directors and principal executive officers held identical positions in the service company and received portions of their compensation from both of these companies. In this case the Commission decided that the functions of the principal executives as officers of Ebasco were commingled with their functions as officers of Bond and Share and that it was an "almost impossible and wasteful task" to ascertain what segments of the services of each of the common officers were for Ebasco and hence properly included in the cost to the service company, and what part was for Bond and Share and therefore chargeable only to it.

Because of the importance of this case and the general principles it laid down, it seems appropriate to quote from the Commission's decision in part:

"Each of the officers in question occupies at least two positions: He is an officer of Bond and Share and an officer of Ebasco. Where his duties as an officer of Ebasco, in a particular transaction, begin, and his duties as an officer of Bond and Share end, cannot be determined. That difficulty is inherent in the situation. Bond and Share, as the parent of each of the companies serviced by Ebasco, has an abiding interest in matters pertaining to those companies. In every transaction by Ebasco, in which Bond and Share is somehow interested, the officers will be acting in dual capacities—as officers of Bond and Share and as officers of Ebasco. It is unreal to assume that the value of their services to each company can be determined with any degree of accuracy. The same is equally true of the services of any employees whose work entails a commingling of holding company and service company functions."

After the Ebasco decision, numerous service companies voluntarily adjusted their practices to conform to the opinion of the Commission. An illustration of the changes resulting is offered by The United Light and Power Service Company, the service company in the United Light and Power Company System.<sup>62</sup> This service company had on its pay roll practically all the officers of the system's holding companies. These salaries, paid in the first instance by the service company,

<sup>61</sup> *In the Matter of Ebasco Services, Incorporated*, Holding Company Act Release No. 2255.

<sup>62</sup> *In the Matter of The United Light and Power Service Company*, Holding Company Act Release No. 2608.

were then recharged to the various operating and holding companies on the basis of time allocation. In form, this was slightly different from the Ebasco case where the holding company officials were paid partially by the holding company and partially by the operating company through the service company. The Commission, however, found that the substance was the same in both cases. Officers and employees of the holding company who owed their primary loyalty to that company were rendering service for a charge to the operating companies. In this case, the Commission reemphasized the principle laid down in the Ebasco opinion and indicated clearly that the statutory prohibition of Section 13(a) against the performance of services for a charge by a holding company, to make sense, must also include prohibition of the performance of services for a charge by holding company officials and their staffs.

In the Middle West Service Company case,<sup>63</sup> the principles laid down in Ebasco and United Light and Power cases were reaffirmed.

One of the important cases pending at the end of the year was *In the Matters of Columbia Engineering Corporation, Columbia Gas & Electric Corporation*.<sup>64</sup> In the Ebasco opinion the Commission had stated that interlocking personnel could not be permitted and that those involved must resign either from the holding company or the service company. In the Columbia case the issue has been raised that the *functions*, rather than the position held or situs on any particular payroll, is the determinant as to whether or not a particular individual is in reality an official or employee of the holding company.

Two cases pending at the close of the fiscal year which deserve comment, involve determining, under Section 13, the proper scope of services for any one system, as well as the services that appropriately can be rendered to various classes of companies within a given system.

One of these cases is that of the Atlantic Utility Service Corporation<sup>65</sup> (formerly the Utility Management Corporation), the mutual service company in the Associated Gas and Electric Company System. Because of the complexities involved in this case, of the changes incident to the replacement of the Hopson management by court trustees, and of contemplated additional changes, this company has not yet been qualified. It continues to operate under temporary exemption provided for in the rules and regulations of the Commission. Substantial progress has already been made in conforming the company to the statutory standards. For instance, when this company first filed for approval it reported service fees of \$4,863,191. Subsequent revisions of its operations have reduced these fees to \$1,940,805, and even this amount remained in issue at the close of the fiscal year.

<sup>63</sup> *In the Matters of Middle West Service Company, The Middle West Corporation, Holding Company Act* Release No. 2696.

<sup>64</sup> Commission File No. 37-22.

<sup>65</sup> Commission File No. 37-28.

The major issue before the Commission in this case is whether services to be performed by this company should not be limited to engineering and purchasing in order to satisfy the standards of Section 13.

The second proceeding involving the proper scope of services permissible to a service company was also noteworthy for various other reasons.

During the course of the past fiscal year, the Commission was called upon by the Vermont Public Service Commission to investigate the servicing arrangements between the New England Power Service Company, a subsidiary service company in the system of the New England Power Association, and its associate operating companies, Bellows Falls Hydro-Electric Corporation and Green Mountain Power Corporation. This was done pursuant to Section 13 (d) of the Act, which provides that the Commission "at the request of \* \* \* a State commission, may, after notice and opportunity for hearing, by order require a reallocation or reapportionment of costs among member companies of a mutual service company if it finds the existing allocation inequitable \* \* \*." This was the first occasion that a State commission had availed itself of the facilities of the Commission to investigate dealings between companies operating within the State commission's jurisdiction and a service company outside its jurisdiction because organized beyond the boundary of the State.

A hearing was held at Montpelier, Vt., at which representatives of the Vermont Commission were present and participated, as well as Commissioner Healy of this Commission. As a result of the Montpelier proceedings, the Securities and Exchange Commission issued an order requiring the service company to show cause why the prior order, conditionally approving its organization and conduct of business, should not be revoked if certain changes in its organization and conduct of business were not effected. Among the issues involved were the problems of interlocking officers discussed above, the proper scope of activities of the service company, and the economy and efficiency of its operations. While a final order in this case had not been issued at the close of the fiscal year, changes already agreed to by the company have brought about substantial savings to the two Vermont companies and the proceeding promises to be productive of substantial results in further reducing servicing costs, not only to the Vermont companies but to other operating companies of the New England Power Association System.

In addition to its responsibilities as to servicing activities of companies in the registered holding company systems, Sections 13 (e) and 13 (f) authorize the Commission to regulate to some extent servicing activities of the so-called independent service companies of the utility field. These sections relate to the servicing activities rendered to any public-utility company engaged in interstate com-

merce or any registered holding company or subsidiary thereof, and to any person whose principal business is the performance of such contracts. Thus far the Commission has exercised this jurisdiction to the extent of requiring by rule the filing of reports by such persons disclosing certain significant corporate and financial data, including a list of utility companies serviced by such persons and the corporate affiliations of such utility companies.

During the course of the past fiscal year the Commission had occasion to investigate the activities of the Edison Electric Institute, an organization which acts in the nature of a trade association for the electric utility industry. As a result of this investigation counsel for the Edison Electric Institute concluded that the activities of the Institute were within the scope of Section 13, as a consequence of which, and after discussion with the staff of the Commission, this organization filed a report pursuant to Rule U-13E-1. In this connection, the question was raised as to whether membership in the Institute might be the basis for the exercise of regulatory jurisdiction over its members who were not otherwise subject to the provisions of the Act. The Institute was advised by the Director of the Public Utilities Division that membership in the Institute would not, in and of itself, result in subjecting member companies to the jurisdiction of the Commission.

The Act, in its definition of service, sales, and construction contracts and other pertinent provisions, places broad statutory obligations upon the Commission. In its discharge of these obligations, the Commission is making continuous studies, not only of intrasystem servicing arrangements, but of all types of servicing affecting the registered holding companies and their public-utility subsidiaries under its jurisdiction. The investigation of the Edison Electric Institute, referred to above, was one of such studies. The Commission, of course, must be alert to determine not only that arrangements in common practice prior to the passage of the Act are not used to contravene the provisions of Section 13, but that new arrangements and devices are not evolved to circumvent the intent and declarations of Congress as defined in the Act.

Table 48 of Appendix II, page 310, indicates the number of applications and declarations under Section 13 relating to mutual and subsidiary service companies, received and disposed of during the past fiscal year.

#### RULES AND REGULATIONS

During the past fiscal year the Commission reexamined the relationship of its rules and regulations to the administration of the Public Utility Holding Company Act of 1935, simplified its procedure for passing upon applications and declarations, and completely revised

the text of the rules. In considering the changes in the rules, it may be helpful to review the scope and function of rule making under the Public Utility Holding Company Act of 1935, which differs substantially in that respect from other Acts administered by the Commission.

Section 20 (a) empowers the Commission to "make, issue, amend, and rescind such rules and regulations and orders as it may deem necessary or appropriate to carry out the provisions of" the Act. More specific authority to make rules, as well as to act by order, is conferred by the various sections of the statute which deal with the regulation or exemption of persons and transactions. Most of these provisions leave to the discretion of the Commission the alternative of dealing with problems in a generalized way by rule, or of acting specifically by order in the light of the particular facts. Because of the extreme complexity of the holding company industry, each company and transaction within the regulatory jurisdiction of the Commission presents its own problems. For that reason, regulation by order rather than by rule has proved, generally speaking, the more satisfactory method of administration.

The various types of rules which have been adopted by the Commission fall within the following general classifications: (1) procedural rules prescribing the form and contents of applications and reports; (2) rules granting a broad exemption to particular classes of persons from provisions of the Act (such as intrastate holding companies, holding companies which are primarily operating companies, and banks which are temporarily holding companies because of the acquisition of securities for liquidation in connection with a debt);<sup>66</sup> (3) rules exempting companies otherwise subject to regulation, as to a limited class of transactions; (4) rules requiring advance notice to the Commission of the intention to consummate certain types of transactions, in order to enable the Commission to issue such orders with reference to the proposed transactions as may be appropriate under applicable standards of the Act; and (5) substantive rules, i. e., rules prescribing the standards by which particular transactions should be governed, such as rules prescribing the uniform system of accounts for holding companies and for mutual service companies.

Except in the accounting field and to a certain extent in respect to service companies, substantive rules have not played an important part in the administration of the Act to date.<sup>67</sup> Substantive regulation

<sup>66</sup> All these general exemptions by rule are subject to termination upon 30 days' notice, as provided in Rule U-6, if the Commission has reason to believe there is a substantial question as to the propriety of the exemption, but without prejudice to the right to apply for exemption by order.

<sup>67</sup> Somewhat difficult to classify are rules under Section 17 (c) with respect to the disqualification of directors by reason of financial connections with commercial banks and investment bankers. Section 17 (c) prohibits such interlocking relationships except as the Commission shall by rule prescribe exceptions and, unlike many other sections of the Act authorizing the Commission to grant exemption from particular provisions, does not empower the Commission to grant exemption by order. Possibly these should be regarded as substantive rules.

has been primarily by order after opportunity for hearing and in the light of the facts of a particular case. To that extent, the Act is essentially what has been described as a "licensing" statute, i. e., one which requires advance authorization or advance scrutiny by the regulatory agency before it is lawful to consummate certain types of transactions.<sup>68</sup>

Rules of the third and fourth categories enumerated above have constituted an important field of rule making under the Act. These are closely related functionally and involve the problem of prescribing; without reference to specific proposals by companies subject to regulation, the extent to which the potential statutory jurisdiction of the Commission will be exercised. Certain provisions of the Act (such as Sections 7 and 10, applicable, respectively, to security issues and acquisitions) require advance authorization from the Commission as to certain classes of transactions, except as exemption may be granted by rule or by order. Other provisions, notably those in Section 12 relating to intercompany transactions, require implementation by rule or order before they become operative. The principal effect of the Commission's rules pursuant to these provisions has been to require the filing with the Commission of declarations of proposed transactions, thereby enabling it to deal with them by order.

To the extent that the Commission's rules leave unregulated transactions which are within its statutory jurisdiction, there is always the danger that there will be loopholes for abuses of the character which the Act was intended to prevent. On the other hand, it has been necessary to take into account the desirability of concentrating the regulatory efforts of the Commission upon what have appeared to be the most serious and pressing problems and, also, the desirability of minimizing the expense to the industry incident to proceedings before the Commission. The attempt to preserve a balance between these conflicting considerations had led to frequent changes in the rules, as experience indicated that a rule drafted with the intention of fitting certain types of transactions, to which the attention of the Commission had been called, had the unintended result of excepting from regulation certain types of transactions which call for close scrutiny or failed to exempt others which did not appear to require such attention. Frequent changes of this character proved inconvenient, and also resulted in great textual complexity in the rules. The elimination of this difficulty through a general revision of the rules has been closely related to the adoption by the Commission of a new procedure for disposing of applications and declarations without hearing, except in cases where substantial difficulties are presented.

<sup>68</sup> The integration and corporate simplification provisions of Section 11 are also enforced by order after opportunity for hearing, but in this instance the burden is on the Commission to initiate the proceeding and compliance with these particular provisions is required only as they are implemented by order.

This new procedure, effective July 9, 1940, was referred to in the Sixth Annual Report of the Commission.<sup>69</sup> As pointed out in that Report, Commissioner Healy dissented from the adoption of the new procedure, stating his belief that the procedure was invalid wherever the Act requires a finding by the Commission as a condition precedent to granting an order permitting contemplated action. He suggested an alternative procedure which he believed could be equally effective in saving time.<sup>70</sup> Despite this difference of opinion among the Commissioners, there was agreement that unimportant cases could be disposed of by order without substantial expense or trouble to the company concerned, and that the exercise of appropriate discretion in dealing with particular applications afforded a more flexible method of sifting out important and unimportant transactions than could be accomplished in the exercise of the rule-making powers of the Commission. By reason of the availability of this procedure, and by relating more closely the content of the application and the scope of the review given to it to the importance and difficulties of the problems presented by a particular transaction, it has been possible to dispense with many automatic exemptions by rule as to classes of transactions. Generally speaking, the effect of the revision of the rules is to require advance notice to the Commission with respect to a larger proportion of the transactions which are within its potential statutory jurisdiction. The elimination of numerous exemptions of infrequent use and of elaborate exceptions and qualifications to such exemptions, has made possible a considerable simplification in the text of the rules.

A number of more important substantive changes in the rules were adopted in connection with the general revision of the rules or otherwise in the course of the year. One important change was a substantial narrowing of the automatic exemption previously granted to non-utility subsidiaries of registered holding companies. Generally speaking, the administrative difficulties of the regulating non-utility subsidiaries are greater than those involved in the regulation of utility subsidiaries. For that reason the Commission had concluded, in the early days of its administration of the Act, to limit its activities for the time being primarily to the regulation of the registered holding companies and their utility subsidiaries. However, the Commission was required by Section 11 to consider the problem of the retainability of non-utility interest, dependent upon whether or not they are "reasonably incidental, or economically necessary or appropriate to

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<sup>69</sup> Page 49.

<sup>70</sup> The Report of the Committee on Administrative Procedure appointed by the Attorney General commented favorably on the adoption of this new procedure, but did not refer to the dispute as to the validity of the procedure. (See Sen. Doc. No. 8, 77th Cong., 1st Sess., p. 182.) The Report of the Commission for the fiscal year ended June 30, 1940, referred to the public memoranda of the Commission and of Commissioner Healy, setting forth their respective views as to the legal and other questions involved.

the operations of" integrated public-utility systems. In the course of its studies in that connection, the Commission reached the conclusion that it was both necessary and feasible to substantially narrow the scope of the exemption heretofore granted to non-utility subsidiaries.

The revised rules also included two new accounting rules under Section 15 of the Act. Rule U-27 requires operating gas and electric utility companies, which are not otherwise required by either the Federal Power Commission or a State Commission to conform to a classification of accounts, to follow the Federal Power Commission classification in the case of electric utility companies and to follow the classification prescribed by the National Association of Railroad and Utilities Commissioners (which is substantially similar) in the case of gas utility companies.<sup>71</sup> Rule U-28 prohibits registered holding companies or their subsidiaries from distributing to security holders, or publishing, financial statements which are inconsistent with the book accounts of the company or with the financial statements filed with this Commission by or on behalf of such companies. Rule U-50, requiring competitive bidding and which became effective on May 7, 1941, is discussed elsewhere in this report.<sup>72</sup>

The revised rules were distributed in draft form to the industry and comments were invited. A number of constructive comments were received and incorporated in the rules. The Commission has continued its policy of consulting the industry before enacting or revising rules. For instance, the difficult problem of requiring competitive bidding for the purchase of public-utility and holding-company securities was presented to the industry early in March 1940, and a copy of a staff report on this question was distributed in December 1940. After conferences and public hearing had been held and briefs were filed, the rule was adopted on April 7, 1941, and made effective May 7, 1941.<sup>73</sup>

In considering the feasibility of advance discussion of rules with the industry or of delaying the period between promulgation and the effective date of a rule, it is necessary to take into account the char-

<sup>71</sup> The Commission had previously prescribed Uniform System of Accounts for holding companies and service companies, the accounting problems of which are peculiarly subject to its jurisdiction. As to operating companies, however, Section 20 (b) prescribes that the accounting requirements of this Commission shall not be inconsistent with requirements imposed by other Federal regulatory authorities or by State commissions. While this limitation is not strictly applicable to the companies which are not subject to such accounting regulation, the Commission, nevertheless, concluded that it was desirable, in the interest of uniformity, to follow the uniform systems which had been adopted after considerable study by the Federal Power Commission and the National Association of Railroad and Utilities Commissioners.

<sup>72</sup> Page 98, *supra*.

<sup>73</sup> See Holding Company Act Release Numbers 2525 and 2676. The Commission also held a public conference on a proposed Rule U-51, relating to payments on indebtedness held by parent holding companies by subsidiary companies which are in arrears as to dividends on their publicly-held preferred stock. A draft of this proposed rule was distributed to the industry on April 16, 1941, and a public conference was held on June 10, 1941. The proposed rule was still under consideration at the close of the fiscal year.

acter of the rule-making function involved. It is recognized that advance notice and opportunity for comment are both feasible and desirable in the case of a rule which requires substantial changes in the practices of the industry, such, for example, as the competitive bidding rule. On the other hand, where the rule-making function involves selection of the types of cases which are to be scrutinized by the Commission, the public interest demands that the Commission be free to act promptly as situations requiring investigation are brought to its attention and that it be able to preserve the *status quo* pending investigation. Otherwise, it can only lock doors after horses are stolen. Moreover, rules of this character contemplate that the essential regulatory decisions, relating to the merits of the transactions involved, will be determined by order after opportunity for hearing. It would seem that such an opportunity for hearing is adequate protection to the industry, although it will occur after the promulgation of the rule.

An illustration of the occasional necessity to adopt a rule, effective forthwith and without advance discussion, is Rule U-65 prohibiting the expenditure of corporate funds in connection with solicitation of proxies unless (subject to certain exceptions) a declaration is filed notifying the Commission of the proposed transaction, and such a declaration has become effective—thereby giving the Commission an opportunity to take appropriate action by order. In connection with the promulgation of the rule, the Commission stated that “the immediate effectiveness of the rule does not change its general policy of submitting utility rules to the industry for comment prior to adoption,” and that “immediate effectiveness was necessary to prevent substantial expenditures of corporate funds by the management of a registered holding company to employ solicitors to aid them in obtaining proxies in a contested election before the Commission had an opportunity to pass upon the propriety of such expenditures under the provisions of Section 12 (e) of the Act”.<sup>74</sup>

One possible reason for allowing a lapse of time between the publication and the effective date of a rule is to give those affected an opportunity to become familiar with the rule. The importance of this consideration is dependent upon the content of the particular rule involved. As to rules adopted under the Public Utility Holding Company Act of 1935, its importance is minimized because of the highly centralized organization of the industry and the comparatively small number of individuals who, as counsel or as officers of the companies concerned, direct the activities within the scope of the Act and subject to such rules; also, because it is part of the business of these individuals to closely follow all developments in the administration of the Act. Moreover, it is sometimes feasible to give specific notice of the

<sup>74</sup> Holding Company Act Release No. 2681.

promulgation of a new rule to those whom the Commission has reason to believe are contemplating transactions within its scope, as was the case in connection with Rule U-65 referred to above. Another factor which may be relevant in determining the appropriate time lag between the promulgation and the effective date of a rule is the extent of the notice which may have been given prior to its promulgation that the Commission had under consideration the adoption of such a rule.

#### EXEMPTION OF COMPANIES FROM THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

Sections 2 and 3 of the Act contain definitions and exemption provisions which determine the status of companies as subject to or excluded from the regulatory provisions of the Act. The definitions are not entirely self-operative, but their applicability depends in part upon the exercise of the rule-making power by the Commission and in part upon its making certain specified findings after opportunity for hearing. Thus "electric utility company" and "gas utility company" mean, respectively, companies owning or operating facilities for the generation, transmission, or distribution of electric energy or for the retail distribution of natural or manufactured gas. The Commission is authorized to exclude from these categories companies primarily engaged in non-utility business and having only a small amount of utility business.<sup>75</sup>

A "holding company" under the Act is a company which has one or more utility subsidiaries. The holding-company subsidiary relationship depends *prima facie* upon ownership of 10 percent or more of the voting securities, but the Commission on application may declare that the relationship does not exist where it is found that neither control nor "controlling influence" is exercised, and may upon its own motion declare the relationship to exist irrespective of stock ownership where it finds that controlling influence is exercised. Section 3 (a) specifies certain categories of holding companies which are entitled to exemption unless and except insofar as the Commission may find the exemption detrimental to the public interest, etc.

These definition and exemption provisions have been of considerable importance as applied to the determination of the status of companies and relationships in existence at the time the Act became effective. Problems will continue to arise from time to time as to their application to new situations. The initial volume of exemption applications was very large. While many of these applications presented relatively simple questions, many others presented very difficult issues and, because of the great variety of problems presented, it seemed desirable for the Commission to proceed cautiously in the

<sup>75</sup>Rule U-7; *South Penn Oil Company, et. al.*, Holding Company Act Release No. 2625.

application of the statutory standards. It was important to avoid creating interpretative precedents which might prove embarrassing as applied to superficially similar, but essentially different, facts. Some of the cases also involved very difficult issues of fact as to the exercise of control or controlling influence. Where an issue of this kind arises, all of the company officers involved who are most familiar with the facts are, of course, interested in establishing absence of control. Accordingly, it is necessary for the Commission to undertake extensive field investigations in order to develop the relevant evidence, which is largely circumstantial in character. These cases involve long hearings, voluminous records, and careful study before the Commission is in a position to decide them.

Most of the exemption provisions grant a temporary exemption pending action by the Commission where an application has been filed in good faith. This made it possible for the Commission, without hardship to the applicants, to postpone action upon some of the more difficult applications, in order to give them the most careful consideration and also, in some instances, to give the right-of-way to what seemed more pressing business. This, of course, has involved the disadvantage of delaying the application of the regulatory provisions of the Act to certain important companies which have ultimately been denied exemption.

During the past year the Commission has decided a number of important cases arising under Section 2 (a) (8) of the Act, involving applications by *prima facie* subsidiary companies (10 percent or more of the voting securities of which were owned by other companies) to be declared not to be subsidiary companies.

The Detroit Edison Company filed an application under Section 2 (a) (8) to be declared not to be a subsidiary of The North American Company, the owner of 19.28 percent of its voting securities; of American Light & Traction Company, the owner of 20.27 percent of its voting securities, or of The United Light and Power Company and The United Light and Railways Company, parents of American Light & Traction Company.<sup>76</sup> The record in that case established that The North American Company had caused the incorporation of the applicant; that thereafter that company had "maintained a position of importance and influence in Edison's affairs based on stock ownership or historical association or both"; and that the relationship between the two companies was such as to preclude the findings requisite to the granting of the requested order with respect to The North American Company. The application was granted with respect to American Light & Traction Company.

On an appeal taken by The Detroit Edison Company, the Circuit Court of Appeals for the Sixth Circuit affirmed the order of the Com-

<sup>76</sup> Holding Company Act Release No. 2208.

mission denying such application.<sup>77</sup> With respect to the issue as to the existence of a "controlling influence" by North American over Detroit Edison, the court said, in part:

"The present Act undertakes to bring within its ambit all subsidiaries subject to 'controlling influences' of a parent. This phrase should be construed in the light of the purpose of the Act of which it is a part, and when understood in this setting and in the light of its ordinary signification, it means the act or process, or power of producing an effect which may be without apparent force or direct authority and is effective in checking or directing action, or exercising restraint or preventing free action. The phrase as here used, does not necessarily mean that those exercising controlling influence must be able to carry their point. A controlling influence may be effective without accomplishing its purpose fully.

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"The fact that the North American Company had abandoned some of the characteristics of 'controlling influence' over the petitioner at the time of the hearing, did not require the Commission to disregard prior interrelated activities. There is no showing that its latent power to resume such control has been extinguished. The relationship is such that they may enter into similar activities in the immediate future. *United States v. Trans-Missouri Freight Association*, 166 U. S. 290, 308; *Labor Board v. Newport News Company*, 241 U. S. 251."

The court also held that, in considering whether the "controlling influence" was such "as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that \* \* \*" Detroit Edison be subject to the obligations imposed by the Act upon subsidiaries of holding companies, it was not necessary for the Commission to show a history of abuses of the type specified in Section 1 of the Act. As to this, the court said:

"The phrase 'public interest' as used means that the public has some pecuniary interest or an interest by which legal rights or liabilities of its individual members are affected by the operation of the utility. The phrase is not to be construed as requiring the Commission to find that the conduct of the applicant's business has or will affect the public adversely. The statute contemplates action prospectively. It is a preventive measure intended to regulate action before the interests of those concerned are adversely affected. The prime factors in determining statutory exemption are the size and extent of the company involved, the inter-company relationship, the distribution of its securities and the opportunity presented because of the relationship between the parent and subsidiary for excessive charges for services, construction work, equipment and materials, and the transactions entered into in which evil may result, because of the absence of arms-length bargaining or restraint of free and independent competition. Giving due weight to the past transactions of petitioner with the North American and the continuing opportunity for the resumption of such activities and the extent of the petitioner's business and the widely scattered ownership of its stock, the Commission committed no error in denying petitioner exemption from the present Act."

The American Gas and Electric Company, a registered holding company, filed an application pursuant to Section 2 (a) (8) for an order declaring it not to be a subsidiary of Electric Bond and Share Company, likewise a registered holding company and the owner of 17.51

<sup>77</sup> *The Detroit Edison Company v. The Securities and Exchange Commission*, 119 F. (2d) 730.

percent of its voting securities. The findings and opinion of the Commission, based upon the record made at the hearing on that application, reviewed at some length the organization of the applicant, the contacts between its management and the executives of Electric Bond and Share Company, and the participation of the latter in applicant's affairs both from a financing and an operating standpoint, and concluded by stating:

"Upon consideration of all the circumstances of this case, we cannot find, as requested by applicant, that its management or policies \* \* \* are not subject to a controlling influence, directly or indirectly \* \* \* so as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that the applicant be subject to the obligations, duties, and liabilities imposed by the Act upon subsidiary companies of holding companies."

The requested order was therefore denied.<sup>78</sup>

Similar conclusions were reached in the applications of The Hartford Gas Company with respect to The United Gas Improvement Company and Connecticut Gas and Coke Company;<sup>79</sup> Panhandle Eastern Pipe Line Company with respect to Columbia Gas & Electric Corporation and Columbia Oil & Gasoline Corporation,<sup>80</sup> and Columbia Oil & Gasoline Corporation with respect to Columbia Gas & Electric Corporation;<sup>81</sup> and Paul Smith's Electric Light and Power and Railroad Company with respect to Associated Gas and Electric Company and its subsidiary holding companies.<sup>82</sup>

Not all the applications under this section, however, have resulted in denials, for during the past year the Commission granted applications pursuant to Section 2 (a) (8) with respect to the relationship of Reading Gas Company to Consumers Gas Company and The United Gas Improvement Company;<sup>83</sup> and with respect to the relationship of Wisconsin Valley Improvement Company to Wisconsin Public Service Company and the Wisconsin Power and Light Company.

Section 3 (a) of the Act provides in substance that the Commission shall exempt any holding company "and every subsidiary company thereof as such" from the provisions of the Act if such holding company fits the description set forth in any one of the five subsections of that section unless and except insofar as it finds the exemption detrimental to the public interest or the interest of investors or consumers. Of these, subsections 3(a) (1) and 3(a) (2) are applicable with certain qualifications to companies "predominantly intrastate" or which are "predominantly" public-utility companies.

<sup>78</sup> Holding Company Act Release No. 2749. (Appeal pending.)

<sup>79</sup> Holding Company Act Release No. 2613. (Appeal pending.)

<sup>80</sup> Holding Company Act Release No. 2778.

<sup>81</sup> Holding Company Act Release No. 2778.

<sup>82</sup> Holding Company Act Release No. 2854.

<sup>83</sup> Holding Company Act Release No. 2175.

In September 1940, the Commission denied the application of Public Service Company of Oklahoma, filed pursuant to Sections 3(a) (1) and 3(a) (2), for an exemption as a holding company with respect to Southwestern Light & Power Company. In discussing the standards of subsection (2) of Section 3(a), the Commission stated that "the most important consideration in determining whether a holding company is 'predominantly a public-utility company' is the relative size of the subsidiaries and their business as compared with that of a parent company" and then held that since it appeared that the fixed gross utility assets, the gross operating revenues, and the net operating revenues of the subsidiary each exceeded 38 percent of those of the applicant, the conditions precedent to the granting of an application under said subsection had not been complied with.<sup>84</sup> It was concluded that the applicant received a material part of its income from its subsidiary "the loss of which would be something more than *de minimis* to the company."

The Commission granted the Section 3 (a) (1) application of Pennsylvania Gas & Electric company for an exemption as a holding company with respect to its three wholly-owned subsidiaries, namely, Interborough Gas Company, Conewago Gas Company, and Peoples Light Company of Pittston, upon a showing that such applicant and each of its subsidiaries were Pennsylvania corporations carrying on their business as gas utility companies solely within that State.<sup>85</sup>

Subsection (3) of Section 3 (a) applies to a holding company which is "only incidentally a holding company, being primarily engaged or interested in one or more businesses" other than that of a public-utility company and either (A) does not derive any material part of its income from its public-utility subsidiaries, or (B) does derive a material part of its income from such subsidiaries but the latter are substantially wholly-owned.

From many standpoints the most important decision rendered by the Commission under Section 3 (a) (3) was the one involving the application of Cities Service Company. That applicant had 110 gas and electric utility and non-utility subsidiaries which were doing business in many States and foreign countries. Its utility subsidiaries included Cities Service Power & Light Company, a registered holding company with 50 subsidiaries; most of which were electric utility companies serving over 500,000 customers in 16 States. Investments in these utility subsidiaries represented, as of December 31, 1938, approximately 16 percent of the applicant's total investments, the aggregate fixed assets of its consolidated utility subsidiaries represented 47.3 percent of the fixed assets of all consolidated

<sup>84</sup> Holding Company Act Release No. 2277. Applicant appealed from the order of the Commission and its appeal is now pending in the Circuit Court of Appeals for the Tenth Circuit.

<sup>85</sup> Holding Company Act Release No. 2726.

subsidiaries, and 38.0 percent of the fixed assets of all subsidiaries. For the year ending on said date, the aggregate gross revenues of the applicant's consolidated utility subsidiaries, exclusive of the 3 gas utility companies serving Kansas City and various towns in Kansas, Nebraska, and Oklahoma, amounted to \$70,257,800, or 32.6 percent of the aggregate gross revenues of the applicant and all of its consolidated subsidiaries, including said gas utility companies.

The Commission stated that it was of the opinion that the question whether a holding company was only incidentally a holding company "must be determined in each case upon consideration of a variety of circumstances; such as the relationship between the gas and electric operations of the company's utility subsidiaries and the other business or businesses in which it is engaged or interested—i. e., whether the business of the utility subsidiaries is incidental or accessory to the non-utility business or is wholly unrelated to it—the size of the company's utility subsidiaries and the scope of their operations, and, where the utility business is small, the company's stake in the utility business as compared with its interest in other lines of business."

The application for exemption pursuant to subsection (3) of Section 3 (a) was denied because the Commission was unable to find that the applicant was "only incidentally a holding company, being primarily engaged or interested in one or more businesses other than the business of a public-utility company."<sup>86</sup>

Pending the determination of the above described application of Cities Service Company, that company pledged all of the voting securities of Cities Service Power & Light Company, which it owned, with the Harris Trust and Savings Bank as additional security for its own debentures, and gave that bank the voting rights with respect thereto. A similar arrangement was made pertaining to all of the applicant's holdings in certain other utility subsidiaries. The contention was then made that the phrase "power to vote" contained in Section 2 (a) (8) (A) modified the word "owned" and that since the applicant had no power to vote the pledged securities it was not a "holding company" within the definition of the Act. On the basis of the previous decision in *H. M. Byllesby & Company*,<sup>87</sup> to the effect that such phrase qualifies only the word "held" and not the words "owned" or "controlled," the Commission refused to adopt such an interpretation. It also denied the applicant's contention that "owned" must be construed to exclude ownership which is not accompanied by voting power and held that a pledgor of voting securities is the owner thereof within the meaning of Section 2 (a) (8) (A) although the voting rights thereon had been transferred to the pledgee. The Cities Service Company did not appeal from this decision but subsequently registered.

<sup>86</sup> Holding Company Act Release No. 2444.

<sup>87</sup> 6 S. E. C. 649, See Sixth Annual Report, p. 42.

Subsection (4) of Section 3 (a) provides an exemption for a company which is *temporarily* a holding company solely by reason of the acquisition of securities for purposes of liquidation of a bona fide debt or in connection with a bona fide arrangement to underwrite securities. Pursuant to this subsection the Massachusetts Mutual Life Insurance Company<sup>88</sup> was granted an exemption for six months, while the exemption of the Manufacturers Trust Company was extended for 9 months<sup>89</sup> with respect to securities of utility companies which they owned. In this connection, the Commission pointed out that a holding company receiving an exemption under subsection (4) of Section 3 (a) must within a reasonable time dispose of its utility holdings because the word "temporarily" used therein negated any intention that such company should receive a continuous exemption.

Subsection (5) of Section 3 (a) relates to the exemption of a holding company which is not itself a public-utility company and which derives no material part of its income from utility subsidiaries operating in the United States. The application of Cities Service Company also requested an exemption under subsection (5) of Section 3 (a), that applicant contending that such subsection was applicable to domestic as well as to foreign systems. After reviewing the legislative history of this subsection, the Commission concluded that the exemption provided thereby "is available only to essentially foreign holding company systems, and that the applicant cannot qualify under this section since the great bulk of its utility subsidiaries are within the United States."

In its findings and opinion in the Cities Service Company case, the Commission also interpreted the "unless and except" clause in the first sentence of Section 3 (a) as being designed "to prevent the exemption of any holding company which, although it might meet the formal conditions under Section 3 (a), is essentially the type of company 'at which the purposes of the legislation are directed'," and found it would be detrimental to the public interest and to the interest of investors and consumers in the United States to grant the application of that company.

The request for an extension of the exemption of Dominion Gas and Electric Company, both as a holding company owning securities of companies operating in Canada and as a subsidiary of International Utilities Corporation, a registered holding company, was denied, except with respect to Section 13. The Commission found that, although the applicant satisfied the factual requirements of both Section 3 (a) (5) and Section 3 (b), the granting of the exemptions would be detrimental to the public interest and to the interests of United States investors, who owned a substantial percentage of the

<sup>88</sup> Holding Company Act Release No. 2852.

<sup>89</sup> Holding Company Act Release No. 2755.

securities, since the record revealed many instances where its officers and directors had acted in "wanton disregard of the fiduciary duties owed to stockholders." <sup>90</sup>

Section 3 (b) provides that the Commission may exempt any subsidiary from any provision of the Act if it finds that such subsidiary derives no material part of its income from sources within the United States and neither it nor any of its subsidiary companies is a public-utility company operating in the United States and that the application of such provisions to such subsidiary is not necessary in the public interest or for the protection of investors.

With respect to the foreign subsidiaries the Commission has generally found, with specified exceptions, that it was not necessary in the public interest or for the protection of investors that they be subject to the duties and obligations imposed upon them as subsidiaries of registered holding companies by Sections 6, 9, 11 (g), 12 (b), 12 (c), 12 (f) and (g), 12 (h) (2), 13, 15, and 17 (c). Such qualified exemption was, however, granted only until June 30, 1943. <sup>91</sup> It has been the policy of the Commission in granting exemptions under Section 3 (b) to retain jurisdiction with respect to further investment of funds in these companies by investors in the United States and over other matters which may affect United States citizens.

During the year the Commission extended the Section 3 (b) exemptions of the following companies: Southern Utilities Company, Limited, <sup>92</sup> Great Northern Gas Company, Limited, <sup>93</sup> New Brunswick Power Company, <sup>94</sup> and Consolidated Electric and Gas Company. <sup>95</sup>

Table 49 of Appendix II, page 310, indicates the number of applications under Sections 2 and 3, relating to exemption from the provisions of the Act, received and disposed of during the past fiscal year.

#### **PETITIONS FOR JUDICIAL REVIEW OF THE COMMISSION'S ORDERS ENTERED PURSUANT TO THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935**

During the past fiscal year, petitions for the review of Commission orders issued under the Public Utility Holding Company Act of 1935 were filed by The Hartford Gas Company, American Gas & Electric Company, Morgan Stanley & Co., Incorporated, Public Service Company of Oklahoma, The Detroit Edison Company, and Lewis H. Morris. The issues involved in most of these cases have been discussed in previous sections of the report.

The Hartford Gas Company seeks a review of an order of the Commission denying its application to be declared not to be a sub-

<sup>90</sup> Holding Company Act Release No. 2810.

<sup>91</sup> Holding Company Act Release No. 2810.

<sup>92</sup> Holding Company Act Release No. 2479.

<sup>93</sup> Holding Company Act Release No. 2480.

<sup>94</sup> Holding Company Act Release Nos. 2481 and 2593.

<sup>95</sup> Holding Company Act Release No. 2724.

subsidiary company of The United Gas Improvement Company, The United Corporation, or Connecticut Gas & Coke Securities Company. The Hartford Gas Company's petition is now pending before the United States Circuit Court of Appeals for the Second Circuit.

American Gas & Electric Company seeks a review of an order of the Commission denying its application to be declared not to be a subsidiary of Electric Bond and Share Company. Its petition for review is now pending before the United States Court of Appeals for the District of Columbia.

Morgan Stanley & Co., Incorporated, has filed a petition to review an order of the Commission in effect prohibiting The Dayton Light and Power Company from paying fees to Morgan Stanley & Co., Incorporated, in connection with the underwriting of an issue of the former's securities, on the ground that Morgan Stanley & Co., Incorporated, and The Dayton Light and Power Company stand in such relation that there is liable to have been an absence of arm's-length bargaining with respect to the transaction. This petition is now pending before the Circuit Court of Appeals for the Second Circuit.

Public Service Company of Oklahoma seeks the review of an order of the Commission denying its application for exemption of itself as a holding company and of Southwestern Light & Power Company as its subsidiary company. This petition is now pending before the United States Circuit Court of Appeals for the Tenth Circuit.

The Detroit Edison Company sought a review of an order of the Commission denying its application to be declared not to be a subsidiary company of The North American Company. On May 12, 1941, the Circuit Court of Appeals for the Sixth Circuit denied the Detroit Edison Company's petition and upheld the Commission's determination.

Lewis H. Morris, a stockholder of International Paper & Power Company, filed a petition to review an order of the Commission dismissing an application of International Paper & Power Company with respect to a proposed change in its capitalization. The Commission had previously passed upon this proposal<sup>96</sup> and at the suit of a stockholder the Circuit Court of Appeals for the First Circuit had held that the Commission was without jurisdiction in the premises because International Paper & Power Company, having an application for exemption pending, was not a registered holding company.<sup>97</sup> Thereafter, the Commission granted the application for exemption of International Paper & Power Company and dismissed the proceeding relating to that company's proposed change in capitalization. Morris thereupon appealed and the Circuit Court of Appeals for the Second Circuit upheld this action by the Commission and dismissed Morris' petition.

<sup>96</sup> See 2 S. E. C. 274 for majority, concurring and dissenting opinions.

<sup>97</sup> *Lawless v. Securities and Exchange Commission*, 105 F. (2d) 574.



## Part V

### ADMINISTRATION OF THE SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934 is designed to eliminate manipulation and other abuses in the trading of securities both on the organized exchanges and in the over-the-counter markets which together constitute the Nation's facilities for trading in securities; to make available to the public information regarding the condition of corporations whose securities are traded on any national securities exchange; and to control the flow of the Nation's credit resources into its securities markets.

#### CONFERENCES ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

In May of 1940 certain bills were pending before both houses of Congress to amend the Securities Act of 1933 in certain respects.<sup>1</sup> The Commission was then aware that representatives of certain stock exchanges, as well as representatives of over-the-counter brokers and dealers, also were advancing additional proposals for various amendments to the Securities Exchange Act of 1934. The pending bills were referred by the Committee on Interstate and Foreign Commerce of the House of Representatives to this Commission for its consideration and comment. Because of the close relationship between the Securities Act of 1933 and the Securities Exchange Act of 1934, the Commission suggested the advisability of its consultation with the investment banking and dealer associations and with representatives of exchanges on all aspects of proposed amendments to each of the Acts prior to the submission by the Commission of its views on this legislation. With the approval of the Chairman of the House Committee on Interstate and Foreign Commerce and the Chairman of the Committee on Banking and Currency of the Senate, the Commission undertook a study, with representatives of the securities industry and others, of the advisability of various suggested amendments to the Securities Exchange Act of 1934, as well as the Securities Act of 1933. The conferences on the general program, at which all of the proposals for amendment of both Acts were exhaustively discussed, commenced in the fall of 1940 and continued at intervals during the past fiscal year. Throughout the year the Com-

<sup>1</sup> S. 3985, H. R. 9807, and H. R. 10013, 76th Cong. 3d Sess

mission has endeavored, on the basis of these conferences, to work out as many areas of agreement as possible.<sup>2</sup>

#### PROCEEDINGS UNDER SECTION 19 (b) WITH RESPECT TO THE MULTIPLE TRADING<sup>3</sup> RULE OF THE NEW YORK STOCK EXCHANGE

On January 2, 1941, the Commission instituted its first proceeding under Section 19 (b) of the Securities Exchange Act of 1934, which section empowers the Commission under certain conditions to alter or supplement the rules of an exchange in respect of certain matters, if the exchange itself refuses to make such changes. On that date, the Commission served notice upon the New York Stock Exchange of a hearing on the so-called "multiple trading rule" of that exchange. The notice of hearing was the culmination of an extended series of staff investigations on the consequences of the rule, which were followed by informal requests by the Commission that the New York Stock Exchange rescind the rule. Upon the repeated refusal of that exchange to comply with these requests, and upon its refusal to comply with a subsequent formal request made pursuant to the statute, this proceeding was instituted.

The recent history of the New York Stock Exchange's multiple trading rule dates from September 28, 1939, when a "Special Committee on Multiple Exchange Trading" was appointed by that exchange to study dealings on other exchanges in securities listed on that exchange. On February 28, 1940, pursuant to the recommendation of this committee, the Board of Governors of the New York Stock Exchange directed its Committee on Member-Firms to proceed to enforce Section 8 of Article XVI of its Constitution. This section provides:

"Whenever the Board of Governors, by the affirmative vote of seventeen Governors, shall determine that a member or allied member is connected, either through a partner or otherwise, with another exchange or similar organization in the City of New York which permits dealings in any securities dealt in on the Exchange, or deals directly or indirectly upon such other exchange or organization, or deals publicly outside the Exchange in securities dealt in on the Exchange such member or allied member may be suspended or expelled as the Board may determine."

Accordingly, the Committee on Member Firms, on July 12, 1940, adopted the multiple trading rule, holding that:

<sup>2</sup> On August 7, 1941, the Commission rendered its report to the two houses of Congress upon the various proposals for amendment which had been canvassed during these conferences.

<sup>3</sup> For a description of multiple trading and its history, refer to "Report to the Commission by the Trading and Exchange Division on the Problem of Multiple Trading on Securities Exchanges" published by the Commission in November 1940. The interest of the New York Stock Exchange in multiple trading lies in the trading on other exchanges in issues listed on the New York Stock Exchange and also listed or admitted to unlisted trading privileges on other exchanges. The New York Stock Exchange maintains that it has not as yet taken any position with respect to multiple trading in its general aspects, but that the rule referred to in the accompanying discussion relates only to the prevention of its own members from acting as odd-lot dealers or specialists and from publicly dealing for their own account on another exchange in securities listed on the New York Stock Exchange.

“\* \* \* after September 1, 1940, any member, allied member or member firm acting as an odd-lot dealer or specialist or otherwise publicly dealing for his or its own account (directly or indirectly through a joint account or other arrangement) on another exchange in securities listed on the New York Stock Exchange shall be subject to proceedings under Section 8 of Article XVI.”

The Commission's staff, which was already engaged in a study of the problems of the regional exchanges, immediately accelerated its efforts and concentrated its study on the effects of the multiple trading rule upon such exchanges. Basing its conclusions in part upon the staff's field investigations in Boston, Cleveland, Chicago, Cincinnati, and Pittsburgh, the Commission on August 22, 1940, through Acting Chairman Sumner T. Pike, requested the New York Stock Exchange to postpone the effective date of the ruling. In part, his letter said:

“\* \* \* having regard \* \* \* to the fact that the Commission's preliminary study indicates that the public interest may be involved, the Commission feels that an extension of the effective date of the ruling for at least sixty days would be advisable.”

The New York Stock Exchange replied on August 28 that its “Committee on Member Firms was specifically authorized to grant any extensions of time necessary to prevent undue hardship to any member firm affected. This Committee has already granted a number of extensions of from 30 to 60 days and will be glad to receive applications from any others that have a legitimate reason for postponing action.” However, the exchange refused to accede to a blanket extension of the effective date.

On October 24, 1940, the Commission, having at hand a summary of its staff's findings and having in mind the impending termination of the 60-day extensions granted by the New York Stock Exchange, released a “Summary of Findings and Conclusions to be Contained in Report to the Commission by the Trading and Exchange Division on the Problem of Multiple Exchange Trading.” Simultaneously, Commissioner Pike, in a letter to the New York Stock Exchange, requested rescission of the multiple trading rule. His letter said in part:

“You have assured us that you have no desire to do any injury to the national system of regional securities markets. Because the findings of its staff investigation show that enforcement of your ruling will, in fact, have this result with consequent injury to the investing public in the regions affected, the Commission requests that your Board of Governors rescind its resolution pursuant to which the Committee on Member Firms issued its ruling of July 12, 1940.”

The New York Stock Exchange, replying on October 30, refused to comply with the Commission's request but instead it acceded to an alternative suggestion by the Commission and extended existing

exemptions to December 1, 1940, pending the full report on multiple trading which was then being prepared for publication.

The full report was made public on November 22, 1940, under the title "Report to the Commission by the Trading and Exchange Division on the Problem of Multiple Trading on Securities Exchanges." The report dealt in detail with the historical developments of multiple trading and the mechanics of such trading and described the magnitude of multiple trading and recent trends in its volume. The report then discussed the effects of multiple trading upon the distribution of business among exchanges and among various groups of brokers and dealers, terminating with an analysis of the effects of the multiple trading rule upon brokers and dealers, upon exchanges, and upon the public. The report concludes:

"\* \* \* the consequences of the New York Stock Exchange's action will be undesirable and may prove to be extremely serious for individual investors in some localities and for the public at large. Local industry, as well as local investors, look to their local financial centers to afford, as they should, a capital market as well as a market in which outstanding securities may be traded under the safeguards which normally attend the functioning of an organized exchange. The regional exchanges have played, and should continue to play, an integral and an essential role in developing and serving industry, the financial community and the investing public within their regions. Therefore, the action of the New York Stock Exchange, even though apparently directed solely to its own members, materially affects inter-exchange competition in a manner harmful to local industry, the general public, and to individual investors."

On December 11, 1940, after having extended existing exemptions to January 1, 1941, the New York Stock Exchange expressed disagreement with the findings in the staff's report and stated in a letter to the Commission that it "must respectfully decline to accede to the request contained in your letter of October 24." On December 20, 1940, the Commission, acting pursuant to the provisions of Section 19 (b) of the Securities Exchange Act of 1934, formally requested the New York Stock Exchange to

"effect such changes in its rules, as that term is defined by Section 6 (a) (3) of the Act, as may be necessary to make it clear that the rules of the exchange, or their enforcement, shall not prevent any member from acting as an odd-lot dealer or specialist or otherwise dealing upon any other exchange outside the City of New York of which he is a member."

By letter dated December 27, 1940, the president of the New York Stock Exchange advised the Commission that the exchange refused to comply with the above-mentioned request. Thereupon, on January 2, 1941, the Commission instituted a proceeding to determine whether the Commission should, pursuant to Section 19 (b) of the Securities Exchange Act of 1934, by rule or regulation or by order alter or supplement the rules of such exchange insofar as necessary or appropriate to effect the changes requested by the Commission on

December 20, 1940. Pending a final determination of the question, the New York Stock Exchange extended exemption from the rule's provisions to those of its members who would have been directly affected by its provisions at the time of its promulgation.

Hearings pursuant to the January 2 order were held from January 21 to January 30, 1941, at which time witnesses called by the Commission offered testimony on the history, methods, and extent of multiple trading and on the consequences of the multiple trading rule. At the same time, the New York Stock Exchange availed itself of the opportunity to challenge the testimony of the Commission's witnesses and to present its own case in full. On March 17, 1941, the trial examiner's report was filed and on May 8 oral argument was held before the Commission. The decision of the Commission in the matter was pending at the close of the fiscal year.<sup>4</sup>

### PROTECTION OF CUSTOMERS' SECURITIES

On November 15, 1940, the Commission promulgated two substantially identical rules known as Rules X-8C-1 and X-15C2-1 under the Securities Exchange Act of 1934 to carry out the principles of Section 8 (c) of the Act governing the pledging of customers' securities. Generally speaking, the rules prohibit brokers and dealers from risking their customers' securities as collateral to finance their own trading, speculating, or underwriting ventures. Accordingly, the rules, subject to certain exceptions, put into operation the three basic standards of desirable brokerage practice which are embodied in Section 8 (c). The first is that brokers or dealers must not commingle the securities of different customers as collateral for loans without the consent of each customer. Second, a broker or dealer must not commingle his customers' securities with his own under the same pledge. Finally, and of the greatest practical importance, a broker or dealer must not pledge customers' securities for more than the total amount which his customers owe him.

The rules were adopted under both Section 15 (c) and Section 8 (c) of the Act in order that uniformity of regulation would be achieved with respect to all branches of the brokerage industry, regardless of whether those subject to the rules are members of exchanges, brokers, or dealers doing business through the medium of members; or over-the-counter brokers or dealers who do not handle any stock exchange business. Because of the complexity of the credit mechanisms affected by these so-called "hypothecation rules" and because of the possibility that compliance with the rules would entail certain readjustments in the business methods of brokers and dealers, they were not

<sup>4</sup> The Commission's decision was published on October 6, 1941. (See Securities Exchange Act Release No. 3033). The Commission altered the exchange rule. The exchange subsequently indicated its acquiescence.

made effective until February 24, 1941. This deferred effective date allowed a lapse of over 3 months during which the industry could adapt itself to their requirements.

The processes of conference and discussion which preceded the Commission's adoption of the rules, as well as its efforts to assist the approximately six thousand members, brokers, and dealers who are subject to the rules in complying with their provisions, may be briefly summarized. After extended study of the problems involved in the pledging and rep pledging of customers' securities by brokers and dealers, and following the customary practice of the Commission, a tentative draft of the rules was submitted, under date of November 24, 1939, to representatives of brokerage and banking interests for their study and comment. In addition to obtaining the written comment of the national securities exchanges, the American Institute of Accountants, and certain accounting firms specializing in brokerage problems, intensive conferences were undertaken with representatives of the Board of Governors of the Federal Reserve System, the New York Stock Exchange, the New York Curb Exchange, the National Association of Securities Dealers, Inc., and the clearing house banks of the City of New York, which handle the major portion of the Nation's brokerage loans. These conferences extended well into 1940. As a result, the rules, in the form in which they were promulgated, contained numerous provisions and exemptions based upon suggestions emanating from these sources.

#### **EXCHANGES REGISTERED AND EXEMPTED FROM REGISTRATION**

During the past fiscal year there has been one change in the number of exchanges registered with the Commission as national securities exchanges. No change has occurred in the number of exchanges exempted from such registration.

Pursuant to the provisions of Section 6 (f) of the Securities Exchange Act of 1934, the New York Real Estate Securities Exchange, Inc., made application to the Commission on May 26, 1941, for the withdrawal of its registration as a national securities exchange. This application was granted by the Commission in its order of June 4, 1941, and the withdrawal became effective June 16, 1941. In its application, the exchange stated:

"The undersigned hereby requests withdrawal of said registration for the reason that the Board of Governors, after all possible efforts to improve and increase its activities, has found it impracticable to overcome certain difficulties and obstacles which stand in the way of making it the useful instrument for public service which its founders and members envisaged."

The 19 registered exchanges and the 6 exchanges exempted from registration as of June 30, 1941, are as follows:

## REGISTERED

- \*Baltimore Stock Exchange
- \*Board of Trade of the City of Chicago
- \*Boston Stock Exchange
- †Chicago Stock Exchange
- \*Cincinnati Stock Exchange
- \*Cleveland Stock Exchange
- \*Detroit Stock Exchange
- \*Los Angeles Stock Exchange
- \*New Orleans Stock Exchange
- \*New York Curb Exchange  
New York Stock Exchange
- \*Philadelphia Stock Exchange
- \*Pittsburgh Stock Exchange
- St. Louis Stock Exchange
- \*Salt Lake Stock Exchange
- San Francisco Mining Exchange
- \*San Francisco Stock Exchange
- \*Standard Stock Exchange of Spokane
- Washington (D. C.) Stock Exchange

## EXEMPTED

- Colorado Springs Stock Exchange
- \*Honolulu Stock Exchange
- \*Minneapolis-St. Paul Stock Exchange
- Richmond Stock Exchange
- \*Seattle Stock Exchange
- \*Wheeling Stock Exchange

\* Unlisted trading privileges with respect to certain issues of securities exist on these exchanges.

†On May 26, 1941, the Chicago Stock Exchange applied for unlisted trading privileges in twenty stocks pursuant to Section 12 (f) (2) of the Securities Exchange Act of 1934, which applications were pending at the close of the fiscal year, and were granted thereafter on July 30, 1941.

Some changes have been made in the rules, practices, and organization of the registered and exempted exchanges as reflected in their applications for registration or exemption. Consequently, during the past fiscal year, the national securities exchanges filed 157 amendments to their applications, and 26 amendments were received from exempted exchanges. Each of these amendments was studied and analyzed, not only that the Commission might determine compliance with relevant legislation and regulations, but also to the end that appropriate comments and suggestions could be addressed to the exchanges concerned in order to facilitate the performance of their public obligations.

During the past fiscal year, national securities exchanges have been reporting monthly to the Commission all cases of disciplinary action taken against their members or member firms. These cases have

been recorded and studied with a view toward strengthening or improving those rules which indicate a possible weakness in the disciplinary machinery of the exchanges.

#### COOPERATIVE UNDERTAKINGS CONSEQUENT UPON WAR CONDITIONS ABROAD

During the year the Commission cooperated with the Treasury Department in the regulation of such securities transactions in domestic markets originating in occupied countries as came under the so-called "freezing order."<sup>5</sup> It conducted investigations to ascertain the effectiveness of the controls over such transactions and prior to the adoption of the amendment to the "freezing order" on June 14, 1941, extending this order to include all transactions originating in continental Europe, investigated and reported on the feasibility of such action. Upon request of the Treasury Department, it has considered and made suggestions with respect to proposed amendments to the regulations and licenses issued under the "freezing order," and has reviewed and given opinions on the desirability of granting specific applications for licenses. The Commission rendered assistance in developing a program for taking a census of the holdings of securities of foreigners in domestic enterprises and has prepared and submitted analyses and studies of the values of many of the British owned securities and direct investments in the United States, including a special study of British ownership of insurance companies. It has also conferred with the Treasury Department with respect to a program for the orderly liquidation of British investments in American enterprises.

In addition the Commission, from time to time, has cooperated with other governmental agencies in connection with problems arising out of domestic transactions in the securities of aggressor nations and transactions in domestic securities originating in foreign countries or for foreign accounts.

#### SURVEILLANCE OF COMMODITY MARKETS

The Commission has recently undertaken surveillance of certain aspects of the commodity markets, as a result of a request under date of June 5, 1941, from Leon Henderson, Administrator of the Office of Price Administration and Civilian Supply. Mr. Henderson's request reads as follows:

"As you are aware, members of this Office in recent weeks have been giving attention to the presently unregulated commodity exchanges. We have been disturbed by the volume of speculative activity in essential foodstuffs on certain of these exchanges and, in cooperation with exchange officials, have taken steps to increase margin requirements and tighten various trading practices. It is my

<sup>5</sup> Executive Order No. 8389.

feeling that in this emergency period there is need for a close watch of the trading in these markets to the end that the public is not victimized by undue speculative activity.

"The Securities and Exchange Commission has had detailed experience in protecting the public from similar manipulation on the securities exchanges. I should like to call upon your organization to undertake on a voluntary basis to keep us informed as to developments on these commodity exchanges. Such cooperative activity would make it unnecessary for us to build up a staff for this purpose and in any case give us the advice of a much more experienced personnel than we could expect to assemble ourselves. It is understood, of course, that the extent of your undertaking would be only to keep this office informed of developments requiring our scrutiny.

"May I hear from you in the near future as to whether you can assist us in this matter."

On June 17, 1941, Chairman Eicher replied as follows:

"We have your letter of June 5, 1941, requesting us to employ our facilities for scrutiny of the unregulated commodities.

"In response to your request, we have reviewed our facilities for market observation and believe that they are substantially adaptable to the additional scrutiny of the unregulated commodities markets. We shall therefore be glad to undertake this work for you, sending you daily (and where necessary, hourly) reports of activity and calling to your special attention any unusual developments which appear to have a bearing upon the problems under your jurisdiction.

"You understand, of course, that we do not have statutory power to proceed against persons who manipulate the prices of these commodities, or who speculate excessively to the detriment of the public. We shall, however, use our facilities to detect such occurrences and call them immediately to your attention."

The results of this surveillance and analyses thereof are being submitted in the form of a frequent letters and reports to the Price Division of the Office of Price Administration and Civilian Supply.

The securities exchanges have been requested to cooperate by requiring margins in commodities transactions equivalent to those required by rules of the commodity exchanges, and have responded favorably to this request.

#### MARKET SURVEILLANCE AND TRADING INVESTIGATIONS

The Commission's aim in its administration of the statutory prohibitions of the Securities Exchange Act of 1934 against stock market manipulation is a sufficient policing of the markets in order to accomplish the extinction of manipulation without interfering with the legitimate functioning of those markets. Its methods of market surveillance and its investigatory procedure are set forth at pages 91 *et seq.* of the Sixth Annual Report of this Commission.

A tabular summary with respect to the Commission's trading investigations follows:

*Trading investigations*

	Flying quizzes <sup>a</sup>	Preliminary investigations	Formal investigations
Pending June 30, 1940.....	34	7	14
Initiated July 1, 1940, to June 30, 1941.....	70	7	10
Total to be accounted for.....	104	14	24
Changed to preliminary or formal.....	12	3	
Closed or completed.....	74	8	15
Total disposed of.....	86	11	15
Pending June 30, 1941.....	18	3	9

<sup>a</sup> A flying quiz is a quick informal survey of the trading in a security to determine if additional investigation is warranted.

<sup>b</sup> Includes reference of cases to various national securities exchanges.

### RECORD OF PUBLIC ACTION TAKEN AS A RESULT OF TRADING INVESTIGATIONS

On February 7, 1941, Joseph L. Merrill, a special partner of Merrill Lynch, E. A. Pierce & Cassatt, was suspended for 6 months as a member of the New York Stock Exchange, the New York Curb Exchange, and nine other national securities exchanges for violating Section 9 (a) (2) of the Securities Exchange Act of 1934. This action resulted from an investigation of his transactions during August 1940, in Diamond Shoe Corporation common stock listed on the New York Curb Exchange. No evidence was obtained which indicated that any other partner of the above firm knew of, consented to, or concurred in the violation.

On May 2, 1941, the United States District Court for the Northern District of Illinois indicted David A. Smart, Alfred Smart, Arthur Green, A. D. Elden, Jeannette Kilmnick, and Alfred R. Pastel, all of Chicago, Walter Lyon and Walter Stein of Walter Lyon & Co., David Van Alstyne, J. J. Hindon Hyde, and Walter Winfield of Van Alstyne & Co., and Leo G. Seisfeld, all of New York City. The indictment charged these defendants with conspiracy to violate Section 9 (a) (2) of the Securities Exchange Act of 1934. This case was referred to the Department of Justice on June 23, 1939, and resulted from an investigation of transactions by the above named persons during 1938 in Esquire-Coronet, Inc., common stock listed on the New York Curb Exchange.

### MARGIN REGULATIONS

The Securities and Exchange Commission is charged with the duty of enforcing Regulation T promulgated by the Board of Governors of the Federal Reserve System. This regulation limits the extension and maintenance of credit by brokers, dealers, and members of national securities exchanges and was promulgated pursuant to Sections

7 and 8 (a) of the Securities Exchange Act of 1934. As in previous years, the Commission has continued to conduct inspections of brokerage firms for the purpose of determining compliance with Regulation T<sup>6</sup>, as well as all other rules and regulations applicable to such firms, and has made the results thereof available to the Board of Governors of the Federal Reserve System whenever appropriate. During the past fiscal year the Commission continued to receive the cooperation of the national securities exchanges with respect to the enforcement of this regulation, the New York Stock Exchange having taken action in nine instances, the Los Angeles Stock Exchange in one instance, and the San Francisco Stock Exchange in one instance, for violation of Regulation T by member firms.

### PEGGING, FIXING, AND STABILIZING OF SECURITIES PRICES

During the fiscal year ended June 30, 1941, the Commission continued the administration of (a) Rule X-17A-2, which requires the filing of detailed reports of all transactions incident to offerings in respect of which a registration statement has been filed under the Securities Act of 1933 where any stabilizing operation is undertaken to facilitate the offering; and (b) Regulation X-9A6-1, governing stabilizing transactions in securities registered on national securities exchanges effected to facilitate offerings of securities so registered in which the offering prices are represented to be "at the market" or at prices related to the market prices.

Out of a total of 335 registration statements filed under the Securities Act of 1933 during the past fiscal year, 199 contained a statement of intention to stabilize to facilitate the offerings covered by such registration statements. Because of the fact that a registration statement in some cases covers more than one offering, there were a total of 227 offerings of securities in respect of which the statement required by Rule 827 of the Rules and Regulations under the Securities Act of 1933 was made to the effect that a stabilizing operation was intended to be undertaken. Stabilizing operations were actually conducted to facilitate 89 of these offerings. In the case of bonds, public offerings of \$799,500,000 principal amount were stabilized. Offerings of stock issues aggregating 12,886,782½ shares and having an aggregate estimated public offering price of \$317,402,354 were also stabilized. Of the 89 stabilizing operations commenced during the past fiscal year, 75 had been completed and notices of termination of stabilization filed with the Commission and the remaining 14 were still in progress as of the close of the fiscal year.

Also during the past fiscal year, 21 notices of intention to stabilize were filed with the Commission on Form X-9A6-1 pursuant to the

<sup>6</sup> Refer to "Supervision of Over-the-Counter Brokers and Dealers" for further mention of this subject, page 154, *infra*.

provisions of Rule X-9A6-3. The offerings described in these notices, to facilitate which stabilizing operations were conducted, involved stock issues aggregating 1,736,808 shares and having an aggregate initial public offering price of \$52,670,419.

With a view toward simplifying the procedure for the reporting of transactions effected by persons engaged in stabilizing activities, a proposed new Form X-17A-1, with instructions therefor, was drafted during the past year. This proposed form was designed to be "self-proving" and to replace the three forms required to be filed by those persons subject to the provisions of Rule X-17A-2 or Regulation X-9A6-1. A draft of Rule X-17A-2, as it would be amended in the event this proposed form were adopted, was also prepared. Following its usual practice, the Commission submitted, on May 20, 1941, these tentative drafts to 67 representative underwriting firms in various parts of the country and to the National Association of Securities Dealers, Inc., for consideration and comment. They were requested, in particular, to state whether they would prefer to continue to use the 3 forms or to use 1 simple short form corresponding substantially to the proposed form. Of the 51 responses received prior to June 30, 1941, all favored the adoption of the proposed new form or one similar thereto.<sup>7</sup>

On information derived in the first instance from reports filed with the Commission pursuant to Rule X-17A-2 or Rule X-9A6-6, the Commission referred two cases of apparent infractions of the statutes or rules thereunder to national securities exchanges and one case of such apparent infractions to the National Association of Securities Dealers, Inc., for consideration and appropriate disciplinary action by those bodies. In another case, on information so derived, a formal investigation was directed, and on the basis of the information developed therefrom the Commission ordered the suspension of the respondent from membership in the National Association of Securities Dealers, Inc. These cases are summarized below:

On January 22, 1941, the Commission referred to the New York Curb Exchange, for consideration and such disciplinary action as it might deem to be appropriate under the circumstances, several apparent infractions of Regulation X-9A6-1 committed by a member firm during the distribution, in the over-the-counter market, of a stock registered on that exchange. On February 7, 1941, the New York Curb Exchange imposed a fine of \$250 on this member firm and reprimanded its member partner.

On February 8, 1941, the Commission referred to the New York Stock Exchange, for consideration and such disciplinary action as it might deem to be appropriate under the circumstances, several appar-

<sup>7</sup> The new Form X-17A-1 and the revised Rule X-17A-2 were adopted by the Commission on July 29, 1941, effective September 10, 1941.

ent infractions of Regulation X-9A6-1 committed by a member firm during the distribution, in the over-the-counter market, of a stock registered on that exchange. In a letter to the Commission dated April 25, 1941, the New York Stock Exchange stated that it had censured this member firm.

On April 28, 1941, the Commission submitted certain information to the Washington office of the National Association of Securities Dealers, Inc., with respect to apparent violations of the association's Rules of Fair Practice by a member of that association during the firm's stabilization and distribution of a stock registered on the New York Curb Exchange and the Los Angeles Stock Exchange. In a letter dated June 16, 1941, the National Association of Securities Dealers, Inc. advised the Commission that the association's District Business Conduct Committee for District No. 2 had imposed a fine of \$200 on this member and had censured the firm.

On May 26, 1941, the Commission, having found that Masland, Fernon & Anderson of Philadelphia, Pa., had violated Section 15 (c) (1) of the Securities Exchange Act of 1934 and Rule X-15C1-2 promulgated thereunder, and having found that it was necessary and appropriate in the public interest and for the protection of investors and to carry out the purposes of Section 15 of the Act to suspend that firm from membership in the National Association of Securities Dealers, Inc., a registered securities association, for a period of three weeks, ordered, pursuant to Section 15A (1) (2), the suspension of that firm from that association from May 27, 1941, to June 16, 1941, both inclusive.<sup>8</sup>

## REGISTRATION OF SECURITIES ON EXCHANGES<sup>9</sup>

### Termination of Registration under Section 19 (a) (2).

The Commission is empowered by Section 19 (a) (2) of the Securities Exchange Act of 1934, after appropriate notice and opportunity for hearing, to deny, to suspend the effective date of, to suspend for a period not exceeding 12 months, or to withdraw, the registration of a security on a national securities exchange, if it finds that the issuer of such security has failed to comply with any provision of the Act or the rules and regulations thereunder. In those cases where after notice of hearing the Commission finds the applications for registration or the annual reports deficient or misleading, the practice to date has invariably been, to order the security delisted unless the registrant corrected the defect. This procedure has been followed in all cases to date—so that in practice the delisting power has become

<sup>8</sup> Securities Exchange Act Release No. 2905.

<sup>9</sup> For information regarding the purpose and nature of registration of securities on exchanges and the Commission's procedure in examining applications and reports, see Sixth Annual Report of the Commission, pp. 100-102, incl., as well as previous annual reports.

an administrative device for procuring accurate and adequate disclosures, although it is possible that the Commission may encounter a case of such flagrancy as to necessitate delisting, despite subsequent efforts to amend. Proceedings instituted by the Commission pursuant to this section have resulted in most cases from the failure of the registrant to file the annual report required under Section 13, although in some instances such proceedings were instituted on the basis of misleading or inaccurate statements of material fact which, upon examination, appeared to exist in applications or reports filed under the Act. Out of a total of 7 cases disposed of during the past fiscal year, 6 were based upon the failure to file the required annual reports and the remaining 1 resulted from the inclusion in an annual report of information which appeared to be misleading or inaccurate. In 5 of these cases, the annual report was subsequently filed or an amendment was filed correcting indicated deficiencies and the proceedings were thereupon dismissed. The Commission ordered withdrawn the registration of securities of the other 2 issuers—which were also involved in bankruptcy proceedings—in view of their continued failure to file the required annual report.

*Disposition of proceedings under Section 19 (a) (2) during the year ended June 30, 1941*

Number pending July 1, 1940	Proceedings instituted July 1, 1940, to June 30, 1941	Disposition of proceedings		
		Dismissed	Registration withdrawn	Number pending June 30, 1941
4	6	5	2	3

The following table indicates, on a cumulative basis, the number of issuers involved in proceedings under Section 19 (a) (2) from July 1, 1935, when permanent registration of securities under the Act first became effective, to the close of the fiscal year ended June 30, 1941:

*Cumulative disposition of proceedings under Section 19 (a) (2) from July 1, 1935, to June 30, 1941, inclusive*

Proceedings instituted	Disposition of proceedings		
	Dismissed	Registration withdrawn	Number pending June 30, 1941
50	21	26	3

#### **New Rules and Regulations under the Securities Exchange Act.**

During the past fiscal year the Commission adopted certain new rules relating to the registration of securities on exchanges, pursuant

to the Securities Exchange Act of 1934. One of these, Rule X-12B-9, is a companion to Rule 523 under the Securities Act of 1933 and simplifies the problem of filing information required of a company subject to both the Investment Company Act of 1940 and the Securities Exchange Act of 1934. Thus, pursuant to this rule, an application for registration of securities on an exchange which is filed by a closed-end investment company may consist essentially of copies of its registration statement filed pursuant to the Investment Company Act of 1940, accompanied by any additional information and documents required by the form which would otherwise be appropriate and are not included in that registration statement, provided such application is filed within 60 days after the date of filing of the registration statement under the Investment Company Act of 1940. The Commission also adopted a technical amendment to Rules X-13A-7 and X-15D-4 to permit investment companies which are required to file annual reports on Form 10-K, 15-K, 17-K, 1-MD, or 2-MD, pursuant to Sections 13 or 15 (d) of the Securities Exchange Act of 1934, as the case may be, to file in lieu thereof (under certain conditions) copies of their registration statement filed under the Investment Company Act of 1940. Certain other changes, of a relatively minor nature, were also made in the rules and regulations governing the registration of securities on exchanges.

**Statistics of Securities Registered or Temporarily Exempted from Registration on Exchanges.**

Up to and including June 30, 1941, 2,929 issuers had filed a total of 5,375 applications for registration of securities under Section 12 of the Securities Exchange Act of 1934 and a total of 24,143 annual and current reports under Section 13 of that Act. As of June 30, 1941, the registration of securities of 2,350 of these issuers was in effect, and the registration of the securities of the remaining 579 issuers had ceased to be effective for a variety of reasons; e. g., withdrawal from registration, etc.

The number of applications, reports, and amendments filed with the Commission during the past year relating to the listing and registration of securities on national securities exchanges and to the listing of securities on exempted exchanges are as follows:

*Number of applications, reports, and amendments relating to the listing and registration of securities on exchanges—Fiscal year 1941*

Applications for registration .....	213
Applications for "when issued" trading .....	10
Exemption statements for issued warrants .....	18
Annual and current reports .....	4,685
Amendments to applications and annual and current reports .....	1,742
Annual reports of issuers having securities listed on exempted exchanges ..	125

Tables 29 to 35 of Appendix II, pages 301 to 305, contain more detailed statistics of securities registered on exchanges.

**Withdrawal or Striking of Securities from Listing and Registration on Exchanges.**

During the fiscal year ended June 30, 1941, applications involving 58 issues were filed with the Commission for the withdrawal or striking of such issues from listing and registration on national securities exchanges. These applications were filed in accordance with the provisions of Section 12 (d) of the Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder. As of June 30, 1940, applications involving 21 issues were pending, and decision upon 1 application had been suspended by the Commission. During the past fiscal year, the Commission granted applications involving 63 issues; denied applications involving 3 issues; dismissed 1 application pertaining to 1 issue; applications involving 4 issues were withdrawn by the applicants; and applications involving 8 issues were pending as of June 30, 1941. The Commission was not called upon, during the fiscal year, to dispose of the application upon which decision had been suspended during the preceding fiscal year.

A considerable portion of these applications resulted from continuation of the New York Stock Exchange's practice of seeking to remove from listing and registration thereon issues deemed no longer to have adequate public distribution, activity, or market value for trading on that exchange. Applications from that source involving 22 issues were filed during the past year. As of June 30, 1940, applications involving 12 issues were pending. During the fiscal year, the Commission granted applications involving 33 issues and 1 application involving 1 issue was pending on June 30, 1941.

During the past fiscal year, the Commission received from national securities exchanges certifications of removal involving 252 issues stricken from listing and registration because of payment, redemption, or retirement. A number of the new applications for listing and registration on national securities exchanges filed during the past year were with respect to issues resulting from refundings and changes in capital structure in connection with these 252 issues.

**Applications for the Granting, Extension, and Termination of Unlisted Trading Privileges on Exchanges.**

*National Securities Exchanges.*—Clause (1) of Section 12 (f) of the Securities Exchange Act of 1934 provides that any national securities exchange, upon application to, and approval by, the Commission, may continue unlisted trading privileges to which a security had been admitted on such exchange prior to March 1, 1934. On June 30, 1941, unlisted trading privileges under clause (1) continued in 1,373 stock and 221 bond issues. This is a reduction of 1,312 stock and 1,067 bond issues from the original total continued by the Commission under

clause (1) on October 1, 1934, and a reduction of 132 stock and 100 bond issues from the total as of June 30, 1940.<sup>10</sup> Outstanding causes of this reduction under clause (1) lie in refundings, recapitalizations, mergers, and reorganizations involving substantial changes in characteristics of issues or substitutions or exchanges therefor. During the past fiscal year, 17 applications were filed with the Commission by exchanges seeking a determination that an altered or substituted security was substantially equivalent to a security theretofore admitted to unlisted trading privileges. Of these applications, 11 were granted, 5 were withdrawn and 1 was denied.

Clause (2) and clause (3) of Section 12 (f) provide that the Commission, upon application by a national securities exchange, may extend unlisted trading privileges thereon to any security duly listed and registered on another national securities exchange, or in respect of which prescribed information is available, provided certain conditions as to public distribution and public trading activity in the vicinity of the exchange and other matters are satisfied. On June 30, 1941, unlisted trading privileges under clauses (2) and (3) existed with respect to 160 stock and 31 bond issues, trading in odd lots only being authorized with respect to 14 of the stock issues. Except for 11 issues subsequently removed, these issues represent the total extension by the Commission of unlisted trading privileges under these two clauses since May 27, 1936, when they became effective upon the amendment of Section 12 (f).

Tables 36 and 37 of Appendix II, page 306, summarize the disposition of all applications under clauses (2) and (3) of Section 12 (f) of the Securities Exchange Act of 1934.

Since unlisted trading privileges in various issues have been applied for and granted to more than one exchange, the figures mentioned therein include substantial duplication of the net number of issues involved. This is particularly true with respect to stock issues under clause (1). The duplication involved can be measured by comparing the aggregate 1,533 stock and 252 bond trading authorizations under clauses (1), (2), and (3) as of June 30, 1941, with the unduplicated totals of 1,077 stock and 252 bond issues admitted to unlisted trading privileges on national securities exchanges as of that date. These unduplicated totals include 525 stock and 222 bond issues which are admitted to unlisted trading privileges only; the remaining issues are fully listed and registered (or, in a few cases, temporarily exempted from registration) on national securities exchanges other than those having unlisted trading privileges therein.

Where an application has been filed for permission to extend unlisted trading privileges to a security, the Act permits any broker

<sup>10</sup> Including the removal of 73 stock and 82 bond issues from the New York Real Estate Securities Exchange, whose registration as a national securities exchange was withdrawn. See p. 136, *supra*.

or dealer who makes or creates a market in such security, and any other person having a bona fide interest in such proceeding to be heard upon application to the Commission. During the past fiscal year, there was one instance in which an issuer opposed the granting of such an application—the application of the New York Curb Exchange for the extension of unlisted trading privileges to the First Mortgage Bonds, series A, 4 percent, due September 1, 1969 of Public Service Company of Indiana. In that proceeding, the president of the company addressed a letter to the applicant exchange in which he stated that until the bond had become seasoned, it was his opinion that it would not be in the interest of the holders of the bond or of the company to have it admitted to unlisted trading privileges. The Commission did not sustain the objection raised by the president of that company.

During the past fiscal year, the Commission instituted a proceeding to determine whether unlisted trading privileges should be terminated in the \$1 Cumulative Participating Stock of Crown Cork International Corporation on the New York Curb Exchange. This security was formerly listed and registered on the Boston Stock Exchange. Subsequent to the Commission's granting of the issuer's application to withdraw such stock from listing and registration on the Boston Stock Exchange, this proceeding was instituted to determine whether such delisting had been effected for the purpose of evading the purposes of the Securities Exchange Act of 1934. Being satisfied that such was not the intention of the issuer, the Commission dismissed the proceeding before it.

The Act provides that the Commission may terminate unlisted trading privileges in a security upon application by an issuer of such security, or upon application by any broker or dealer who makes or creates a market in such security or by any other person having a bona fide interest in the question of such termination. During the year, Chicago Rivet and Machine Company filed with the Commission an application for the termination of unlisted trading privileges in its Common Stock, \$4 Par Value, on the New York Curb Exchange. This application was filed on all three of the statutory grounds: inadequate public distribution of such security in the vicinity of the exchange, inadequate public trading activity, and character of trading in such security on the exchange. The application had not been disposed of by the Commission as of June 30, 1941.

The Chicago Stock Exchange filed applications during the year for the extension of unlisted trading privileges to twenty securities. This action reversed a policy of long standing and left the New York Stock Exchange the only major market without unlisted trading. The hearing in connection with these applications was held on June 13,

1941, and the decision in connection therewith was pending as of June 30, 1941.<sup>11</sup>

#### **Exempted Exchanges.**

On June 30, 1940, the Seattle Stock Exchange had pending before the Commission applications for the extension of unlisted trading privileges to seven stock and three bond issues. On March 5, 1941, the Commission denied 4 applications involving one stock and three bond issues on the ground that such securities were ineligible for admittance to unlisted trading privileges pursuant to the terms of the order issued by the Commission granting this exchange exemption from registration as a national securities exchange. The remaining applications involving six stock issues were denied, the Commission concluding that no application of this exchange for unlisted trading privileges should be approved unless and until its rules are amended so as to require all trades effected by its members in listed securities and in securities admitted to unlisted trading privileges thereon, whether on or off the floor of the exchange, to be currently reported to the exchange and to be considered exchange transactions subject, so far as physically possible, to all the rules and regulations of the exchange pertaining to transactions actually effected on the floor of the exchange. As another prerequisite, the Commission stated that the exchange should require the current reporting to the secretary or other appropriate officer of the exchange of all bids and offers made by its members in securities traded on the exchange.

### **OVER-THE-COUNTER MARKETS**

#### **Activities of National Securities Association.**

Cooperative regulation of the over-the-counter markets has developed in many different ways during the past fiscal year. The National Association of Securities Dealers, Inc., remains the only association registered under Section 15A of the Securities Exchange Act of 1934. Its membership (2,973) comprises those sole proprietors, partnerships, and corporations which transact the bulk of the Nation's business in over-the-counter securities, other than exempted issues, such as municipal bonds. The N. A. S. D., as it is popularly known, has been active, under the cooperative supervision of the Commission, in seeking to raise the standards of business practice in the over-the-counter field through disciplinary proceedings handled by its many local business conduct committees, through the promulgation of certain new rules and the compilation of a Uniform Practice Code, and through educational work carried on both independently by its various committees and jointly with the Commission.

<sup>11</sup> These applications were granted July 30, 1941. Securities Exchange Act Release No. 2970.

**Disciplinary Proceedings.**

*Commission cases.*—Under the provisions of Section 15A of the Securities Exchange Act of 1934 the Commission may invoke the penalty of suspension or expulsion from a registered securities association. Such action represents an economic sanction since the firm thus disciplined cannot enjoy the trade preferences which members of such associations may grant to each other pursuant to the statute. This penalty, however, is less severe than the revocation of broker-dealer registration, which bars the affected firm from use of the mails and instrumentalities of interstate commerce.

In two proceedings during the past year the Commission suspended four firms from N. A. S. D. for engaging in manipulative activities in over-the-counter securities. In one case three firms jointly raised the price of a stock prior to the contemplated distribution,<sup>12</sup> and in the other a house, through its trading and quoting activities, raised prices during the period of distribution.<sup>13</sup> The periods of suspension were rather brief, running from 2 to 6 weeks. While expressly warning that the penalties inflicted would not be regarded as a precedent, the Commission considered such leniency appropriate because of the novelty of the questions presented. During the latter part of the fiscal year, the Commission instituted five other proceedings contemplating suspension or expulsion from N. A. S. D. among the remedies to be considered, but these had not been concluded as of June 30, 1941.

*Cases referred to N. A. S. D. by the Commission.*—Two manipulation cases were referred to the N. A. S. D. by the Commission for the reason that the malpractices involved again constituted matters of first impression. In one of these, the association fined its member \$200 and in the other, where the violation was found unintentional, it issued an informal warning. The facts of the latter case, involving manipulation under the guise of stabilization, were reported for the benefit of the general membership in the association's publication<sup>14</sup> which from time to time has set forth in detail practices condemned by the association as contrary to law or business ethics.

The Commission has referred a large number of additional cases to the N. A. S. D. in pursuance of its policy of submitting to the association information indicating nonobservance of high standards of commercial honor not involving transactions which would justify institution of proceedings by the Commission.

Ten cases which had been referred by the Commission were open at the end of the previous fiscal year. Since July 1, 1940, these cases have been disposed of by the association as follows: one member was

<sup>12</sup> *In the Matter of Barrett & Company (Providence, R. I.), Satterfield & Lohrke, and Bond & Goodwin, Inc.,* Securities Exchange Act Release No. 2901.

<sup>13</sup> *In the Matter of Masland, Fernon & Anderson,* Securities Exchange Act Release No. 2905.

<sup>14</sup> See N. A. S. D. NEWS, Vol. 1, No. 8, p. 1 (May 8, 1941).

expelled, another was fined \$150, and seven were censured and warned that a repetition of the offense might subject them to severe disciplinary action. In the remaining case, the association took no action since its representatives concluded that the profits charged by the member were not excessive. In connection with five of these cases, the association conducted supplementary inspections in the course of which it found that three of the members had changed their methods of doing business and were observing rules of fair dealing; another member was induced to refund part of the profit taken on one trade; and with regard to the fifth member it was resolved to conduct another recheck in the future since the course of business being followed by this firm was deemed not wholly satisfactory. The association also advised the Commission of its intention to exercise continued surveillance in three more of these ten cases.

During the past fiscal year, in addition to the manipulation cases already mentioned, 36 cases were referred by the Commission to the association, of which the following disposition was made: 2 members were expelled and 1 was suspended for 6 months; 1 member was induced to refund part of the profits he had taken and another to rescind a transaction which showed a rather excessive profit; 9 members were censured or warned; 1 member, whose violations were deemed due to ignorance, was instructed as to the difference between a principal and agency relationship. Another member discharged a salesman whose practices seemed to have been questionable. In 5 cases no action was taken since the prices charged to customers were deemed not unreasonable because of the nature of the securities involved or of other peculiar circumstances. With regard to 1 case the association felt that it did not have jurisdiction because the transactions occurred before the dealer became a member, and with regard to 3 further cases the memberships had been terminated before the association could take action. Eleven cases remained open at the close of the fiscal year; the association had filed complaints against 6 of the firms involved therein and was still investigating the others.

*Cases originated by N. A. S. D.*—The association also handled a large number of cases which originated either in complaints filed by customers or in proceedings brought by various of the association's local business conduct committees on information and belief of probable violation of N. A. S. D. rules. Some of these cases were handled in accordance with the formal procedure set forth in the N. A. S. D. rules which are on file with the Commission as part of the association's registration statement; but many, which involved merely minor instances of poor business practice, were settled in an informal manner.

Ten cases pending on July 1, 1940, were disposed of as follows: two memberships were cancelled; one member was fined \$2,000; and

another, as the result of an arbitration, refunded over \$10,000 to the complaining customer. Three members were censured and warned, one of these having first made a settlement with the complainant. In three cases no action was taken.

During the past fiscal year the association handled 63 cases, of which 21 involved customer complaints and 42 were originated by the association. Five memberships were cancelled and 1 was suspended for 6 months. In 8 instances the customers withdrew their complaints and in 4 settlements were effected in amounts running up to in excess of \$1,000. Eight members were fined in varying amounts running up to \$1,000. Letters of censure or caution were directed to 18 firms. In 1 case the association felt that it lacked jurisdiction and in 5 the respondent firms were exonerated. Thirteen cases were pending on June 30, 1941. With respect to several cases, the N. A. S. D. advised the Commission of its intention to conduct future supplemental inspections.

During the fiscal year ended June 30, 1941, the association also filed 90 complaints against members for violation of the selling agreement used in connection with a distribution of Public Service Company of Indiana bonds. In 59 of these cases fines were imposed and 8 members were censured. These penalties imposed by various local committees were at the close of the fiscal year still under review by the association's National Business Conduct Committee. Its decisions are appealable to or reviewable by the Commission on its own motion. The final disposition of all of the so-called P. S. I. cases is, therefore, still pending.<sup>15</sup>

*Developments in N. A. S. D.'s policing methods.*—In connection with the disposition of complaints (excluding P. S. I. complaints) the association conducted 18 investigations, employing its own field representatives in 7 and certified public accountants in 11. In the remaining cases interviews with the parties concerned were relied upon to develop the facts. In the future, the N. A. S. D. will presumably be in a position to conduct its own investigations in a greater number of instances, since it increased its paid staff materially during the past fiscal year.

After the meeting of N. A. S. D.'s Board of Governors in April 1941, the chairman of the board sent out a circular letter to all district committees advising them that

“\* \* \* from this point on our major emphasis must be placed upon regulating the business conduct of our members if we are to achieve the primary purpose for which the Association was formed \* \* \*. In line with this policy, it was decided, therefore, that all District and Local Business Conduct Committees should be ever watchful to discover violations of the Association's Rules and that violators should be vigorously prosecuted and punished.”

<sup>15</sup> After the close of the fiscal year the Commission called up 6 of these cases for review. The 6 cases present all the typical instances involved.

Some time subsequent thereto, all of the district secretaries were called to Washington for a course of instruction in the investigation of complaints which was followed by practical field work in the form of an inspection of all members located in St. Paul, Minneapolis, Duluth, and other adjacent cities. A general inspection of this nature represents a distinct step forward compared to the association's original policy of taking action only upon specific complaints. The new policy, if carried through with thoroughness, should prove of real assistance to the Commission in meeting its problem of policing the 6,000-odd over-the-counter houses scattered throughout the land.

**Additional N. A. S. D. Rules and Uniform Practice Code.**

On March 14, 1941, the association filed with the Commission a proposed amendment to its Rules of Fair Practice concerning the activities of its members in connection with the distribution and redemption of securities issued by open-end management investment companies. These rules were adopted by the association pursuant to authority conferred by Sections 22 (a) and 22 (b) of the Investment Company Act of 1940 which authorize registered securities associations to formulate rules designed to minimize dilution caused by defective pricing methods and to eliminate excessive sales loads. Since the Commission had been advised that certain interested members of N. A. S. D. objected to several provisions of the proposed rules, a public conference was held on March 28, 1941, before the full Commission. After considering the various points of view advanced, the Commission concluded that the proposed rules were within the scope of the Investment Company Act of 1940 and did not run counter to the standards prescribed by Section 15A of the Securities Exchange Act of 1934. Therefore, the Commission held that it need not exercise its statutory power of disapproving the rules and they automatically became effective 30 days after filing. The Commission in its opinion<sup>16</sup> emphasized that it was neither approving those portions of the rules dealing with dilution nor intimating that they were adequate to solve the problem. It felt, however, that since the Investment Company Act of 1940 clearly contemplated that the association should be given reasonable latitude in attempting to work out a practical solution of the dilution problem, until the Commission's power to promulgate rules with regard thereto becomes effective, it would hardly be justified in rejecting the proposed rule because it did not go far enough. Under the Investment Company Act of 1940 the Commission may promulgate rules covering dilution and excessive sales loads 1 year after the effective date of the Act; meanwhile, the association is given the first opportunity to tackle the problem. If the association is unwilling or unable to do so, the Commission has

<sup>16</sup> *In the Matter of a Proposed Amendment to the Rules of Fair Practice of N. A. S. D.*, Securities Exchange Act Release No. 2866; Investment Company Act Release No. 118.

residual power to assume the task. The statutory scheme thus furnishes another instance of the cooperative regulatory process.

On June 25, 1941, N. A. S. D. filed with the Commission another amendment to its rules consisting of a Uniform Practice Code and the relevant bylaw authorizing its adoption. A draft of the code had been sent to all N. A. S. D. members at the time they were asked to vote on the bylaw. Numerous objections directed particularly at the terms of the provisions governing "buy-ins" caused the association to modify the code before filing it. The Commission decided that the code, as thus revised, should be submitted to the membership and that it would permit the new amendment to the rules to become effective unless, by July 12, 1941, it received a substantial number of demands for a public hearing based on serious criticism of the code.

#### **Supervision of Over-the-Counter Brokers and Dealers.**

During the past fiscal year the Commission continued its program of inspection of over-the-counter brokers and dealers on a more extensive scale than in any previous period. The primary purpose of this program is, of course, protection of investors by ascertaining compliance with the statutes administered by the Commission and the rules and regulations thereunder. But of substantial importance, too, is the secondary purpose of aiding brokers and dealers themselves to a better understanding of legal requirements imposed upon them. Measured by either objective there is abundant evidence that these inspections have had salutary effects.

The scope of the problem of supervision of over-the-counter brokers and dealers is to some extent reflected in the fact that, as of the close of the fiscal year, there were 6,065 such brokers and dealers registered with the Commission. Approximately 1,200 of these are also members of various national securities exchanges and about 900 others are engaged chiefly in the distribution of oil royalties or other similar interests in oil, gas, or mineral rights.

During the year the Commission received reports from its various regional offices on 1,082 inspections. Although the Commission's rules prescribing the books and records to be maintained and preserved by brokers and dealers had been in effect since January 1940, failure of compliance with these rules frequently made inspection difficult and, in some instances, it was found necessary to defer inspections until the proper books and records could be established or brought up to date. In the course of these inspections numerous questions relating to these rules have been raised requiring interpretative consideration, but experience has shown that these rules are fundamentally sound. The requirements involve records which a well-organized firm with a substantial business would reasonably be expected to maintain; yet the rules are sufficiently flexible so that even

to a firm with a very limited volume of business they need not be onerous.

In about one-fourth of the total inspections made during the year, questions of compliance with provisions of the statute required consideration. In 66 inspections, for instance, the question of extension of credit in possible noncompliance with Regulation T presented itself and in all such cases the firms promptly took steps to bring accounts into full compliance. In a large number of inspections in this 25 percent segment, conditions and practices were discovered which, to say the least, appeared in varying degrees to be inimical to the interests of customers and in numerous instances, as will be noted from the analysis which follows, actual violations of law were involved.

There were 24 inspections in which evidence of dangerous practices relating to hypothecation and commingling of customers' securities in the possession of the firm was discovered but where no evidence of insolvency or of violation of minimum capital requirements under Section 8 (b) of the Securities Exchange Act of 1934 was found. Eighteen of these cases antedated the Commission's rules under Section 8 (c) of the Act relating to commingling and hypothecation, which became effective February 24, 1941. These firms, however, acknowledged that the practice of subjecting customers' securities to risks of which customers were unaware was not in conformity with good business practice and took prompt corrective measures. Since the effective date of the hypothecation and commingling rules only six inspections have reported practices in nonconformity with the rules and appropriate action was taken in each.

A far more serious situation was found in connection with 69 other firms, the financial condition of which was found to be either precarious or definitely unsound. Some of these firms were insolvent. Others, though solvent, had aggregate indebtedness in excess of 2,000 percent of their net capital, contrary to Section 8 (b) of the Securities Exchange Act of 1934. Some of the firms in question had borrowed against customers' securities more than customers owed the firm on such securities. When such conditions and practices are discovered, the firm is generally given a reasonable time within which to remedy the situation; inability or failure to do so, however, results in prompt action by the Commission. Twenty-six of the 69 in this category have discontinued business.

The action to be taken is determined largely by considerations of public interest. Besides other courses, the Commission may move to enjoin further violations or to revoke or suspend registration, or it may seek to invoke both such remedies. It may also refer the facts to the Department of Justice for consideration of criminal prosecution, or to an agency of the State, if violation of State law appears to be

involved, for such action as such agency may deem appropriate. Obviously, the Commission's primary aim when it appears that the interests of customers may be in jeopardy is to secure, with the greatest speed possible, action to correct the situation or to freeze it so that no further harm is done. On numerous occasions, helpful cooperation has been extended by various State agencies and the following are but a few of the cases which could be cited as evidence of effective cooperation:

In the case of William E. Atwood & Co., Inc. (Maine), inspection disclosed liabilities in excess of \$22,000 with assets of only \$1,000. Customers' fully paid securities had been pledged to secure bank loans for the firm's own use, without the knowledge or consent of the customers. A bill in equity was filed 2 days after the inspection was begun and a decree, to which the firm consented, was obtained, which effectively prevented the firm from continuing its business while insolvent. On the facts disclosed by the inspection, prosecution under State law was instituted by the State of Maine and Atwood, president of the company, was convicted.

In the case of Joseph W. Burden, New York, it appeared from the inspection that the firm was insolvent by a sum in excess of \$320,000. Customers' funds and securities had, it appeared, been misappropriated. The facts were referred to the Attorney General of the State of New York who moved promptly to enjoin and later brought criminal proceedings resulting in the conviction of Burden.

In July 1940, on a plea of *nollo contendere*, George McGhie, Jr., a partner in the firm of George McGhie & Co., who had been a registered broker and dealer, was found guilty by the Federal court in the Western District of Wisconsin of mail fraud, conspiracy, and violation of the fraud provisions of the Securities Act of 1933. The criminal proceedings in this instance grew out of an investigation made upon information furnished by the Wisconsin Department of Securities.

Following an investigation conducted in November 1940, in cooperation with the Pennsylvania Securities Commission, Robert J. Boltz of Philadelphia was indicted in both State and Federal courts on charges of fraud growing out of the operation of an "investment counsel" scheme. Boltz pleaded guilty to both indictments.

No problem arises more frequently in reports on broker-dealer inspections than the problem involving the sale of securities at prices greatly in excess of the prevailing market prices.<sup>17</sup> During the past year studies were made of the schedules of transactions of 108 dealers inspected, with a view to determining whether any rules can or should be urged. The problem has been discussed with representatives of the National Association of Securities Dealers, Inc., and the association and the Commission are engaged in further study of the problem.

<sup>17</sup> This is a situation of which the Commission took initial cognizance in an aggravated case in 1939 (Duker and Duker). See Sixth Annual Report of the Commission, p. 110.

In its Sixth Annual Report,<sup>18</sup> the Commission commented on a type of fraudulent conduct by which a broker obtains secret profits through the device of misrepresenting the price at which a customer's order is executed. For instance, a broker may confirm a purchase of a security for a customer for \$1,000 plus a commission for his services, when in fact the order was executed for the total sum of \$900. Such practices not only fall short of the standards of conduct recognized by national securities exchanges and the National Association of Securities Dealers, Inc., but may also be in violation of the fraud provisions of the securities Acts. Instances of such practices were found in seventeen inspections during the year. An example in which such practices were found involved Hope & Co., St. Louis, Mo. The Commission instituted proceedings to revoke its registration, charging that by misrepresenting to customers the price at which the firm, as agent, had effected transactions for such customers and by violating its fiduciary duty in certain other transactions, the firm had fraudulently obtained secret profits aggregating more than \$9,000. The firm admitted the facts and consented to revocation of its registration.

The preceding case is one of a series of cases involving revocation of registration ordered by the Commission during the year in which fraud, arising out of an abuse of a fiduciary duty, has been alleged. Other cases were: *In the Matter of Commonwealth Securities, Inc.*; *In the Matter of Securities Distributors Corporation*; *In the Matter of Equitable Securities Company of Illinois*; and *In the Matter of Geo. W. Byron & Co.* In some of these cases, including *Commonwealth Securities, Inc.* and *Securities Distributors Corporation*, the registered broker or dealer had attempted to avoid fiduciary responsibility by use of words on the confirmation intended to indicate that in the particular transaction it had not acted in a fiduciary capacity, but, in such cases, the Commission held that the form of confirmation could not alter the fiduciary character of the relationship where this was clearly established from the other facts and circumstances surrounding the transaction. The case of *Geo. W. Byron & Co.* involved transactions in which the firm acted as agent for both parties to the transaction and accepted commissions from each without the other's knowledge and consent, which constituted an abuse of the fiduciary responsibility to which an agent is subject. *In the Matter of Securities Distributors Corporation* involved failure of a securities firm, while acting as a fiduciary, to disclose information in its possession which the customer would wish to have in deciding whether to enter into the transaction. *In the Matter of Equitable Securities Company of Illinois* involved a fiduciary obligation arising from a relation of trust and confidence between the customer and the securities company. In the decision in *In the Matter of Hope & Company* the Commission held:

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<sup>18</sup> Page 111.

"A broker-dealer exercising supervision over a discretionary account is, of course, an agent and under the principles already discussed these transactions constitute a violation of the statutory provisions cited."

and further held:

"A broker is an agent and it is, of course, a general principle of law that an agent may not, in the absence of consent of the person whom he purports to represent, deal with such person as a principal. This is so irrespective of any injury or loss to the principal. It follows that when a broker-dealer represents to a customer that he is effecting a transaction as broker, and, without the knowledge or consent of the customer buys from or sells to the customer as a principal, he is making a misrepresentation of a material fact and is engaging in a fraudulent practice which violates Section 17(a) of the Securities Act, Section 15(c) of the Securities Exchange Act and Rule X-15C1-2 thereunder."

In this opinion the Commission quoted the following statement of the law by the Supreme Judicial Court of Massachusetts in *Hall v. Paine*:<sup>19</sup>

"A broker's obligation to his principal requires him to secure the highest price obtainable, while his self-interest prompts him to buy at the lowest possible price. The law does not trust human nature to be exposed to the temptations likely to arise out of such antagonistic duty and influence. This rule applies even though the sale may be at auction and in fact free from any actual attempts to overreach or secure personal advantage, and where the full market price has been paid and no harm resulted \* \* \*"

If the transaction is in reality an arm's-length transaction between the securities house and its customer, then the securities house is not subject to fiduciary duty. However, the necessity for a transaction to be really at arm's-length in order to escape fiduciary obligations has been well stated by the United States Court of Appeals for the District of Columbia in a recently decided case:<sup>20</sup>

"\* \* \* the old line should be held fast which marks off the obligation of confidence and conscience from the temptation induced by self-interest. He who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector. He cannot commingle his trusteeship with merchandizing on his own account \* \* \*"

Statistics with respect to applications for registration as broker-dealer and effective registrations and with respect to proceedings on questions of denial and revocation of registration are shown in the following tables:

<sup>19</sup> 224 Mass. 62, 112 N. E. 153.

<sup>20</sup> *Earll v. Picken* (1940) 113 F. 2d 150.

TABLE 1.—Registration of brokers and dealers under Section 15 (b) of the Securities Exchange Act of 1934, for the year ending June 30, 1941.

Effective registrations at beginning of year.....	6, 555
Applications pending at beginning of year.....	46
Applications filed during year.....	668
<b>Total.....</b>	<b>7, 269</b>
Applications withdrawn during year.....	13
Registrations withdrawn during year.....	1, 000
Registrations cancelled during year.....	111
Registrations denied during year.....	1
Registrations suspended during year.....	1
Registrations revoked during year.....	20
Registrations made inactive during year.....	21
Registrations active at end of year.....	6, 065
Applications pending at end of year.....	37
<b>Total.....</b>	<b>7, 269</b>

TABLE 2.—Statistics on proceedings during the year ending June 30, 1941, on question of revocation, suspension, and denial of registration as brokers and dealers pursuant to Section 15 (b) of the Securities Exchange Act of 1934.

Revocation proceedings pending as of July 1, 1940.....	10
Denial proceedings pending as of July 1, 1940.....	0
Revocation proceedings ordered during year.....	28
Denial proceedings ordered during year.....	7
<b>Total.....</b>	<b>45</b>
Revocation proceedings dismissed upon withdrawal of registration.....	3
Revocation proceedings dismissed and registration not revoked.....	1
Revocation proceedings dismissed and registration cancelled.....	2
Denial proceedings dismissed upon withdrawal of application.....	2
Denial proceedings dismissed and registration permitted.....	1
Registrations denied.....	1
Registrations revoked.....	20
Registrations suspended.....	1
Revocation proceedings pending June 30, 1941.....	11
Denial proceedings pending June 30, 1941.....	3
<b>Total.....</b>	<b>45</b>

#### Study of Over-the-Counter Markets in Exchange Stocks.

A broad study of the nature and magnitude of transactions in the over-the-counter markets in stocks listed or having unlisted trading privileges on national securities exchanges was commenced during the past fiscal year. As a basis of this study the Commission has obtained a record of virtually all transactions in such stocks in the over-the-counter markets for a period of 6 months ending February 28, 1941. This study has been undertaken pursuant to the Commission's policy

of obtaining an adequate factual background for appraising the necessity and desirability of various proposed changes in exchange policies and procedure which have lately been under discussion. In conducting this study the Commission has received the cooperation of the various national securities exchanges and of the National Association of Securities Dealers, Inc.