connection with this balance sheet that we would like to get your specific opinion on before endeavoring to have the auditors alter them our way.

I will skip the first point and get to the second, which relates to losses:

Second, income and expense account: Neither Mr. Burwell (who was the president of the company, that is, of Continental Shares) nor myself is at all satisfied with this, insofar as we believe that it would not be any particular breach from accounting principles if the four hundred and twelve thousand-odd dollars representing the loss in Continental Allied and the $2,052,000, the written down total treasury stocks, were combined by way of a reduction under the caption "Profit on Sales of Securities," so that there would be only one heading here, representing approximately $15,700,000.

Mr. Eberstadt approved, and the treasurer and president of Continental Shares induced the auditors not to show the trading losses in the report but to bury them among the profits on other transactions. As a result the fact that Continental had lost $412,000 supporting its own stock, was concealed. By the end of the year the loss had increased to over $600,000, and this was similarly concealed in the annual report.

Although the majority of Continental's Board was supposedly independent, most of the securities business of Continental Shares, Inc., was handled by Mr. Eaton's and Mr. Eberstadt's brokerage firm, Otis & Co.

Continental Shares purchased $139,000,000 of securities, in lots of over $100,000 each, of which $104,000,000 were bought from or through Otis & Co.

I might explain that I did not go into transactions in less than $100,000 lots because of the amount of detail involved, but the indications are that they follow the same trend as the larger lots.

Continental Shares issued about $113,600,000 of stocks. Otis & Co. underwrote those which were underwritten, and received therefor commissions of $2,654,000.

Otis & Co. also acted directly or indirectly as manager of all of the syndicates in which Continental Shares participated or from which it bought securities.

Continental Shares had acquired such large blocks of companies in key industries that it had a controlling or strongly influential position with regard to their policies. None of its money was used for new enterprises. Along with other Eaton investment trusts and interests, it was used by Mr. Eaton to help him, for instance, bring about the merger of predecessor companies into Republic Steel Corporation, and also to support his successful fight to prevent the merger of Youngstown Sheet & Tube Corporation with Bethlehem Steel Corporation.

In connection with the Youngstown fight, Continental Shares' holdings of Youngstown stock were substantially increased. Continental was allocated about 25 percent of the legal expense, and after the proxy fight took over from Mr. Eaton's Foreign Utilities over 45,000 shares more, Continental realizing a loss of over $4,300,000.

Senator Taft. What percentage of Foreign Utilities, Ltd., did you say Mr. Eaton owned?

Mr. Bolton-Smith. Twenty-six percent.

Senator Taft. He and his wife together do you mean?

Mr. Bolton-Smith. Yes, sir.

Senator Taft. Who owned the rest of that company?

Mr. BOLTON-SMITH. He did not disclose that at the hearings. He said there were some Canadian businessmen that were close to him who held the other stock.

Senator TAFT. I take it it was all closely held stock, that it was not on the market.

Mr. BOLTON-SMITH. That is right.

Senator TAFT. None of it was owned by Continental Shares until this merger you speak about.

Mr. BOLTON-SMITH. None of the stock issued by Foreign Utilities was ever owned by Continental Shares, but portfolio securities that this private Canadian investment company had owned were purchased by Continental Shares.

Senator TAFT. All right.

Mr. BOLTON-SMITH. Although Mr. Eaton's and Otis & Co.'s other interests were large, it is undoubtedly true that the key holdings by Continental Shares aided Otis & Co. in obtaining underwriting business. It is not surprising to note, for instance, that the two largest issues underwritten by Otis & Co. in 1929 were issues of securities of companies in whose stock Continental Shares held substantial positions.

I believe one can see from this brief summary how the partners of Otis & Co. were able, through their dominating position in the management of Continental Shares, and in spite of the independent majority on the board of directors, to use that investment trust to draw business to their brokerage and underwriting firm, advancing its interests in various ways, and, finally, to meet a crisis in the business of Otis & Co. by using money which Continental Shares had borrowed and was never able to repay.

Mr. Chairman, the statements in this paper from which I have been reading are supported by footnotes, and for that reason I should like permission to file a copy of this statement to be included in the evidence.

Senator HUGHES (presiding). Hand a copy to the committee reporter and he will make it a part of our record.

Mr. BOLTON-SMITH. Including the letter?

Senator HUGHES. Yes. We understood the letter was to go in.

Mr. BOLTON-SMITH. Any questions?

Senator HUGHES (presiding). Any further questions by the members of the subcommittee?

Senator TAFT. I have no more.

Senator TOWNSEND. I believe not.

(The statement is as follows:)

STATEMENT OF CARLILE BOLTON-SMITH

Witnesses have expressed the opinion that if the bill requires that a majority of the board of an investment trust be independent, there is no need of further restricting the membership of the board.[1]

It may throw light on these statements to tell you something of an investment trust, a majority of whose directors were independent of the firm which sponsored it.[2] The facts I shall give you were brought out in a public hearing which I conducted before a trial examiner of the Securities and Exchange Commission as

[1] "Verbatim record of the hearings of Senate Banking and Currency Committee, on the investment-trust bill (S. 3580), Thursday, April 18, 1940," published by the Bureau of National Affairs, Inc., Index Nos. 440–450.

[2] Securities and Exchange Commission file 35–106, Commission's exhibit 3250. Board of Continental Shares: Cyrus S. Eaton, partner, Otis & Co.; W. Russell Burwell, member, Eaton's family; Richard Inglis, partner, Otis & Co.; F. H. Hobson, vice president of Cleveland Trust Co.; Philip Wick, Wick & Co.; R. V. Mitchell, R. V. Mitchell & Co.; David Ingalls, of Squire, Sanders & Dempsey. (Tolless, Hogsett, Ginn & Morley were counsel.)

part of the investment-trust study. The witnesses were men connected with the investment trust and its sponsor.

Otis & Co. was a partnership engaged in the brokerage and underwriting business with headquarters in Cleveland, Ohio.[3]

Mr. Cyrus Eaton had a 40-percent interest in the partnership and was its dominant partner.[4]

In 1926, Mr. Eaton and Otis & Co. organized an investment trust called Continental Shares, Inc.[5] Mr. Eaton acquired 15 percent of the voting stock of this investment trust.[6] In addition to Mr. Eaton, another partner of Otis & Co.[7] and a member of Mr. Eaton's family [8] became members of the board of seven directors of Continental Shares, Inc.;[9] and, although the majority of the board were independent of Mr. Eaton and his firm,[10] Mr. Eaton became chairman of the board. His relative became president. Together they could control the executive committee. And Mr. Eaton was able to control the investment trust, with results beneficial to himself and Otis & Co.[11]

It should be added that Mr. Eaton controlled 26 percent of the stock of Foreign Utilities, Ltd., a private Canadian investment company.[12]

Continental Shares had raised $111,000,000 mostly from the public,[13] had bought heavily in special situations in order to influence policies in large key companies and by October 9, 1930, had been able to pay off almost all of its bank loans.[14]

For some time there had been talk in the Street about Otis & Co. and on October 10, 1930, Otis & Co. had about $11,500,000 of its call loans called by New York banks.[15]

About October 10, 1930, Continental Shares, Inc., agreed to purchase most of the portfolio of Mr. Eaton's Canadian company at a valuation of about $57,000,000, of which $35,000,000 was to be paid in cash and the balance in stock of Continental Shares, Inc.[16] In order to finance this cash payment,[17] Continental Shares, Inc., borrowed $30,000,000 from the Chase National Bank in New York and $5,000,000 from the Union Trust Co. in Cleveland, Ohio,[18] pledging securities as collateral.[19]

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[3] Id. Commission's exhibit 3249.

[4] Id. at 21795.

[5] Id. at pp. 21070, 21072.

[6] Id. Commission's exhibit 3250.

[7] Richard Inglis.

[8] W. R. Burwell, freshman dean at Brown University (Id. at 21071), whose father-in-law was a brother of Cyrus Eaton's father (Id. at 21070).

[9] Id. Commission's exhibit 3259.

[10] Id. Commission's exhibits 3250, 3259, and 3315.

[11] Id.

[12] Id. at 21761.

[13] Id. Commission's exhibit 3256, Id. at 21125, 21733–21735. At the end of 1926 the company had about $4,900,000 of gross assets and about $2,400,000 of net assets. By the end of 1930 the gross assets had risen to approximately $156,500,000, the net assets to approximately $106,850,000. By June 22, 1933, the date of the receivership of the company, the gross assets had dropped to about $16,670,000 and the net assets to $6,456,381 (id. at 21130).

[14] Id. Commission's exhibit 3285. It was enabled to pay off these bank loans as a result of the final cash payment on a large sale of securities to Samuel Insull (id. Commission's exhibit 3339).

[15] Id. at 21311 and Commission's exhibit 3302, memorandum dated Oct. 10, 1930, to Mr. Wiggin, then president of Chase National Bank, from Sherrill Smith, a vice president, reading, inter alia, as follows:

"Re: Otis & Company,
Continental Shares:

"* * * In all probability some of this loan at least, maybe in temporary form, will be taken tomorrow, because of the following:

"*Otis & Co.*—There has been considerable conversation about the firm for some time past; more of it today when they had $11,500,000 of loans called. Morgan's, First National, Guaranty, and ourselves agreed to take these up. Eberstadt says they already have $7,500,000 cash on the way for partial payment. He says the firm this morning conservatively had capital of $20,000,000, probably more, that they are absolutely solvent. Their total loans were probably $120,000,000, all properly secured, but of course he is uneasy if continual calling like there was today continues. He says the $30,000,000 loan will clean up their biggest debit account which is Foreign Shares or Foreign Securities Co. They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no other debit balances which are large enough to cause them any uneasiness. He says the members of the firm altogether don't owe the firm more than $4,000,000 all properly secured. He don't think there is anything in their debts outside to cause any concern. In addition he is satisfied the principal partners have very substantial net worth outside the firm. I think he estimated this conservatively at $25,000,000. He is very emphatic there is no internal situation or buying in of their own shares which is a problem. He says that of course in their customers' collateral are large amounts of the stocks of companies they have bought into but they are properly margined and he feels sufficiently diversified with no concentration in any one of such size as to cause undue concern."

[16] Id. Commission's exhibits 3287 and 3318–A. 1,040,000 shares. Because Foreign Utilities, Ltd., did not have sufficient cash to release certain of its portfolio securities from pledge, Continental Shares, Inc., agreed on January 21, 1931, to increase its cash payment to $42,600,000; but because the securities had fallen on the market the total purchase price was reduced to $45,400,000, the difference of $2,800,000 being paid in 280,000 shares of stock of Continental Shares, Inc. (Id. at 21253–21254 and Commission's exhibit 3296).

[17] Id. at 21781, 21259.

[18] Ibid.

[19] Id. Commission's exhibits 3343, 3306, 3308–3309 and 3292–A.

It was Mr. Eberstadt, the New York partner of Otis & Co., who negotiated this loan of $30,000,000 from the Chase Bank to Continental Shares, Inc.[20]

By the night of October 13, 1930, the situation with respect to Otis & Co. had reached such a pass that at a meeting between members of the board of governors of the New York Stock Exchange and representatives of Otis & Co., including Mr. Eberstadt, it was made clear that the New York Stock Exchange would not permit Otis & Co. to open for business the next day unless Otis & Co. raised $12,000,000 of new capital.[21] It is interesting to note that at this time the books of Otis & Co. show that Foreign Utilities, Ltd., owed it about $12,000,000.[22]

By the next day, October 14, 1930, the $35,000,000 which Continental Shares, Inc., had borrowed from banks had been paid to Foreign Utilities, Ltd.;[23] Foreign Utilities had paid to Otis & Co. about $33,000,000 which Otis & Co. used to pay off bank loans.[24] Of this sum $12,000,000 represented capital contributed in the name of Mr. Cyrus Eaton which he borrowed from Foreign Utilities, Ltd., for 8 percent, plus a share in his profits.[25] In this way Otis & Co. met the requirement of the New York Stock Exchange that it raise $12,000,000 of new capital, and Continental Shares, Inc., was caused to pledge portfolio securities to borrow the money from which this capital came.[26] Foreign Utilities, Ltd., had paid its $12,000,000 debt to Otis & Co. and deposited with it a credit balance of about $21,000,000.[27] Otis & Co. had paid about $33,000,000 of its bank loans.

In this way, Otis & Co. was enabled to continue in business.[28]

On the other hand, Continental Shares, Inc., was never able to pay off the $35,000,000 of bank loans,[29] from time to time additional portions of its portfolio were pledged to secure these loans [30] and, in June 1933 the Chase foreclosed its loan, selling at auction the major portion of Continental Shares' portfolio [31] so that when Continental Shares went into receivership its portfolio was carried at only $16,500,000 gross and $6,500,000 net.[32]

Although Mr. Eaton claims that the simultaneousness of these transactions was only "a striking coincidence" and that 15 months before he had thought of Continental's buying the Foreign Utilities' portfolio,[33] the actual transactions speak for themselves. And over $8,000,000 of the $57,000,000 of securities sold to Continental Shares had just been bought from Otis & Co. by Foreign Utilities, so that Otis & Co. was indirectly selling over $8,000,000 of securities to Continental Shares. Incidentally, Mr. Eaton's Foreign Utilities made a profit of over $3,000,000.[34]

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

"* * * the $30,000,000 loan will clean up their (Otis & Co.'s) biggest debit account which is Foreign Shares or Foreign Securities Co. (meaning Foreign Utilities, Ltd.). They have been buying utility securities and owing Otis. The proceeds of our loan to Continental Shares will go to Foreign Shares and from them to Otis. Eberstadt says he is satisfied that they have no *other* debit balances which are large enough to cause them any uneasiness." [35]

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[20] Id. Commission's exhibit 3302.

[21] Id. at 21757-21761, cf. 21755-21756. Hearings before the Senate Committee on Banking and Currency 72d Cong., 1st sess., on Stock Exchange Practices, pp. 969-970.

[22] Id. Commission's exhibit 3312.

[23] Id. Commission's exhibits 3291 and 3292.

[24] Id. Commission's exhibit 3297.

[25] Id. at 21794-21795.

[26] Also see infra.

[27] Id. Commission's exhibit 3312.

[28] Later, this partnership sold its brokerage business and commenced a gradual liquidation of its other business under the supervision of Mr. Eaton. A corporation by the same name was formed which is now engaged in the underwriting business and, although Mr. Eaton does not appear as an officer or director, he is connected with it and does "special work" for it. Id. at 21263-21265. See also Securities and Exchange Commission files 43-270, re Consumers Power Co., testimony of William R. Daley, December 4, 1939, at Tr. pp. 7-8.

[29] Id. Commission's exhibits 3285, 3305, 3311, and 3266.

[30] Id. Commission's exhibit 3305.

[31] Id. Commission's exhibit 3311.

[32] Id. Commission's exhibits 3257, 3258, 3266.

[33] Id. at 21787.

[34] Id. Commission's exhibit 3312 and at 21772.

[35] Italic added. Id. Commission's exhibit 3302.

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

"I really think we are doing Otis & Co. a big service. * * *" [36]

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

The effect of this sale of securities to the investment company, which had to borrow the money to pay for them, was responsible for the receivership of the investment company. W. R. Burwell, former president of the investment company, testified:[37]

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

"A. Yes.

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

"A. That is quite true, yes.

"Q. That is, it was the borrowing of this $35,000,000 that put Continental shares into trouble, isn't that right?

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

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

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

Continental's losses as of the beginning of the receivership were about $97,900,000;[38] capital raised by sale of stock had been about $111,000,000.

Continental Shares, in 1930, organized a subsidiary (Continental Allied) to trade in the stock of its parent, Continental Shares.[39] By middle of the year this subsidiary had lost $412,000 [40] and by the end of the year over $600,000,[41] trying to support the market price of Continental Shares stock [42] and this loss was borne, of course, by Continental Shares.[43]

Losses realized on sale of securities in portfolio (net)	$54, 904, 118
Shrinkage in assets upon revaluation by receiver	43, 021, 261
Total	97, 925, 379

On May 22, 1930, Mr. Rex P. Arthur, the Denver partner of Otis & Co.,[44] wrote to Mr. Eberstadt, the New York partner, urging that more money be poured into a more aggressive support of the stock of Continental Shares and stating as a reason for this contention the following:[45]

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

Failing to support more aggressively the falling market for the stock was described as "the most perfect example of killing the goose that laid the golden egg that has ever come to my attention."

The $412,000 trading loss was specifically shown in the draft of audit report submitted by Ernst & Ernst for June 30, 1930. However, the treasurer of Continental Shares had written a letter dated July 21, 1930, to Mr. Eberstadt saying, among other things:[46]

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

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[36] Id., Commission's exhibit 3300. An interoffice memorandum of the Chase National Bank dated Oct. 9, 1930, from Mr. James Bruce to Mr. Clarkson concludes a discussion of the proposed loan as follows:

"I really think we are doing Otis & Co. a big service, chiefly because they are not securities which they could put up for their loans but would have to make special loans on them and I believe the Cleveland banks are pretty well loaded up with loans on Otis' enterprises and I think the New York banks are probably a little skeptical. For this reason they should certainly pay a substantial rate on a loan of this kind, and I do not think we should soften up Mr. Wiggin's proposition in any way."

[37] Id. at 21326.

[38] Id. Commission's exhibit 3258.

[39] Id. Commission's exhibit 3327.

[40] Id. Commission's exhibit 3324, 3326.

[41] Id. at 21456.

[42] Id. at 21456-21457.

[43] Id. at 21477 and Commission's exhibits 3328, 3263.

[44] Id. at 21450. See also Securities and Exchange Commission file 8-1 re Otis & Co. (Colorado).

[45] Id. commission exhibit 3322.

[46] Id. commission exhibit 3324.

connection with this balance sheet that we would like to get your specific opinion on before endeavoring to have the auditors alter them our way.

* * * * * * *

"Second, income and expense account: Neither Mr. Burwell nor myself is at all satisfied with this, insofar as we believe that it would not be any particular breach from accounting principals if the four-hundred-and-twelve-thousand-odd dollars representing the loss in Continental Allied and the $2,052,000, the written down total treasury stocks, were combined by way of a reduction under the caption 'Profit on Sales of Securities', so that there would be only one heading here representing approximately $15,700,000."

Mr. Eberstadt approved and the treasurer and president of Continental Shares induced the auditors *not* to show the trading losses in the report but to bury them among profits on other transactions.[47] As a result, the fact that Continental had lost $412,000 supporting its own stock was concealed. By the end of the year, the loss had increased to over $600,000 [48] and this was similarly concealed in the annual report.[49]

Although the majority of Continental's Board was independent, most of the securities business of Continental Shares, Inc., was handled by Mr. Eaton's and Mr. Eberstadt's brokerage firm, Otis & Co. Continental Shares purchased $139,000,000 of securities in lots of over $100,000 each, of which $104,000,000 were bought from or through Otis & Co.[50]

Continental Shares issued about $113,600,000 of stocks. Otis & Co. underwrote those which were underwritten and received therefor commissions of $2,654,000.[51]

Otis & Co. also acted directly or indirectly as manager of all of the syndicates in which Continental Shares participated or from which it bought securities.[52]

Continental Shares had acquired such large blocks of companies in key industries that it had a controlling or strongly influential position with regard to their policies. None of its money was used for new enterprises. Along with other Eaton investment trusts and interests, it was used by Mr. Eaton to help him, for instance, bring about the merger of predecessor companies into Republic Steel Corporation and also to support his successful fight to prevent the merger of Youngstown Sheet & Tube Corporation with Bethlehem Steel Corporation.[53]

In connection with the Youngstown fight, Continental Shares' holdings of Youngstown stock were substantially increased, Continental was allocated about 25 percent of the legal expense and after the proxy fight took over from Mr. Eaton's Foreign Utilities over 45,000 shares more, Continental realizing a loss of over $4,300,000.[54]

Although Mr. Eaton's and Otis & Co.'s other interests were large, it is undoubtedly true that the key holdings by Continental Shares aided Otis & Co. in obtaining underwriting business. It is not surprising to note, for instance, that the two largest issues underwritten by Otis & Co. in 1929 were issues of securities of companies in whose stock Continental Shares held substantial positions.[55]

You can see from this brief summary how the partners of Otis & Co. were able, through their dominating position in the management of Continental Shares and in spite of the independent majority on the board of directors, to use that investment trust to draw business to their brokerage and underwriting firm, advancing its interests in various ways and, finally, to meet a crisis in the business of Otis & Co. by using money which Continental Shares had borrowed and was never able to repay.

CARLILE BOLTON-SMITH.

APRIL 26, 1940.

[47] Id. at 21460, Commission's exhibit 3325 and exhibit B.
[48] Id. at 21456.
[49] Id. Commission's exhibits 3263 and 3388.
[50] Id. at 21477–21478. On the basis of $100,000 lots and excluding exchanges and the $57,000,000 purchase from Foreign Utilities (id. at 21480).
[51] Id. Commission's exhibit 3256.
[52] Id. Commission's exhibits 3340, 3280, 3313, etc. Analysis of Continental Shares, Inc., p. 46.
[53] Id. generally.
[54] Id., committee exhibits 3262, 3287A, 3296, 3318A, exhibit B. Analysis, pp. 121, 93, 116, 138–151.
[55] According to American underwriting houses and their issues, Otis & Co. underwrote, inter alia, the following:
May 1929: 500,000 shares the United Light & Power Co. $6 cumulative convertible first preferred stock (no par). Otis & Co. led the list of underwriters.
October 1929: $60,000,000 the Firestone Tire & Rubber Co. 6 percent cumulative preferred stock A (par $100) with stock warrants. Otis & Co. led the list of underwriters.
Continental Shares, Inc., had substantial common-stock interests in these companies (id., committee exhibit 3262) and in October 1930 took over the even larger blocks of United Light & Power held by Foreign Utilities, Ltd., and Otis & Co. (supra and id., committee exhibit 3296).

Docket No. —. Commission's exhibit No. 3322. In the matter of Continental Shares, Inc.; January 26, 1938

OTIS & Co.,
Denver, May 22, 1930.

Mr. FERDINAND EBERSTADT,
Otis & Co., New York City.

DEAR FERD: On several occasions I have been at the point of writing you exactly what I think of the Continental Shares situation. Your telegram of yesterday decided me.

First, let me assure you we are not overestimating the seriousness of the local situation. When Continental Shares breaks below 30 we are in imminent danger of having to sell out a large number of our best accounts: not joyriders and weak speculators but friends of ours who bought this stock in the beginning and all the way up. Naturally, if we start this selling the market will go lower which will in turn force further liquidation. Granted, that this predicament is most serious to the Denver office I still feel that it is not our predicament alone, but one which in a much larger sense affects the entire firm and the firm's future. When I tell you that the morale of the entire selling organization of Otis & Co. is shot to pieces just over this Continental Shares matter alone, I'm not guessing as I know the feeling of practically every office in the circuit.

As I see Continental Shares, this company is not only the most important financial vehicle which Cyrus Eaton has at his command but is potentially a tremendous business incubator for us as bankers. For the past 9 months this stock has been continuously and persistently working down. With all due allowance for the condition of the general market, it is perfectly clear that the handling of this particular market has been extremely bad. Sporadic attempts have been made from time to time to give support but there has been no continuity to the effort and at no time has the market been aggressively worked on the upside. Negative support only, that is, buying orders under the market is just wasted effort and money since any stock left to flounder will inevitably work down and through any support level.

I don't think the above assertion is open to argument. Continental Shares is worth, roughly, $10,000,000 more than it was on December 31 and the market for the shares is 15 points lower. To cite an instance, several thousand shares of stock were taken at 30 recently in one day. Following that and ironically enough, after the pressure was removed from the list and stocks were climbing, Continental Shares was left to kick about for itself as best it could so that on one day, May 19, the market broke three-quarters of a point on a sale of 100 shares and opened the next morning seven-eighths of a point down on another 100 shares. In the past week, since the market broke 32, there has at no time been any real pressure on the market, the sales not running much more than 2,000 shares a day, yet the stock is down 4 points. This situation strikes me as a serious one, a costly one, not only in its effect on our own business but in that the growth of Continental Shares is absolutely cut off while the stock acts in such a manner.

Stabilizing the share at a fair value is highly important not only for the reason that we wish to keep our stockholders but from a future financing standpoint. If the stock is stabilized at 40 I believe you will agree that in a rising market it would be easier to take it to 60 than if we start at 20 and attempt to take it to 50. On an offering of rights, 1 for 4, a difference of 10 points in the market would mean $6,000,000 to the company. To remedy this situation: First, the market should be placed entirely in the hands of one operator. I don't think the streets of New York need to be combed to find someone talented enough to handle this market but whoever the operator is he should stay in New York and be given a free hand. Second, the popgun idea should be definitely abandoned and heavy artillery brought on. The Allied Corporation should authorize the buying of as much as 10 percent of the outstanding capitalization at current levels.

No better investment could be made if this stock could be acquired to average under 35. As a matter of fact, I do not suppose that over 75,000 shares could be bought at such a price. If the company is not in funds why not sell some of their blocks of securities which do not have a key position in the picture and with the proceeds buy Continental Shares. Third, pave the way for an increase in dividend. Whether this increase is in stock or cash makes little difference. Personally, I would favor the former. We must accept human nature as it is and while in theory an investor should be willing to patiently await the outcome of large plans we must recognize the fact that investors will not keep a stock which has neither market action nor dividend to recommend it.

The liquidating value of Continental Shares is, I understand, about 36, or, in other words, the market value is approximately 15 percent below the liquidating value. The purchase of the shares on the open market obviously affords us an arbitrage of great value. When the general market has an upturn these shares could easily be distributed by our retail organization and outside dealers.* It is just a cinch, by the way, that money and effort spent on building up a dealer-following is thrown away until such time as the share is properly sponsored. Other corporations who need capital constantly are perfectly alive to this and we must come to it. Our own retail clientele alone could supply us with millions of dollars each year. At present, instead of doing this, we are letting them and their money be booted right to Hell or into the hands of our competitors. It is the most perfect example of killing the goose that laid the golden egg that has ever come to my attention.

With best regards, I am

Most sincerely yours,

REX ARTHUR.

Senator HUGHES (presiding). Who will be the next witness?

Mr. SCHENKER. Senator, we should like to have you hear from the Commission's chief accountant at this point, Mr. Werntz.

Senator HUGHES. Very well; please come forward, Mr. Werntz.

STATEMENT OF WILLIAM W. WERNTZ, CHIEF ACCOUNTANT, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. WERNTZ. Mr. Chairman, my name is William W. Werntz. I have been chief accountant of the Commission for the past 2 years.

I have prepared a statement which outlines in some detail certain accounting practices and abuses which we have seen in the investment trusts which have filed with us under the Securities Act and the Exchange Act. In order to save time, I should like, rather, just to mention briefly some of those now, and then submit the paper for the record, if you agree to that.

Senator HUGHES (presiding). Very well.

Mr. WERNTZ. I should like to make clear first that I did not participate in the investment-trust study, although I have considered the reports and have offered some comments upon certain of them. I gave particular attention to the United Founders report and to the general report on accounting practices.

The statement is frequently made that investment-trust accounting can be made very simple. Unfortunately, the principal difficulty in considering investment trusts is that there are very widely divergent practices as between trusts. Unless you are able to compare the performance record of various trusts, it seems to me that you would have a great deal of difficulty in appraising the relative merits of two companies; and, unless their statements are on substantially the same basis, we have found great difficulty in comparing them.

Now, Senators, let me say that, unlike industrials, the investment trust does not have a great array of complex problems. The problems it does have are, however, very intricate. They center around two or three major points.

First, of course, is the matter of the valuation of the portfolio; second is how you determine whether you have made a profit when you sell it; third is the treatment of your own actions in declaring dividends and in redeeming or selling stock; and last is the question of taking into income noncash receipts; that is, such things as stock dividends and stock rights and the like.

Just to show you the diversity, I should like to cite one example. Take, for instance, this question of determining whether you have made a profit when you sell a security: Suppose you purchased 10,000 shares at $10, and some other time 10,000 shares at $20. When those shares are sold, there are at least three methods of reporting a profit. Many—perhaps the majority—would report it on the basis of average cost, which would be $15 a share, so if they sold 10,000 shares for more than $15 apiece, they would report a profit.

Others, however, would follow the first-in and first-out method; and in my example I assume the first shares were purchased for $10. So if they sold them for $15, they would report $5 a share profit.

Some others would use the specific certificate method. In that procedure they select the certificate they will sell; so at the election of the management they could report a $50,000 profit or a $50,000 loss, or presumably could take some from each and report neither a profit nor a loss.

To my way of thinking, if you have two trusts and one of them does one of those and one does the other, you would have exactly comparable situations and completely different results.

I think it is possible to overcome most of those difficulties by means of agreed-upon rules in the form of uniform classifications.

Of course, the same procedure would have an effect on the way the trust carried its portfolio. If it takes securities out at average cost, then the remaining securities are held at average cost. If it takes them out at specific certificate, the remaining securities would be on a cost basis, figured according to that method, and you would get diverse results.

Possibly by comparing the two factors, namely, the value of the securities kept or the carrying value of them and the profits realized, you can compare the two trusts; but ordinarily that information is not always given. Furthermore, even if it is given, it requires a rather complex compilation, at times, to make a comparison.

Some of the companies even use two methods at the same time. For example, they will carry one block of securities of a particular issue at average cost and use the first-in, first-out method for similar securities that they are trading in from day to day.

The second question—the basis of carrying the portfolio—raises just as many problems. For example, you will find that some companies have written down their portfolios to less than cost, taking the market at some particular date. Thereafter, some of those trusts will report the excess over that written-down figure as profit. Some of them will call it merely recapture of write-offs. When you try to compare that type of company with the company that stuck to the costs or the company that carried its securities at market, you inevitably have difficulties.

Even if the information is all available in one form or another or by reference to market quotations, it makes a rather difficult computation to get the two on the same basis.

Senator TAFT. You are suggesting that uniform methods of accounting should be prescribed? Is that the point?

Mr. WERNTZ. That is correct. I wanted to point out one or two illustrations of that.

Senator TAFT. Yes.

Mr. WERNTZ. The stockholders' reports which we have examined in connection with our work reflect all of these differences: That is,