

Mr. SMITH. No; they got common stock.

Senator WAGNER. Were they voting?

Mr. SMITH. Yes; but there is quite a lot of concealment of what the actual facts were. They did not know. For instance, they took over about two or three other firms or investment companies and concealed all of these loans, and never disclosed them at all. The people who were merged that way paid a premium to get into this investment company associated with the bank.

There is another bank in that same city which had a similar experience with its officers; this was a case where an investment company was associated with a bank, and with parallel, interlocking officers, all the way through. On December 24, 1931, the loans to those officers and employees aggregated \$744,000 out of one million nine of loans; and those accounts in turn caused the investment company to borrow from the bank. Finally, I think, this company got up as high as \$31,000,000; and by 1936 or 1937, when we held the hearing, it was down to just \$700,000 or so—a large portion of which was lost. Now, that is one type of situation.

Senator WAGNER. While you cannot call that looting, of course, and I would not characterize it as that, yet these practices should not be permitted; do you think so?

Mr. SMITH. Oh, no, sir. I do not think these practices should be permitted. These are all people who are now holding responsible positions as heads of these banks up there, and who claim to have acted in good faith. Perhaps they did; I am not trying to be too critical of the times.

Senator TAFT. And the stockholders have a perfect right to have them thrown out, although they lost money?

Mr. SMITH. And the stockholders have a perfect right to have them thrown out, if they can get them out.

Senator TAFT. And they were the ones who lost—the most active stockholders in the bank, who lost their money; and still they are satisfied?

Mr. SMITH. I think there is a long history to that, with respect to whether or not they are satisfied. You hear some of these people say, "Oh, our stockholders are satisfied," and the next morning we receive a letter from a stockholder in an investment company, saying, "I can't do anything; I am helpless."

Senator TAFT. Well, all individual stockholders are helpless, unless you can get an individual group of them together?

Mr. SMITH. That is right.

Then coming to the investment bankers, there is the instance of a company up in Boston that has been in business since 1873, I think. This case shows the change that can occur. It was an old, respectable banking house, and it brought out three investment companies. Twenty-five million dollars was raised, and a great deal of that money was put into security issues in which they were interested in one way or another; and \$21,000,000 was lost.

Senator TAFT. Going back to the case you mentioned, I do not quite see why someone does not bring a suit against the gentlemen who loan money to themselves in that way—particularly when it is loaned without security. Would they not, under the common law, be subject to liability?

Mr. SMITH. In the second case, sir, the suit was brought or threatened to be brought by a stockholder who had, let us say, paid \$5,000 for his stock. They settled it with him and paid him off.

We have in this act a section about settlement of civil claims, and that is one of the situations to which that applies.

Senator TAFT. In most places that I know of, the lawyer who collected it would then get a client and bring another suit.

Mr. SMITH. They paid this man off, and I suppose it was understood that he would have to keep quiet.

Senator WAGNER. However, it would be better to prevent it, rather than to have to bring suit.

Mr. SMITH. That is right. The president of the bank said, "Mr. Smith, I am ashamed of having made this payment, and I should not have done it."

He admitted it, to the other stockholders who did not get paid off—that is, took the funds of one to pay another. It is my impression that it was a suit against the investment company.

Senator TAFT. And not against the individual president or officer of the bank?

Mr. SMITH. I am not clear on that point, sir.

Senator WAGNER. You were speaking of this other case.

Mr. SMITH. Yes; I am coming back to this case up in Boston. In that case you had an independent board; but at the operating level you had a man who dominated the whole picture. As I say, he was head of one of these old banking houses, and he brought out three investment trusts, one after another. Apparently he got into difficulties, because he borrowed money and had large sums borrowed, kept on deposit with the investment company. By 1931 he was insolvent; yet, after that insolvency, he took another million and a half from the investment company—I forget the exact amount.

He managed to stay alive until 1933 or 1934; there was segregation then; he had to get rid of his banking functions, and so he transferred the funds over to another account, as advances for the purchase of securities. Eventually all of that money was lost—about \$3,000,000 which was advanced to this investment banking house. That is another type of risk.

Senator WAGNER. How was it lost?

Mr. SMITH. The money was lost by advancing it to him, and he dominated the investment companies, and borrowed the money and carried it on deposit or advance for securities to be purchased; and a lot of that was advanced after he was actually insolvent.

Senator WAGNER. Do you mean he made a bad investment?

Mr. SMITH. Oh, he used that for his personal interest.

Senator TAFT. Do you mean embezzlement?

Mr. SMITH. I would not go so far as that, sir; I think you have a very hard case to prove.

That is the difficulty of these situations. As I say, it is not the looting cases that bother me; it is where the individual investment broker says, "I can carry water on both shoulders."

I happen to be a trustee in several estates. I would not attempt to do it; and yet they say, "I can do it." They disregard the experience of years.

Then there is another case, where I do not attack the integrity of the people; but this investment company out in your State, Senator,

raised \$116,000,000, and it dropped down to \$16,000,000—I do not want to mention names, you understand.

Senator TAFT. I think I know which one it is.

Mr. SMITH. Yes, you probably know. It coincided; there is a purchase of \$45,000,000 of securities—a purchase for cash or largely for cash—from a personal holding company which was dominated by this investment banker. That coincided with a demand for \$12,000,000 from the New York Stock Exchange. He had to put up \$12,000,000 additional. I do not know whether it is why he raised this money; I say these things happened at that time: This investment company bought \$45,000,000 worth of securities from the personal holding company, putting up \$35,000,000 in cash. In order to get the \$35,000,000 it had to go to two big banks, and it was able to meet its requirements.

Senator TAFT. The man who owned the holding company was a director or manager?

Mr. SMITH. He was the dominating figure of the investment company, and in complete control of it.

Senator TAFT. Was he the president of the investment company?

Mr. SMITH. That is right. Now, sir, they denied there was any connection. Perhaps there was not; I do not know; but I just do not like it.

Senator WAGNER. What happened to the money?

Mr. SMITH. Well, what happened to it was that the investment company put up about \$53,000,000 worth of securities to secure this \$35,000,000 loan which was used to raise the cash; and then the banks foreclosed on that in 1933, and the investment company lost most of its assets.

As I say, it dropped from about \$116,000,000 down to about \$16,000,000 or \$15,000,000, I think; and they went into receivership.

Senator WAGNER. The \$35,000,000 was lost in the speculation, I take it, or lost somewhere on the way?

Senator TAFT. No.

Senator WAGNER. What happened to it?

Senator TAFT. They lost the difference between the collateral?

Mr. SMITH. Yes.

Senator HUGHES. They lost about \$20,000,000?

Mr. SMITH. Yes. It is very hard to make a positive statement and say that such and such a thing is a direct result of that, in dollars and cents.

That same investment company was involved in a number of steel mergers in which it used the funds to go around and try to merge two big steel companies, and got into the control of some rubber companies, and a lot of other industries. I do not know; perhaps those things are all right; but they coincided, also, with the interests of the investment bankers.

Senator TAFT. Yes.

Mr. SMITH. That problem, I say, creates difficulty—even with the people who are trying to act in good faith. We have numerous illustrations of what happens when they do not have the highest faith; but even with the people acting in good faith it creates difficulty.

Let me give you another example; this is a New York banking house: In 1929 this banking house was in control of two investment companies, and it decided to form a railroad account.

Senator TAFT. The investment banking house?

Mr. SMITH. An investment banking house which is in control of two investment companies, and quite large ones. So it started a so-called railroad account, to purchase \$30,000,000 of railroad securities. The investment banking house did not put up any cash; all the cash came from the investment trust. They actually purchased about \$15,000,000 worth of railroad securities.

Senator TAFT. Who did?

Mr. SMITH. This joint account which was conducted by the——

Senator TAFT. The investment trusts?

Mr. SMITH. The investment banker and the investment trust went into a joint operation to invest in railroad securities up to \$30,000,000.

Senator WAGNER. The same interests controlled both—the bank and the investment trust?

Mr. SMITH. The investment banker controlled the investment trust.

Senator WAGNER. Yes.

Mr. SMITH. This New York investment banking house went into this joint account with the investment trust for \$30,000,000, as I say. Actually, they spent only \$15,000,000 to purchase railroad securities; but all the money was put up by the investment trust; all the \$15,000,000 was put up by the investment trust, although the investment banker was responsible for a one-half interest. The investment banker, it is true, paid interest on that money, but it was lower than the existing call rates.

I examined the minute books in July, and I could find no record of authorization for this joint account until September. Then along came November 1929, and practically the entire portion of the investment banker was turned over to the investment trust, that is to say, turned over to the top investment trust; and then it found its way back again to the investment trust that was originally in the partnership.

So that with the crash and afterward with the hard times of 1929, the question immediately arose in my mind as to whether investment bankers do not need cash. I am not imputing any bad motives to this banker, but I say they need cash and they put this \$7,000,000 worth of securities into the investment company.

Now, let me give you two of those situations: They had \$5,500,000 in the Frisco and \$5,500,000 in the Rock Island.

Senator TAFT. They transferred the \$5,500,000 at the then market price and not at what they bought them at originally?

Mr. SMITH. Yes, at the then market prices; but in transactions of that sort there is always a question, and I asked this gentleman——

Senator TAFT. A question of in whose interest it was?

Mr. SMITH. Yes, and also whether the market prices were the criterion. In November 1929, Senator, you know what the market conditions were. Perhaps they should have gotten it at a discount; I do not know; but they had this big block in these two railroad companies. This investment banker is interested in underwriting, in a big way, and has done a great deal of underwriting; and there is a further history which indicates that they did get something of the underwriting of these railroads.

Eventually, both railroads went into receivership; and out of the 5½ million dollars invested in each railroad, I think the net realization was four or five hundred thousand dollars, or something like that.

In that case I do not want to attack the integrity of the investment

banker involved; but I say that that creates a great many difficulties, when the investment company is in partnership with somebody who is in the underwriting business, who cannot afford to have long-term investments, and who is interested in it.

The witness, on the stand, said, "We cannot afford to have long-term investments. We have to have short-term investments." The underwriter gets in and must get out again. He turns over his capital.

We have some figures, Judge Healy, which show that the average underwriter turned over his capital 15 times in 1 year. That is better than Macy's; Macy's turns over its investing about 10 times a year and that is rather fast for a retail store.

Senator WAGNER. Approximately how much was the loss in that transaction?

Mr. SMITH. About 90 percent, which would mean about \$10,000,000 out of the \$11,000,000 invested in these two railroads.

Senator TAFT. On the other hand, if the investment trust had invested \$15,000,000, as you say it planned to do, it would have had the same loss, anyway; I mean the mere fact the loss occurred was the result of the fact that the stock went down.

Mr. SMITH. Yes; but the question arose——

Senator TAFT. I agree that there is a question as to whether they should have bought the second \$7,500,000 at a time when stocks were going down, and so forth, and you cannot be sure they were not doing it to help the investment banker.

Mr. SMITH. That is right.

Senator TAFT. But as far as the actual loss was concerned, they might in the beginning perfectly properly have an investment of \$15,000,000 in securities and lost 90 percent of it?

Mr. SMITH. They might, except there is always the further question of whether they went into these railroad securities——

Senator TAFT. To help the investment banker bolster up the prices?

Mr. SMITH. Well, to get underwriting business from these two railroads which were dominated by investment banking houses; and these investments amounted to about 3 or 4 percent of the stock.

Senator WAGNER. Those who controlled the investment trust were those who also controlled the investment bank?

Mr. SMITH. That is right; they had complete control of the stock.

Senator WAGNER. Where did that money come from? That is what I want to find out. Whose money was the \$10,000,000 that was lost?

Mr. SMITH. That is the public's money that was contributed to these investment companies. We are here talking only about cases of investment companies that have sold their shares.

Senator HUGHES. It did not come from the bank?

Mr. SMITH. No.

Senator TAFT. The only thing I was trying to suggest is when it was suggested that there was a certain loss, as in all these cases, anybody who invested in anything would have had large losses, and it is hard to apportion the amount that would have been lost anyway simply because of market conditions and because of the trust or failure or lack of trust. You cannot say how much was one or how much was the other.

Mr. SMITH. That is right. That is the difficulty in dealing with people who are more or less high class. It is not a question of whether they loot them at all, but a question of how much of the profit belongs

to them, as opposed to the investment company, and who gets the good situation and how much the investment is worth, and things of that sort.

Senator WAGNER. Mr. Smith, exactly what is the abuse of which you complain here, in the particular instance that you mention, to show that there ought not be—

Mr. SMITH. I am trying to show that the relationship between investment trusts and investment bankers has difficulties; and it is that relationship which section 10 in part covers.

For instance, in connection with these railroads there is another investment trust that was involved in it; and a letter was written shortly after that time—

He said that they expect to expand the syndicate for 3 months and he thought that Mr. Blank

This is the investment banker—

would probably take up with the participants the question of a longer extension. He said their idea was not to cover an account by any given day but to continue to buy the stock as cheaply as possible, to accomplish the purposes of the syndicate and to keep "the other fellows from getting the road."

That meant the railroad.

Senator TAFT. The railroad?

Mr. SMITH. Yes; and there is quite a lot more of that.

Senator HUGHES. "The other fellows" were the two other investment trusts?

Senator TAFT. No; "the other fellows" were two other banks.

Mr. SMITH. There was another banking house that had another investment company which was also interested in the deal. So you get quite a few fingers in a pie like this.

Senator HUGHES. Yes.

Mr. SMITH. Then we have another big brokerage house which raised \$25,000,000 in cash. Its history showed that \$11,000,000 of securities were put into the trust in which they are interested. At the time when the stock exchange came along and demanded money more capital was put up, and they got indirectly a million and a half loan from the investment company, to cover the stock exchange examination; and then when their annual report went out, they shoved it back again; and then they took it out again.

That company went bad, and I think that \$25,000,000 went down to about \$3,000,000.

I can go on like this, with example after example of an investment company sponsoring a \$5,000,000 investment company. You go down to November 4, 1929, and you find that on that day, which was one of the fateful days of November 1929 they were selling about \$3,000,000 of securities to the investment company.

Senator TAFT. Which is the specific provision here which proposes to remedy this particular situation? Is it (a)?

Mr. SMITH. In section 10. You will see that we deal with it in various sections in section 10.

In section 10 (a) we say, first, that the majority of the board shall consist of people who are not members of any one firm. In other words, that is to avoid the type of situation like Eastern Utilities investing, which was dominated by Associated Gas in conjunction with investment bankers, and that company went from \$77,000,000 down to \$2,000,000 or \$3,000,000 and went into receivership and was

used as an adjunct for the Associated Gas system. That is section 10 (a) (1).

Senator WAGNER. To provide a certain amount of independence in the operation of these investments?

Mr. SMITH. That is, at the board level.

Senator WAGNER. I am speaking of the board.

Mr. SMITH. Yes, sir. We approach this problem at the board of directors' level but also at the actual operating level, which is the official level, as I shall show you in 10 (d) in just a moment.

In subsection (a) (2) we say that the majority of the board shall not consist of persons who are pecuniarily interested in the investment company, such as the manager, investment adviser, broker, or principal underwriter or affiliated persons of such persons. We say that the majority of the board shall be independent of them, and we have got a number of investment companies in which that practice is followed and successfully followed. This is nothing new; I call your attention to the fact that the New York Stock Exchange, on April 22, 1931, came out with a statement as follows, re directorates:

It has been urged that the public interest in investment trusts is entitled to adequate representation on directorates, and that such independent representation should be had through qualified individuals not directly affiliated either with the management of the trust itself or with its banking sponsors, if any.

It is felt that, in default of such representation, the possibility of questionable transactions between investment trusts and their banking sponsors exists, and that this danger may lead to the feeling that investment trusts are not always managed with an eye single to the interests of their own stockholders.

Against any such suspicion, investment trusts should be protected, and this protection will in the long run prove a benefit not only to the public but to the trusts themselves, and the banking houses with which they are at times identified.

It appears to the committee as if such protection could be most readily obtained by independent directors under whose scrutiny and friendly criticism contemplated transactions would pass for review.

This view will weigh with the committee in considering listing applications.

The investment code for bankers also recognizes the importance of an independent board.

Senator WAGNER. Mr. Smith, you have enumerated a number of instances where these transactions have occurred. Were any of them subsequent to 1929?

Mr. SMITH. Oh, yes.

Senator WAGNER. They are?

Mr. SMITH. Oh, yes; oh, yes.

Senator WAGNER. Those that you mentioned seem to have been in 1929, of course.

Mr. SMITH. Well, I started with them in 1929; but they continue on.

Senator WAGNER. These operations or similar operations occurred subsequent to that?

Mr. SMITH. Oh, yes; oh, yes.

Senator WAGNER. All right.

Mr. SMITH. But I suppose I got back to 1929 because that is the time when the majority of investment trusts were organized by investment bankers and brokers. Since that time there has been a reaction against them, and a large section of the industry has been organized saying, "We have nothing to do with investment bankers and brokers," because of that situation.

Just to show that this is not a fragmentary statement, I have some analyses of a large number of investment-banker-sponsored companies and broker-sponsored companies, in regard to loans to "insiders,"