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SECURITIES AND EXCHANGE COMMISSION
Washington

HOLDING COMPANY ACT
Release No. 2654

In the Matter of THE DAYTON POWER AND LIGHT COMPANY MORGAN STANLEY & CO., INCORPORATED File No. 65-3 (Public Utility Holding Company Act of 1935 - Rule U-12F-2)	FINDINGS AND OPINION OF THE COMMISSION

DECLARATION OF STATUS

AFFILIATE

Underwriter found to be affiliate of subsidiary of registered holding company for the purposes of Rule U-12F-2, the Commission finding pursuant to said Rule that such underwriter stands in such relation to the subsidiary that there was liable to have been absence of arm's-length bargaining between them within the meaning of paragraph (a) (3) of the Rule and Section 2 (a) (11) (D) of the Act.

RULES, REGULATIONS AND ORDERS

VALIDITY OF RULE

In proceeding pursuant to paragraph (a) (3) of Rule U-12F-2, in connection with issue and sale of securities of subsidiary of registered holding company under Section 6 (b) of the Act, held, *Rule U-12F-2 is valid under the provisions of the Act, particularly Sections 6 (b), 12 (f) and 2 (a) (11) (D).*

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APPEARANCES:

John W. Houser, Sherley Ewing, and *Maurice C. Kaplan,* of the Public Utilities Division of the Commission.

George A. Brownell of Davis Polk Wardwell Gardiner & Reed, for respondent Morgan Stanley & Co., Incorporated.

Edward S. Pinney and *Howard C. Petersen* of Cravath, *de Gersdorff, Swaine & Wood,* and *Charles F. Pfarrer,* for respondent The Dayton Power and Light Company.

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The questions before us are whether Morgan Stanley & Co., Incorporated stood in such relation to The Dayton Power and Light Company that there was liable to have been an absence of arm's-length bargaining between them with respect to the issuance and sale to the public of $25,000,000 of first mortgage bonds of The Dayton Power and Light Company in February 1940, within the meaning of paragraph (a) (3) of Rule U-12F-2; and, in addition, whether Rule U-12F-2 is valid.

This proceeding was instituted pursuant to Rule U-12F-2 of the General Rules and Regulations under the Public Utility Holding Company Act of 1935, by an order to show cause addressed to The Dayton Power and Light Company and Morgan Stanley & Co., Incorporated. The Dayton Power and Light Company is a public utility subsidiary of Columbia Gas and Electric Corporation which is in turn a subsidiary of The United Corporation.1/ Both Columbia and United are registered holding companies. Morgan Stanley is an investment banker. Prior to our issuance of the order to show cause Dayton had applied to us pursuant to Section 6 (b) to exempt the issue and sale to the public of $25,000,000 of its mortgage bonds from the provisions of Section 6 (a) of the Act. The application disclosed that Morgan Stanley was one of the underwriters to whom Dayton proposed to sell the bonds and that Morgan Stanley's participation was to be more than 5 per cent.2/

The questions raised in this proceeding are most intricate and difficult. Our desire to be thoroughly familiar with the record facts and to probe the ramifications of the problems involved has occasioned long delay.

The Rule

One of the more serious holding company problems arises out of the frequent existence of interrelationships between holding company systems and their investment bankers that give rise to considerable doubt whether, in transactions between them, the subsidiary public utility companies in the system have had the advantages of arm's-length dealing. 3/ Congress indicated considerable concern about such relationships in various sections of the Act as well as in

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1/ Rule U-12F-2, Dayton Power and Light Company, Morgan Stanley & Co., Incorporated, Columbia Gas and Electric Corporation and The United Corporation are hereinafter sometimes referred to respectively as the "Rule", "Dayton", "Morgan Stanley", "Columbia" and "United". The Public Utility Holding Company Act of 1935 will be referred to as the "Act".

2/ In order to avoid delaying the issue, we granted the application on February 7, 1940, reserving jurisdiction over the issues raised in this proceeding under the Rule. *In the Matter of The Dayton Power and Light Company*, 6 S.E.C. 787. (1940)

3/ Elgen, *Value of Competitive Bidding for Utility Securities*, 19 Pub. Utilities Fortnightly 723 (1937). For specific examples see the Federal Trade Commission's *Report in Response to Senate Resolution 83*, 70th Congress (1st Sess.), Senate Document 92, Part 36, pp. 261-663, Part 72A, pp. 352-367; *Kansas Electric Power Company*, 1 S.E.C. 891 (1936); *H. M. Byllesby Corporation*, 6 S.E.C. 639 (1940).

reports and debates which formed the basis for the Act. These we will discuss in some detail further along in our opinion. In the administration of the Act, one serious difficulty which we have encountered in our efforts to carry out the Congressional intent has involved the timing of issuance of securities. Either because of a maturity date or a call date, or because of threats of market disruptions, we were under pressure to permit the financing to go through in the form and upon the terms proposed.

On the basis of our experience in carrying out the provisions of the Act, we believed that the solution to the problem lay in establishing a mechanism which would sift out in advance the cases of special relationships and neutralize the effects of such relationships wherever found. Accordingly, on December 28, 1938 the Commission adopted Rule U-12F-2 to become effective March 1, 1939. When an investment banker stands in such relation to a public utility company that there is liable to be an absence of arm's-length bargaining between them in an underwriting transaction, the Rule forbids the payment of an underwriter's or manager's fee to such investment banker if its participation exceeds 5% of the total offering; provided, that the prohibition of the Rule is not applicable if diligent effort was made to obtain competitive bids for the securities, or if such effort is shown to have been impracticable and certain other conditions are satisfied.4/ In the case before us no effort was made to obtain competitive bids, nor has there been any showing that such effort was impracticable.

4/ Rule U-12F-2 provides:

"(a) In connection with an issue, sale or acquisition of any security with respect to which an application or declaration is required by sections 6, 7, 9, 10 or 12 (d), (f), or (g) of the Act, no underwriter's or finder's fee shall be paid to--
(1) Any company in the same holding company system as the applicant or declarant, or
(2) Any affiliate of the applicant or declarant, or of a company of which the applicant or declarant is a subsidiary, or
(3) Any person who the Commission finds stands in such relation to the declarant or applicant, or to the person by whom the fee is to be paid, that there is liable to be or to have been an absence of arm's-length bargaining with respect to the transaction. The Commission shall not make such finding unless it has issued an order to show cause why such finding should not be made, which order to show cause shall be returnable on the date and at the place fixed for hearing upon the application or declaration to which it is ancillary, unless the Commission otherwise orders. Proceedings on the order to show cause and on the application or declaration shall be consolidated, unless the Commission shall otherwise order. In appropriate cases, the Commission upon application may make a finding or render an opinion for purposes of this paragraph in advance of any issue, sale, or acquisition of any security. Except for purposes of this rule, a finding by the Commission under this paragraph shall not constitute a finding for purposes of section 2 (a) (11) (D) of the Act.

(b) Paragraph (a) of this rule shall not apply in respect of any underwriter's fee if it appears to the Commission that--

(Continued)

As the validity of the Rule cannot be determined except in the light of its applicability to the facts of this case, we shall proceed at once to a consideration of such facts.

The Relationship

The relationship, if any, between Dayton and Morgan Stanley arises out of certain intermediate relationships, namely: (1) the position of Dayton as a subsidiary of Columbia and the position of Columbia as a subsidiary of United; (2) the incentive attributable to leading partners of J. P. Morgan & Co. 5/ to secure underwriting business for Morgan Stanley; and (3) the influential position of J. P. Morgan & Co. in the affairs of United. In other words, the argument of counsel for the Public Utilities Division is that Dayton, through Columbia, is susceptible to domination by United; that leading partners of J. P. Morgan & Co. have a strong motive for securing business for Morgan Stanley; and that J. P. Morgan & Co. has occupied such an influential position with respect to United that it has been able to place Morgan Stanley in a preferred position with respect to the underwriting business of companies within United's sphere of influence, including Dayton. Through the links of this chain, counsel for the Public Utilities Division maintain that Dayton and Morgan Stanley stood in such relationship to each other that there was liable to have been an absence of arm's-length bargaining in the underwriting transaction relating to the Dayton bond issue.

We take up each of these propositions in the order stated.

(1) *Dayton is a subsidiary of Columbia, and Columbia is a subsidiary of United.*

Under the Act, a company is automatically given the status of a subsidiary of a holding company if 10% or more of its voting securities are owned, controlled, or held with power to vote, by such holding company.

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4 cont'd/ (1) Appropriate and diligent effort was made to obtain competitive bids for the securities which are the subject of the application or declaration, by publication or otherwise, and the affiliate's bid was not less favorable than that of any other bidders'; or
(2) Such effort was not practicable and (a) the fee to be paid does not exceed customary fees for similar services where the parties are dealing at arm's-length, (b) the service rendered is necessary, and (c) the remuneration is reasonable in view of the cost of rendering the service, the time spent therein, and other relevant factors. (d) Any underwriter's fee within the meaning of this rule shall include any fee, commission, discount or other remuneration (except a finder's fee) paid in connection with a public offering of any securities to an underwriter as defined in the Securities Act of 1933: Provided, however, That the term shall not include any fee paid to an underwriter whose participation does not exceed 5 percent of the total offering, if such underwriter does not receive any commission or remuneration (whether for originating the issue or otherwise) in addition to the fee computed at the rate applicable to other underwriters who take the same or similar participation in the offering.

5/ Throughout this opinion, references to J. P. Morgan & Co. are references to that firm as constituted from time to time prior to its incorporation, which occurred after the close of the hearings herein.

Dayton's voting securities have been 100% owned by Columbia since 1925; and since May, 1930, at least 19.6% of Columbia's voting securities have been owned by United. Both Columbia and United are registered under the Act as holding companies. The consequences that attach to the status of subsidiary companies of registered holding companies arise out of the statute itself, not out of any determination we may make. If such consequences are to be avoided, it is incumbent upon either the subsidiary company or the holding company to apply to us for an order declaring such subsidiary company not to be a subsidiary of the specified holding company. 6/ No such application has ever been filed with respect to Dayton; and although at one time Columbia filed an application for an order declaring it not to be a subsidiary of United, that application was withdrawn by Columbia before it came to a hearing.

By reason of the status of Dayton and Columbia as subsidiaries of United, therefore, it follows as a matter of course that a person influential in the financial affairs of United would also stand in a similar relationship to United's subsidiaries, and is within the scope of the Rule. Of course, it is not necessary for the purpose of the Rule to find a parent-subsidiary status between Dayton and Columbia and United. The Rule also embraces more subtle relationships which may so link corporations and individuals that there is liable to be an absence of arm's-length bargaining in transactions between them. On the facts, as hereinafter set forth, we also find that such a relationship exists between Dayton and Columbia and United.

(2) *The incentive of leading partners of J. P. Morgan & Co. to secure business for Morgan Stanley.*

Morgan Stanley was formed as an investment banking house by partners of J. P. Morgan & Co. and its Philadelphia firm, Drexel & Co. 7/ These firms, forced by the Banking Act of 1933 to elect between commercial banking and investment banking, chose the former. They were therefore compelled to terminate their underwriting business as of June, 1934.

At that time the securities markets were virtually dormant, and when they began to reopen in 1935 the members of the Morgan-Drexel firms entertained hopes that the Banking Act might be amended to permit commercial banks to underwrite and wholesale securities. About July of 1935, however, it became apparent that such an amendment would not be enacted, and the members of the Morgan-Drexel firms concluded that a separate organization should be formed to engage in investment banking. It was agreed among them that certain partners and employees should leave the firms and become directors, executive officers, and employees of the new organization. Some of the remaining partners of J. P. Morgan & Co. agreed to "grub-stake" the new organization by purchasing its preferred stock, and this they did according to their individual means and inclinations.

6/ Section 2 (a) (8) of the Act.

7/ It is stipulated that J. P. Morgan & Co. and Drexel & Co. have been the same firm since 1916.

On September 6, 1935, Morgan Stanley was incorporated, and its organization was completed on September 16. The three principal officers were Harold Stanley, William Ewing and Henry S. Morgan, formerly partners of J. P. Morgan & Co. They were joined in the new enterprise by two members of J. P. Morgan & Co.'s Philadelphia firm of Drexel & Co., three senior employees of J. P. Morgan & Co. and a staff of employees also from that firm. Harold Stanley became president and a director of the corporation, William Ewing became executive vice president and a director, and Henry S. Morgan became treasurer, secretary and a director. Four of the others became vice presidents and directors, and one was made assistant treasurer and assistant secretary. All of these persons still occupy their original positions, the only changes occurring to date being the addition in 1936 of two vice presidents and directors. These were Alfred Shriver, formerly president and a director of Guaranty Company of New York, and Sumner B. Emerson, formerly a vice president of Fire Association of Philadelphia and associated companies.

The capital of Morgan Stanley originally consisted of $7,250,000, of which $6,600,000 was contributed by individual partners of J. P. Morgan & Co. The capital was divided into 50,000 shares of common stock of $5 par value and 70,000 shares of preferred stock of $100 par value. 8/ The common stock was given full voting rights and was taken at $10 per share by the persons who became Morgan Stanley's officers and directors. The preferred stock was given no voting rights except as especially provided by the laws of the State of New York, under which Morgan Stanley was organized, but it carries a preferred dividend of 6% if earned, cumulative to the extent of 4%. The preferred stock was purchased at $100 per share, chiefly by the principal remaining partners of J. P. Morgan & Co. 9/ At the inception of Morgan Stanley, pecuniary interests therein were held as follows:

8/ According to the certificate of incorporation, the common stock of Morgan Stanley cannot be sold, assigned or bequeathed except, in the case of a deceased stockholder, to his executors or administrators, without first being offered for sale to the corporation; and the preferred stock is similarly restricted as to transfers except that it may be transferred to a person who is already a stockholder of the corporation, or to testamentary trustees. Thus, from the inception of the enterprise, the stock of Morgan Stanley has been closely held and closely restricted as to transferability.

9/ The record does not disclose that J. P. Morgan & Co. as such ever had any interest in the preferred stock of Morgan Stanley, or whether any individual partners of J. P. Morgan & Co. purchased such preferred stock out of the firm's capital or other funds withdrawn by them from the firm. On the record before us, we find that the preferred stock was purchased by nine of the seventeen partners of J. P. Morgan & Co. (excluding the partners who resigned to go with Morgan Stanley), out of their own funds, as their own individual investment.

Owners	Amount		Percent
Individual partners of J. P. Morgan & Co., preferred stock	$6,600,000		88%
Officers and directors of Morgan Stanley, preferred stock	400,000	5.33-1/3%	
common stock and surplus	500,000	6.66-2/3%	12%
Total Capitalization and Surplus	$7,500,000		100%

In August, 1937, the number of common shares was increased to 200,000, and the additional shares were distributed to the then holders of common stock in proportion to their holdings. At the present time the common shares are still held only by the officers and directors of Morgan Stanley and the three largest stockholders, holding 20% each, are Harold Stanley, William Ewing and Henry S. Morgan.

The interests of the partners of J. P. Morgan & Co. in the preferred stock of Morgan Stanely have been reduced, principally by the death of two partners, partly by transfers. On August 31, 1939, partners of J. P. Morgan & Co. owned 30,700 out of the 70,000 shares of outstanding preferred stock, while 20,000 of the outstanding shares were held by the estate of a deceased partner and a total of 3,100 shares were held by two partners in trust. In the meantime the equity attributable to the common stock had increased from the original $500,000 to nearly $3,000,000 so that on the basis of the net worth of Morgan Stanley as of August 31, 1939, pecuniary interests therein were held approximately as follows:

Owners	Amount		Percent
Living partners of J. P. Morgan & Co., individually and in trust, preferred stock	$3,580,000		35.8%
Estate of deceased partner of J. P. Morgan & Co., preferred stock	2,000,000		20.0%
Others, preferred stock	170,000		1.7%
Officers and directors of Morgan Stanley, preferred stock	1,250,000	12.5%	
common stock and surplus	3,000,000	30.0%	42.5%
Total Capitalization and Surplus	$10,000,000		100.0%

Aggregate income in dividends on the preferred stock held by living partners of J. P. Morgan & Co. has ranged from $396,000 in 1935 down to $143,200 in 1939. 10/ When the nine partners of J. P. Morgan & Co. invested in the preferred stock, they were as hopeful as the officers and directors of Morgan Stanley that the enterprise would succeed. It was clearly to their own pecuniary advantage to secure as much underwriting business for Morgan Stanley as possible.

In so concluding, we do not impute improper conduct to any one. We merely point out that those partners of J. P. Morgan & Co. who held Morgan Stanley's preferred stock possessed a strong incentive for helping Morgan Stanley obtain business. 11/ Among the Morgan partners included in this group were J. P. Morgan, Thomas W. Lamont, Russell C. Leffingwell, George Whitney, and until his death, Charles Steele. With the leading members of J. P. Morgan & Co. thus interested, it is a matter of no great significance that not all of the partners of the firm had a pecuniary interest in Morgan Stanley.

Our conclusion is that at all times since the formation of Morgan Stanley, the pecuniary interests of the leading partners of J. P. Morgan & Co. have been such that those partners have had a powerful incentive to secure what business they could for Morgan Stanley. We do not deem it necessary to find in this case that the partners of J. P. Morgan & Co. exert an influence over the management and policies of Morgan Stanley. The failure to so find, however, does not weaken the force of our conclusion that there was an identity of pecuniary interest. It is not to be supposed that partners of J. P. Morgan & Co. would have to possess influence over Morgan Stanley to induce it to accept such high-grade underwriting business as they were able to procure for it.

(3) *J. P. Morgan & Co. has occupied such an influential position in United that Morgan Stanley has been placed in a preferred position with respect to the financing of Columbia subsidiaries, including Dayton.*

J. P. Morgan & Co.-Drexel & Co., together with Bonbright & Company, Incorporated, an investment banking house then controlled by Landon K. Thorne and Alfred L. Loomis, organized United in January, 1929. The organizers and an affiliated company 12/ initially turned over to United cash in

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10/ The regular 6% dividend was paid up to August, 1938, and a 4% dividend was paid during the year ended August, 1939.

11/ It appears, moreover, that a considerable amount of financial planning was done for various companies by partners and employees of J. P. Morgan & Co., in 1934-1935, in the hope that such work would lead to underwriting business in the future, although when the work was done the firm was not eligible to engage in underwriting business. In accordance with the foregone conclusion prevalent among financial men at the time, Morgan Stanley proceeded immediately to act as principal underwriter for companies that had previously employed J. P. Morgan & Co.-Drexel & Co. in that capacity, and also for companies whose financial programs had been formulated in the offices of J. P. Morgan & Co.

12/ The American Superpower Corporation, controlled by Thorne and Loomis.

the amount of $20,000,000 and large amounts of voting securities of United Gas Improvement Company, Public Service Corporation of New Jersey, and Mohawk Hudson Power Corporation, 13/ causing United to issue to them its preferred and common stock and option warrants in exchange for such cash and securities. The initial board of directors of United consisted entirely of representatives of the Morgan-Thorne-Loomis groups. Shortly thereafter, George Howard was added to the board and elected President of United. He has retained these positions to this date. Having established their representatives on United's board of directors the organizers proceeded to dispose of their holdings of United preferred and common stock to their clients. But in spite of the organizers' small holdings of United's voting securities, 14/ they continued to retain their dominant position on the board of directors, partly through control of the proxy machinery. No opposition was ever encountered from the stockholders, few of whom ever attended meetings in person.

The evidence is conflicting as to what purposes the organizers had in mind when they formed United. The Morgan-Drexel firms had been underwriters for the U.G.I. and Public Service Systems for many years, had held minority interests in their securities, and had representatives on their boards of directors. There is evidence that around 1928 outside financiers in the utility business had approached either U.G.I. or Public Service with the idea of buying into those companies, and that there were discussions among the Philadelphia partners of Drexel & Co. as to the dangers that might come from such activities. Early in 1928 J. P. Morgan & Co. purchased substantial additional blocks of U.G.I. and Public Service stock, and discussed with other stockholders the advisability of working in concert.

At about the same time General Electric Company asked J. P. Morgan & Co. to buy a substantial amount of securities of Mohawk Hudson. Thorne and Loomis had been discussing with Morgan partners for some time the benefits to be gained from utility investments, but the Morgan-Drexel firms already had a good many millions of dollars tied up in their portfolio of U.G.I. and Public Service stocks. Rather than increase their own utility portfolio, therefore, they decided to form a holding company to take over not only the proffered Mohawk Hudson securities but also their U.G.I. and Public Service holdings together with the even larger holdings therein of The American Superpower Corporation. This enabled the Morgan-Drexel firms to reduce their portfolio of utility investments without disrupting the market prices

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13/ Hereinafter sometimes referred to as "U.G.I.", "Public Service" and "Mohawk Hudson", respectively.

Morgan-Drexel contributed $10,000,000 in cash, and voting securities of the named utility companies which were valued on United's books at about $50,000,000.

14/ At the end of 1939, voting securities of United held by the Morgan-Drexel firms and their individual partners aggregated less than 1/2 of 1%, and the holdings of officers and directors of Morgan Stanley aggregated about 7/100 of 1%. Except for St. Regis Paper Company and affiliated interests (holding about 7.9%) and The American Superpower Corporation (holding about 6.2%), the other holdings in United stock were small and widely scattered.

thereof, and through the sale of the holding company securities, to realize a substantial profit on their investment 15/ and yet retain and even increase their influential position with the constituent utility systems.

In preparing a memorandum to be used in the sale of United stock, it was of interest to J. P. Morgan & Co. to see how other holding companies lacking in diversification of investments had dealt with that problem in their advertising. On January 2, 1929, Thomas S. Lamont, who had just become a partner of J. P. Morgan & Co. but who had been in its employ for some years, wrote a letter to the firm's lawyer reading in part as follows:

> "In this connection the names of two other investment trusts occurred to me, the purposes of which are in a way similar to the one proposed, 16/ in that they make little if any pretense of diversification, and their purpose is obviously to insure continued control by the bankers . . . and their clients."

Realistic as this statement seems, there was testimony denying that continued control was among the purposes of the bankers in organizing United. But whatever the purposes, the effect was (a) to assure the continuation of the position of the Morgan-Drexel firms in the leadership of U.G.I. and Public Service financing; (b) to obtain for J. P. Morgan & Co. the leadership in the financing of Niagara Hudson (which was created by the consolidation of Mohawk Hudson and other upstate New York utilities); and (c) to assure to Bonbright & Company, Incorporated, an important participation in all such financing. Later, when the Morgan-Drexel firms went out of the investment banking business and Morgan Stanley was formed, Morgan Stanley succeeded to the leadership in the underwriting transactions of companies in these systems.

United did not acquire the bulk of its holdings in Columbia common stock until May, 1930, when through an exchange offer apparently instigated by P. G. Gossler, then Columbia's president, it obtained nearly 25% of Columbia's outstanding common stock. Before that, however, Gossler had expressed a personal interest in United, buying some of its stock and selling to United some of his personal holdings in Columbia.

On May 14, 1930, the United board caused a letter to be sent to Columbia offering to acquire approximately 25% of the outstanding shares of Cilumbia's common stock, and to issue in exchange for each share so acquired 1/3 of a share of United's preference stock and 1-1/2 shares of its common stock. One of the terms of the offer was that upon consummation of the exchange, Gossler should be elected a director of United. Columbia's board approved the offer and resolved to recommend to the Columbia stockholders "that they deposit at least 25% of their holdings pursuant to said proposal." A circular dated May 16 was sent out to all Columbia stockholders by the Columbia management, urging their acceptance on the ground that:

15/ The securities were turned over to United at a valuation which was below the prevailing market quotations but substantially in excess of the original cost of acquisition.

16/ Concededly this refers to United.

"It is expected that the close association of The United Corporation with Columbia Gas & Electric Corporation as a result of this acquisition of stock will facilitate the making available of the great natural gas resources of the Columbia System to the large industrial and domestic markets along the eastern seaboard.

"Your Board of Directors believe that the proposal made by The United Corporation is of advantage to Columbia Gas & Electric Corporation and its Shareholders. . ."

Stanley, who was then a member of the Columbia board and executive committee, a partner of J. P. Morgan & Co. and admittedly an influential factor in (though not then formally a director or officer of) United, approved the form and content of this letter to stockholders. Gossler was one of the officers who signed the letter, and was also one of three Columbia officers who set themselves up as a stockholders' committee to work for the success of the plan. This committee employed J. P. Morgan & Co. as depositary. Columbia itself agreed to and did share all expenses equally with United, including a fee of $200,000 to J. P. Morgan & Co. The result of the transaction, in respect of which Columbia paid expenses to the extent of $178,684.06, was the acquisition by United of over 2,000,000 shares of the outstanding common stock of Columbia. Gossler was duly elected to the United board of directors.

From the foregoing and from the testimony it appears that Columbia was hopeful of expending its business through contacts and leadership which it would gain by joining the United group. For whatever purpose the acquisition by United was made, it did not result in an immediate transfer of Columbia's financing to the Morgan-Drexel or Bonbright interests.

Guaranty Company of New York had been Columbia's investment banker since 1922, and continued as such until it was dissolved as a result of the Banking Act in June, 1934. Meantime, no effort was made by J. P. Morgan & Co. to obtain Columbia's underwriting business for itself or to participate in that which was headed by the Guaranty Company.

Stanley, who as president of the Guaranty Company had handled Columbia financing prior to 1928 (at which time he became a Morgan partner), testified that in his experience with J. P. Morgan & Co. the firm had never approached a company for underwriting business where such company already had a satisfactory banking relationship with others; 17/ and that he knew personally that Columbia had satisfactory relations with the Guaranty Company. It may well be supposed, moreover, that J. P. Morgan & Co. would not be inclined to compete with the Guaranty Company, which was a subsidiary of Guaranty Trust Company, a large and friendly institution on whose board at at least two Morgans partners sat.

17/ There is other testimony in the record to the effect that among investment bankers generally there is a custom, or a standard of conduct, to the effect that no banking house is justified in trying directly to break in upon an established relationship between another banking house and what are regarded as its satisfied clients.

After the Guaranty Company had gone out of the investment banking business, however, Stanley told Gossler in the summer of 1935 that he and others of J. P. Morgan & Co. planned to go back into the investment banking business. Gossler told his associates at Columbia that if that happened, he would probably want this new organization to take the leadership in a refunding operation then contemplated for Dayton. The refunding operation in question had been first undertaken with other investment bankers but had been postponed in April because of the impossibility of getting a satisfactory commitment from the bankers prior to the date for publishing the notice calling the outstanding bonds for redemption. Negotiations with these bankers were thereafter continued during the summer with the idea of getting out the issue in the fall. Meanwhile these bankers were informed of Gossler's tentative decision, in which the other officers of Columbia and Dayton concurred, and a few days after public announcement of the formation of Morgan Stanley, it was arranged that Morgan Stanley should manage the Dayton issue. This was a $20,000,000 issue of Dayton 3-1/2% bonds due 1960, offered to the public in October, 1935.

Columbia has continued since then to have Morgan Stanley lead its subsidiaries' bond issues, and its officers, according to their own testimony, have not thought seriously about employing any other underwriter for that purpose.

Since the present relationship of Morgan Stanley with Dayton and Columbia grew out of the Dayton bond issue of 1935, it is pertinent to examine the circumstances that might have led to Columbia's selection of Morgan Stanley as leading underwriter at that time. Counsel for the Public Utilities Division maintain that the selection was made because of existing affiliations, while Dayton and Morgan Stanley contend that it was because of the confidence the Columbia officers placed in Stanley personally and in others who went into the new organization with him, and because Columbia wanted the services of a strong firm with adequate capital. There is no real inconsistency in these two contentions, and each of the reasons given undoubtedly played its part.

It was on September 10, 1935, that Gossler, in behalf of Columbia, went to Stanley and arranged for Morgan Stanley to manage the underwriting syndicate for the proposed issue. On that date Stanley was still a partner of J. P. Morgan & Co., for though the formation of Morgan Stanley had been announced, the corporation had not yet been organized for business. On that date seven of the eight directors of the United board were: Harold Stanley, George Whitney and Edward Hopkinson, Jr., all partners of J. P. Morgan & Co.; their fellow organizers of United, Landon K. Thorne and Alfred L. Loomis; George Howard, who was chosen by both groups to be president of United; and F. L. Carlisle, chairman of Niagara Hudson (a subsidiary of United) and of Consolidated Gas Company of New York (in which United held a substantial interest and which has since changed its name to Consolidated Edison Company of New York). That had also been the situation, a few months earlier, Stanley had informed Gossler that he and others of J. P. Morgan & Co. were probably going back into the underwriting business in the fall.

On the other hand it is urged by respondents that such matters had nothing to do with the selection of Morgan Stanley as leading underwriter for the Dayton bond issue of 1935. Three days after that selection had been made, Stanley's resignation from the firm of J. P. Morgan & Co. took effect, and a few days

later he resigned as a director of United. He had had a close personal and business relationship of long standing with Grossler long before he became a partner of J. P. Morgan & Co., as Gossler had been a friend and former employee of Stanley's father. In 1922, when Columbia's predecessor company terminated its banking relations with A. B. Leach & Co., Stanley was president of Guaranty Company and an officer of Guaranty Trust Company, and it was testified that it was largely for that reason that Gossler established banking relations with Guaranty for the Columbia system. Stanley personally worked on Columbia financing for some years before going over to J. P. Morgan & Co. He was on Columbia's board of directors and executive committee from 1922 until February, 1935, and was held in high esteem by the management. Edward Reynolds, then executive vice president and now president of Columbia, had worked under him at the Guaranty Company years before.

Accepting the argument that all these and other similar considerations were influential in the original selection of Morgan Stanley, the conclusion is nevertheless inescapable that J. P. Morgan & Co. in September, 1935, had such an influential position in the management of United that Morgan Stanley was placed in a preferred position with respect to its selection as leading underwriter for the Dayton bond issue of 1935, and we so find.

We also find that Morgan Stanley was in a preferred position with respect to its selection and its conduct of negotiations as leading underwriter for bond issues in the amounts of $35,000,000 and $10,000,000, in 1936 and 1937, of Cincinnati Gas & Electric Company, another Columbia subsidiary. In 1936, Dayton sold preferred stock with W. E. Hutton & Co. as leading underwriter. The record shows, however, that Columbia officers spoke to Morgan Stanley representatives about this proposed issue beforehand, while the issue was still under consideration and plans were being made to use W. E. Hutton & Co. Morgan Stanley, in keeping with its general practice of not participating in equity security underwritings, agreed that it would not be interested in the preferred stock issue. In March 1937, Dayton placed $1,500,000 bonds privately. Apparently this small private placement, however, was not effected until the matter had been talked over with Morgan Stanley representatives. Our finding with respect to Morgan Stanley's preferred or inside position is based not only upon the continuous banking relationship then existing between Columbia and Morgan Stanley, but also on the fact that at the time of the underwriters' selection in those issues, four of the five directors on the United board were George Whitney, Landon K. Thorne and George Howard, whose connections have already been described; and Thomas H. Stacy, an interim director elected to make up a quorum, and who had previously been employed by Howard and was serving as United's bookkeeper.

It remains to be seen what the position of Morgan Stanley was in November, 1939, when it was selected as the leading underwriter for the Dayton bond issue of 1940.

The question whether, with respect to the Dayton bond issue of 1940, the relation between Dayton and Morgan Stanley was such that there was liable to have been an absence of arm's-length bargaining between them within the meaning of paragraph (a) (3) of the Rule.

There can be no question but that Morgan Stanley had a preferential position over other underwriting houses when the time came for Columbia to

select a leading underwriter for the Dayton bond issue of 1940. For one thing, it was in a preferred position because of its historical relationship to United and the Columbia system. For another, it was in a preferred position in the sense that continuous investment banking relations still existed between it and the Columbia system and the Columbia officers gave no serious thought to seeking other investment bankers.

Aside from the historical and continuing banker relations, we find other evidence of a special relationship existing between Columbia and Morgan Stanley at the time the latter was selected to lead Dayton's bond issue of 1940. On March 28, 1938, the day of the United States Supreme Court decision in *Electric Bond & Share Co. vs. SEC* upholding the constitutionality of the registration provisions of the Holding Company Act, United registered as a holding company under the Act and Whitney and Thorne resigned from the United board.

Elimination of banker influence over holding company and utility managements is a duty given us by Congress. Section 17 (c) of the Act provided the initial step in that direction by prohibiting registered holding companies and their subsidiaries from having officers or directors with banking connections except where the Commission decided that there would be no adverse effect upon the public interest or the interest of investors or consumers. Apparently in view of this provision, George Whitney resigned from the United board of directors. In our opinion, however, that resignation did not sever the special relationship that existed between the Morgan interests and United.

This problem of banker domination or special influence is not new nor is it limited to the utility field. It has been demonstrated in similar instances that the mere fact that a banker cannot sit on the board of directors of a client company does not necessarily change the banker's influential position with respect to his client. For instance, Section 10 of the Clayton Anti-Trust Act provides, in effect, that if a banker sits on the board of directors of a common carrier company, his firm may not underwrite the securities of that company in amounts of more than $50,000 in any one year, except after competitive bidding. 19/ The reports of the Senate Committee investigating railroads, holding companies and affiliated companies show that absence of official board representatives because of this Clayton Act provision did not prevent investment bankers from continuing to dominate the financial policies of railroad systems. 20/

18/ 303 US 419 (1938).

19/ 38 Stat. 734 (1914), 15 US CA Sec. 20 (1934).

20/ Thus, Kuhn, Loeb & Co., investment bankers, were able to dominate the financial policies of the Missouri Pacific Railway Co. system, despite of the absence of official representatives on the Missouri Pacific board. In the words of the Senate Committee:

> "Despite the acknowledged prohibition of Section 10 of the Clayton Act. . . Kuhn Loeb contrived to put, if not 'representatives', at least friends and informants on the Missouri Pacific board."

(Continued)

On the board of United at the time of the present underwriting transaction there were five directors: George Howard, president of United practically since its inception; F. L. Carlisle and Roy K. Ferguson, chairman and president, respectively, of the St. Regis Paper Company and affiliated interests, which control 7.9% of United's voting securities, the largest block held by any unified group; John J. Burns, a former general counsel of this Commission, presently engaged in the general practice of the law and retained as counsel for United; and Edward H. Luckett, who had come to United recommended by an attorney whose firm acted as counsel for Niagara Hudson. The original election of Howard, Carlisle and Ferguson had been approved by partners of J. P. Morgan & Co., and both Howard and Carlisle had done business with the Morgan-Drexel firms for years. Howard's relationship to the Morgan interests appears to have been intimate. Originally placed on the United board as president by the Morgan and Thorne-Loomis groups, the record shows his reliance on George Whitney, leading representative of J. P. Morgan & Co. on the United board. Despite Whitney's resignation from the board of United, Howard's behavior toward Whitney in regard to United matters, as we shall hereinafter relate, has been that of a man who feels that he owes Whitney courteous fealty.

Carlisle came in contact with J. P. Morgan & Co. 21/ when that firm, representing United's large interest in Mohawk Hudson securities, participated with Carlisle, the Schoellkopfs and others in organizing Niagara Hudson Power Corporation, a subsidiary of United. Niagara Hudson was the result of a consolidation between several upstate New York utilities, among which were Mohawk Hudson and Northeastern Power Corporation. Carlisle had for some years been president of Northeastern, and represented it in conferences with the Morgans and others in formulating the plan of consolidation. He was made chairman of the board of Niagara Hudson at its inception and has held that position ever

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Revealing letters were uncovered by the Senate Committee evidencing the allegiance of directors of the Missouri Pacific to Kuhn Loeb. Thus, one director of Missouri Pacific, in writing to Mr. Cravath, attorney for both Kuhn Loeb and Missouri Pacific, said:

> "Dear Mr. Cravath: In the absence of Mr. Kahn (Kuhn Loeb partner), will you please use me in any way best for his interest in connection with the Missouri Pacific situation. I should like to keep in touch with you and Mr. Hanaver (Kuhn Loeb partner) in carrying out any detailed plans he has in mind insofar as my services can be of any help."

Another letter to Mr. Cravath from this director, in connection with the selection of a president of Missouri Pacific, read:

> "I am extremely anxious to be sure we do the very best we know how in our selection. I am thoroughly conscious of the fact that it was through Mr. Kahn's courtesy that I am serving on the Missouri Pacific board, and my only interest naturally, therefore, is to so discharge my obligation there as to be a credit to him."

Report of Senate Committee on Interstate Commerce, pursuant to Senate Resolution 71 (74th Congress), 76th Cong., 3d Sess., Report No. 25, Part 7, pp. 6-7 (1940).

21/ It appears that Carlisle was first consulted by J. P. Morgan & Co. in connection with its contemplated purchase of Mohawk Hudson securities and the proposed formation of United.

since. In 1930 he was first elected to the United board of directors along with the other titular heads of companies in which United was substantially interested. At about the same time he and George Whitney were elected to the board of trustees of Consolidated Gas Company of New York (now Consolidated Edison Company of New York), and in 1932 Carlisle was made its chairman. J. P. Morgan & Co., and later Morgan Stanley, have been the almost invariable leaders in both Niagara Hudson and Consolidated Edison debt financings.

The record indicates that both Howard and Carlisle have frequently relied on George Whitney, a leading partner of J. P. Morgan & Co., and formerly the principal representative of J. P. Morgan & Co. on the United board. Although Whitney resigned from the board of United on March 28, 1938, the following facts cause us to believe that only the outward appearance of a changed relationship between J. P. Morgan & Co. and United had thus been effected.

For about six months after the resignations of Whitney and Thorne, reports which were ordinarily sent only to directors of United continued to be sent to them. George Howard testified that this was done by mistake and that when he found out about it he stopped it.

Yet the influence of George Whitney did not cease thereafter. In August, 1938, United received a letter from William O. Douglas, then Chairman of this Commission, relating to compliance by United and its subsidiaries with Sections 11 (b) (1) and 11 (b) (2) of the Holding Company Act. Thereafter a reply to that letter was composed by the board of directors of United in which there was outlined a future program for United. After that reply had been prepared Howard showed it to Thorne and also went to Whitney and submitted it to him for advice and suggestions. This took place around November, 1938. A program for meeting the integration provisions of the Act was, of course, of great importance to United and its subsidiaries. Of what importance it might have been to J. P. Morgan & Co., at that time a commercial bank, is not clear. Yet Whitney who had left the United board some eight months before was consulted by the president of United prior to forwarding an integration program to the Commission. If, as this incident might indicate, Whitney's advice continued to be regarded as influential, it would appear that members of the United board were not yet free from the influence of J. P. Morgan & Co.

In August, 1938, United effected a so-called quasi-reorganization which involved the write-down of the carrying value of United's investments by some $400,000,000. Howard went to Whitney prior to putting the program into effect and talked over this situation. It was testified that since the result of the write-down was to stop the payment by United of dividends on its preferred stock for which J. P. Morgan & Co. were paying agents, Howard went and explained this to Whitney "only because I knew many inquiries would come to his firm about the paying of those dividends and I wished him to understand it." Embarkation upon this quasi-reorganization, like the integration program, was a momentous step by United. It is noteworthy that once again Whitney, no longer formally associated with United, was sought out before the step was taken by United. It is at best doubtful whether J. P. Morgan & Co.'s interest in the quasi-reorganization as paying agent required consultation with George Whitney, a member of the firm, before United finally decided to effect this

financial program. We think the incident is one more indication that J. P. Morgan & Co., through George Whitney, continued to wield influence in the determination of United's significant affairs.

The sequel to United's quasi-reorganization also involved George Whitney. Due to the quasi-reorganization, a deficit in United's consolidated earned surplus account resulted and dividends could not be paid. Consequently, cash accumulations, which could not be paid out in dividends, increased to about $8,000,000. United had on file with this Commission in the early part of 1939 an application under Rule U-9C-4 for permission to engage in a program of investing this cash in non-utility securities. 22/ Howard's testimony shows that he consulted Whitney about this program too. His explanation was that opposition to this projected program had arisen in Philadelphia and he believed that Whitney might suggest how the opposition might be eliminated.

The continued existence of a special relationship between Morgan Stanley and United and its subsidiaries is made clear by a review of the bond and debenture financings by companies in the United group. It is a matter of record that Morgan Stanley is not favorably disposed toward underwriting equity securities. Since Morgan Stanley's underwriting business rests nearly entirely upon debt securities, we have attempted to analyze such security issues by the United group companies. The record in this proceeding covers the debt financings of subsidiaries in the Columbia Gas & Electric, Niagara Hudson, Public Service of New Jersey, and United Gas Improvement systems, all of which are subsidiaries of United. 23/ In addition, the record covers debt financings by companies in the Consolidated Edison Company of New York system. 24/ We have

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22/ *In the Matter of The United Corporation*, 4 S.E.C. 663 (1939).

23/ Public Service of New Jersey is a statutory subsidiary of United since United owns 13.9% of the voting securities of Public Service, and UGI, a subsidiary of United, owns 28.5% of the voting securities of Public Service. Public Service, however, has filed an application pursuant to Section 2 (a) (8) (A) to be declared not to be a subsidiary of United or UGI. This application is still pending.

24/ Consolidated Edison Company of New York has been considered exempt from the provisions of the Act since it is organized and conducts all of its business in a single state within the meaning of Section 3 (a) (2) of the Act. Consolidated Edison has continued to file an annual report pursuant to Rule U-3A-2, thereby entitling it to the exemption in the absence of adverse Commission action.

Although Consolidated Edison is not a statutory subsidiary of United its chairman and leading figure, F. L. Carlisle, is a director of the United Corporation and also chairman of Niagara Hudson, a subsidiary of United. George Whitney, a partner of J. P. Morgan & Co., is also a director of Consolidated Edison. Moreover, United has a substantial stock interest in Consolidated Edison Company of New York.

also included the debt financing record of companies in the Commonwealth and Southern Corporation system. 25/

The record shows that from September 1935, the date of the formation of Morgan Stanley, to February 1940, the close of the hearings in this proceeding, Morgan Stanley has been the leading underwriter 26/ in every public financing of bonds or debentures by these United companies except in three instances. The three exceptions involved the issuance of securities by Connecticut Light & Power Company and were underwritten in each instance by Putnam & Co. and Scranton & Co., underwriters located in Connecticut. These three exceptions are probably attributable to the strong policy of promoting local control expressed in the Connecticut statute which provides that no foreign holding

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25/ Commonwealth and Southern is a statutory affiliate of United, The United Corporation owning slightly more than 5% of the outstanding common stock of the Commonwealth and Southern Corporation. While the record herein shows the security issues of Commonwealth and Southern Corporation and its subsidiaries underwritten by Morgan Stanley, the total long-term debt financings (including private placements of the Commonwealth and Southern system) during the period were not put in evidence. We have taken notice of these financings for the purpose of determining the underwriting leadership of public offerings and the number and amounts of private placements in the Commonwealth and Southern system during this period.

All these financings were announced in newspapers and financial and statistical services as they occurred and are, we believe, facts of general knowledge of which we may take judicial notice. *Chicago & N.W. Ry.* v. *Railroad Commission*, 156 Wis. 47, 145 N.W. 216 (1914); *cf. Werk* v. *Parker*, 249 U.S. 130, 131-132 (1938); *Kennedy* v. *General Motors Corporation*, 99 F (2d) 627, 629 (CCA 6th, 1938); *United States* v. *Best & Co.*, 86 F. (2d) 23 (CCPA 1936). These financings were, moreover, reported to us as required by the Act and a number of them were the subject of our findings and opinions. To ignore them would not only be self-stultifying but would be closing our eyes to the very type of knowledge which we are supposed to acquire and bring to bear upon our exercise of administrative functions under the Act. See *infra*, footnote 26a. We have referred to the reports in our files in regard to these transactions "as a means of verifying facts of which the Commission, like a court, takes judicial notice." See *United States* v. *Abiline etc., Railroad Co.*, 265 U.S. 274, 287 (1924).

However, inasmuch as the attention of respondents was not at the hearing directed to the possibility that we might take notice of these facts, and no opportunity was afforded them to present evidence in rebuttal we will, if respondents desire to challenge the accuracy, materiality, or relevancy of these facts, upon application of respondents made within 10 days from the date of our findings and opinion herein cause the record to be reopened for the purpose, of putting such facts directly in evidence and of permitting respondents to offer rebuttal evidence. *Cf. Morgan* v. *United States*, 304 U.S. 1, 18-19 (1937). If no such application is made by respondents we shall assume they make no objection.

26/ Morgan Stanley has shared the managership of Commonwealth & Southern security issues with Bonbright & Company, Inc.

company shall control or interfere with the operations of Connecticut gas and electric companies, like Connecticut Light & Power Company. 27/ In view of this statutory provision, it is not hard to understand why Morgan Stanley, through United influence, did not head Connecticut financings.

The significant uniformity of underwriting by Morgan Stanley of the above mentioned United companies is, of course, true only of publicly offered debt security issues. In the past several years, there have been several long-term private financings by these companies. Careful analysis of these private placements reveals that nearly all of them have been for relatively small amounts, only five of them exceeding $10,000,000 in amount. Of these, the only very large private placement took place in the fall of 1939 when the outbreak of the European war made the public markets unstable and public offerings were risky. It is also noteworthy that one of these substantial private placements was made by Connecticut Light & Power Co. We have already considered the special local statutory considerations which govern the operations of Connecticut utilities. Finally, it appears that two other substantial private placements were made by subsidiaries of Consolidated Edison Company of New York, which is not a statutory subsidiary of United. We believe that the private placements listed in this record are not inconsistent with the existence of a relationship between Morgan Stanley and subsidiary companies in the United group such as is embraced by our Rule. This special relationship might well exist without resulting in exclusive participation by Morgan Stanley in all United system financings.

In conclusion, it should be noted that Morgan Stanley has not headed the financing of any public utility company, as defined in the Act, except subsidiaries of United and companies in the Consolidated Edison and Commonwealth and Southern systems. Confinement of Morgan Stanley's underwriting leadership of utility securities to companies in the orbit of United is particularly interesting in view of repeated testimony by respondents in this record that

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27/ Chapter 196, Section 1414c of the General Statutes of the State of Connecticut provides:

"(a) The general purposes of this section are to assure to the state of Connecticut its full power to regulate its public service corporations, to increase the powers of the public utilities commission and to promote local control of the public service corporations of this state, and it shall be so construed as to effectuate these purposes."

* * * * *

"(f) No gas, electric or water company, or holding company, or any official, board or commission purporting to act under any governmental authority other than that of this state or its divisions, municipal corporations or courts, shall interfere with or attempt to interfere with or exercise authority or control over any gas, electric or water company incorporated by this state and engaged in the business of supplying service within this state, or with or over any holding company incorporated by this state and doing the principal part of its business within this state, without having first obtained the approval of the Commission, except as the United States may properly regulate actual transactions in interstate commerce. Any action contrary to the provisions of this sub-section shall be voidable on order of the commission."

Morgan Stanley was successful in obtaining United system financings only because it was a strong firm with adequate capital and furnished satisfactory services.

There are, of course, powerful economic incentives for investment bankers to strengthen their influence over the management and policies of holding companies and their subsidiaries. Not only does such influence assure the banker of the profits from underwriting, but there are additional emoluments which come from the ability to select custodians, depositaries, transfer agencies and coupon and dividend paying agencies. This is a type of financial patronage which customarily goes to the banker who is able to exert influence over the financial policies of a utility system. In connection with the present proceeding, it is noteworthy that J. P. Morgan & Co. has always been the transfer and dividend paying agent for the United Corporation. From its very inception, United Corporation has maintained a substantial deposit account with J. P. Morgan & Co. From 1934 Columbia Gas & Electric Corporation has maintained a sizeable deposit account with J. P. Morgan & Co. And J. P. Morgan & Co. has always been custodian for securities owned by United. J. P. Morgan & Co. has also been the coupon paying agent for bond issues of numerous companies in the United group.

This brings us down to the Dayton bond issue of 1940 which occasioned the Commission's order to show cause pursuant to Rule U-12F-2. This involved the issue and sale by Dayton of $25,000,000 principal amount of First Mortgage Bonds, 3% Series Due 1970, to underwriters for resale to the public. The bonds were sold to a group of 38 underwriters, headed by Morgan Stanley, at a price of 102-1/4. They were offered to the public at a price of 104, resulting in a spread of 1-3/4 points, or underwriting discounts or commissions totaling $437,500. Of the spread of 1-3/4 points, Morgan Stanley was to receive one-fourth of a point for services as syndicate manager; underwriters, including Morgan Stanley, were to receive seven-eighths of a point for wholesale sales; and five-eighths of a point was to be received for retail distribution. The total fees to be received by Morgan Stanley, upon successful placement, aggregated $100,562.50.

It was estimated that, subject to certain qualifications, the refunding portion of the proposed financing would effect an annual saving to Dayton of approximately $48,000 28/ (after allowing for federal income taxes). Dayton also benefited from the extension of the maturity date of $19,015,000 of its previously outstanding debt from 1960 to 1970.

Some of the circumstances surrounding this security issue have caused us concern. The amount of new money involved was about $5,700,000. It appears from the record that when Morgan Stanley was first approached in regard to the instant financing, the Columbia officials had in mind a security issue of either stocks or bonds to raise only this new money. Morgan

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28/ The annual savings of $48,000 do not take into account the duplicate interest of approximately $55,460.40 which the company was required to pay for the period between the issue of the new bonds and the call date of the presently outstanding bonds.

Stanley advised that bond financing for the new money was sound. And Morgan Stanley on this occasion also suggested refunding outstanding Dayton bonds in the same financing with the new money issue. R. H. Delafield, financial Vice-President of Columbia, testified that Columbia officials had previously made many studies in regard to refunding the $19,015,000 outstanding Dayton bonds.

Dayton, of course, got cheap money which cost it only 2.91% per annum. But in order to obtain this cheap money it had to pay substantial call premiums of $855,675, and expenses of about $125,000. The maturity date of the refunded debt was extended 10 years. Yet the refunded debt was not to mature until 1960, scarcely a pressing obligation requiring refunding. Dayton's annual saving of $48,000 over the life of the refunded bonds, approximately $1,000,000, is to be compared with the Morgan Stanley commission of $100,562.50 and the $336,937.50 which other underwriters and dealers obtained from the financing. Dayton's savings should also be considered in the light of the cost of the refunding to investors in these Dayton bonds. Investor good will, often deemed an attribute of the public offering method as distinguished from private placements, is scarcely likely to be encouraged by frequent refundings accompanied by small savings to the issuer.

Although these facts have caused us concern, we recognize that the price of 104 to the public and 102-1/4 to the company were not discernibly out of line with the prevailing market, and the spread of 1-3/4 for the underwriters was among the lowest of those taken on comparable public utility issues during the last five years. Of course most of these negotiations took place while the hearings in this proceeding were being conducted, and that circumstance must have affected the outcome.

Application of the Rule to the Facts

Before we proceed to apply the Rule to the facts that we have found, a preliminary question is raised as to the kind of relationship which falls within the meaning of the Rule. The kind of relationship between underwriter and issuer embraced by subparagraph (a) (3) of the Rule is obviously something less than a relationship predicated upon control or domination, and something that may be different from interlocking directors or officers, or prescribed amounts of stock ownership. The Rule, in subparagraphs (a) (1) and (a) (2), encompasses the relationships of associate and affiliate, including that of subsidiary as well. These relationships are expressly defined in the Act. A parent-subsidiary relationship arises when one company owns, controls, or holds with power to vote 10 per cent or more of the outstanding voting securities of another. And the same relationship may arise out of certain controlling influences which a person exercises over a utility or holding company. An associate company means any company in the same holding company system. An affiliate relationship includes, among others, the situation where a person holds 5 per cent or more of the outstanding voting securities of a company or where there are certain interlocking directorates or officerships. These are relationships which clearly fall under subparagraphs (a) (1) and (a) (2) of the Rule.

Subparagraph (a) (3) must necessarily have a different meaning or its provisions would be mere surplusage. Turning our attention to Section 2 (a) (11) (D) of the Act, we find that the definition of affiliate therein

contained is substantially the same as the provisions of subparagraph (a) (3) of the Rule. Section 2 (a) (11) (D) provides that "affiliate" of a specified company means:

> "* * * any person or class of persons that the Commission determines, after appropriate notice and opportunity for hearing, to stand in such relation to such specified company that there is liable to be such an absence of arm's-length bargaining in transactions between them as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon affiliates of a company."

In the words of the Senate Committee on Interstate Commerce and the House Committee on Interstate and Foreign Commerce that reported out the bills which finally became the Holding Company Act, this provision was meant to be "flexible." 29/ Its broad language, as well as its position in the statute after the more precise definitions concerning stock ownership and interlocking officer and director affiliates, indicate that Congress intended that this Commission be given flexible standards to deal with the more subtle relationships which are liable to result in an absence of arm's-length bargaining. Obviously the types of intangible interrelationships are so varied that the Act had to be broadly phrased to meet the problem. Our Rule, no less than the provisions of Section 2 (a) (11) (D), embraces relationships which are dependent upon something less than control or controlling influence, and something that may be different from interlocking directors or officers, or prescribed amounts of stock ownership. And both Section 2 (a) (11) (D) and the Rule, in our opinion, were meant to cover relationships which span corporations and individuals linked together by financial and other connections. Bearing this in mind, we proceed to apply the Rule to the facts that we have found.

We have carefully reviewed the genesis, historical development and continued existence of relations between Morgan Stanley and J. P. Morgan & Co. and United, its subsidiary, Columbia, and its subsidiary, Dayton. The record facts show not the casual affinity borne of mutually satisfactory financial relations, but ties and connections that, though less than control, are nevertheless sufficient to establish a relationship between Morgan Stanley and Dayton, at the time of the Dayton financing, such as is embraced by the Rule. Our conclusion is reached despite the elimination, upon the Supreme Court's Electric Bond & Share Company decision, of some of the more superficial indicia of Morgan influence in the financial affairs of the United system. In our opinion, the record contains facts that show more than a relationship based upon "emotional and physchological affiliation." In making an ultimate finding of fact under the Rule, we are fully cognizant that the maze of interconnections, which constitute the relationship here in issue, are, by their very nature, usually not susceptible of proof by way of explicit memoranda, letters and conversations in which the parties in *haec verba* set forth or

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29/ Senate Committee Report on S. 2796, Report No. 621, May 13, 1935, p. 23; House Committee Report on S. 2796, Report No. 1318, June 24, 1935, pp. 9-10.

explicitly admit such a relationship. 30/ Such finding must therefore rest upon reasonable inferences and conclusions drawn from the basic facts. 31/

30/ We do not overlook the testimony of witnesses for respondents to the effect that no fact or circumstance had come to their attention which indicated to them that there was liable to be or to have been an absence of arm's-length bargaining in transactions (including the Dayton bond issue of 1940) between Morgan Stanley and Dayton or Columbia. This, in substance, expressed the opinions and conclusions of the witnesses as to the ultimate fact at issue, and as such would not be admissible in a court of law. *Robbins* v. *Atkins*, 46 N.E. 425 (Mass. 1897); *People* v. *Bidleman*, 38 Pac. 502, 503 (Cal. 1894); *Lehman* v. *Lindenmeyer*, 109 Pac. 956, 958 (Colo. 1910); *Kerr* v. *Lunsford*, 8 S.E. 493, 498 (W. Va. 1888); *People* v. *Burrows*, 150 Pac. 382, 384 (Cal. 1915); *Pennsylvania RR Co.* v. *Chamberlain*, 288 U.S. 333, 340 (1932); *cf. Moore on Facts*, Vol. 11, p. 1247. Although rules of evidence are properly applied less strictly in administrative proceedings, we think such testimony is entitled to little or no weight in the face of the mass of concrete facts which lead to the opposite conclusion. *Boggs & Buhl, Inc.* v. *Commissioner of Internal Revenue*, 34 F. (2d) 859 (C.C.A. 3d, 1939).

31/ It has often been noted that Congress contemplated that an administrative agency such as this Commission, because of its special knowledge and experience in a particular field, was to be peculiarly able to weigh evidence, on matters within that field, and to draw reasonable inferences therefrom. In *American Sumatra Tobacco Corporation* v. *Securities and Exchange Commission*, 110 F. (2d) 117, 120 (App. D.C. 1940), Groner, C. J., speaking for the Court, said:

> "Congress unquestionably intended that the Commission should bring to bear upon the decision of this and like questions, what has been called, in cases within the jurisdiction of the Interstate Commerce Commission, the knowledge and experience of experts."

In *Securities and Exchange Commission* v. *Associated Gas and Electric Company*, 99 F. (2d) 795, 798 (C.C.A. 2d, 1938), the Court of Appeals for the Second Circuit said with respect to this Commission's administration of the Public Utility Holding Company Act:

> "One of the principal reasons for the creation of such a bureau is to secure the benefit of special knowledge acquired through continuous operations in a difficult and complicated field."

See also Stephens, (now Mr. Justice Stephens of the Court of Appeals for the District of Columbia) "Administrative Tribunals and the Rules of Evidence." (1933) 93-94:

> "It is the view of both courts and commissioners that the latter are experts who may on that account be trusted to seek facts for the foundation of their orders without the aid of the rules which courts have believed necessary to assure an honest, accurate and unprejudiced assembling of information for juries, indeed, for judges. Commissioners or examiners can weigh the evidence, whatever its nature and however informally presented, better than the courts. Their expertness enables them to know the worth of hearsay, the probable authenticity of unidentified signatures, the comparative value of evidence taken in other causes, without being confused or misled by or obliged to sift out the collateral issues involved; to understand how far to

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The Rule is applicable if the underwriter stands in such relation to the issuer that there is liable to be or to have been an absence of arm's-length bargaining with respect to the underwriting transaction between them. It was practically a foregone conclusion that Dayton would go to Morgan Stanley for financial advice. Under these circumstances, free and independent competition plays no part in the selection of the underwriter, and it is reasonably probable 32/ that in arriving at the terms and conditions of the transactions

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31 cont'd/ give credence to matters not within a witness' knowledge; to judge of the correctness of secondary evidence as to the contents of books; to know whether or not to consider testimony not shown to be connected with the case; to judge the value of letters and telegrams and copies of contracts; to sense the accuracy of commercial ratings, newspaper clippings; to know the worth of common knowledge; *to know to what extent proof of commission of one act is proof of the commission of a similar one;* to take evidence for what it is worth without discrimination at the outset as to competency; and to act dependably and fairly upon their own information undisclosed to parties or to reviewing courts -- all better than judges and juries." (Emphasis added.)

32/ The meaning of the word "liable," as used in Section 2 (a) (11) (D) and the Rule, has occasioned some discussion. Considered without reference to context, the word "liable" has more than one meaning. If followed by a noun, it may mean "subject to" or "exposed to." The word is sometimes colloquially used without reference to degress of possibility or probability, but lexicographers indicate that the term connotes exposure to a contingency which is likely to arise. *Black's Law Dictionary* defines the word as: "exposed or subject to a given contingency, risk or casualty which is more or less probable." *Webster's New International Dictionary* defines the word as: "exposed to a certain contingency or casualty more or less probable." The definitions in *Fowler's Modern English Usage* emphasize the close relationship between the words "liable" and "apt" when followed by a verb. So also do the *Century Dictionary* which defines "liable" as "having an aptitude or tendency," and gives the synonyms "apt" and "likely," and *Funk and Wagnalls*, wherein the word is defined as "having a tendency, inclination or likelihood, likely (with unfavorable sense)." The *Oxford Universal English Dictionary* defines the word generally as: "subject to the operation of or likely to undergo; subject to the possibility of doing or undoing something undesirable."

The judicial interpretations of the word "liable" seem to define it as requiring more than "a possibility of" and generally end up with a test of "probability." Thus, in *Hallum* v. *Village of Omro*, 122 Wis. 337, 344, 99 N.W. 1051, 1054 (1904), the court said:

> "An examination of the cases cited will show that 'probable', 'likely' and 'liable' have been treated as synonymous, each dealing with reasonable probability, not with possibility, and that way may probably or or is likely or liable to be the future result of a personal injury is competent evidence to prove what is reasonably certain in the matter. That is according to lexical authority as to the meaning of the words."

In *Adams* v. *Moberly Light & Power Co.*, 237 S.W. 162, 165 (1922), is discussing objections to an instruction to a jury, the court said:

> "The objection of defendants is directed to the use of the word 'liable.' In the use of the word in the instruction we do not understand that the court intended the jury to understand, nor that it did

(continued)

arm's-length bargaining will be absent or materially restricted. When there is a continuing financial relationship which has come about through banker participation and influence in utility holding company affairs, it is reasonably probable that arm's-length bargaining will not prevail in dealings between the issuer and banker. In such cases, the issuer lacks the protection of competitive conditions, and there is liable to be an absence of arm's-length bargaining. At no time since 1935 has any attempt been made by Columbia subsidiaries to secure financing on a more favorable basis from investment bankers other than Morgan Stanley. 33/ It is this type of situation, among others, which we believe Congress intended to eliminate when it passed the Act. Among the evils enumerated by Congress in Sections 1 (b) (2) and (5) of the Act were those resulting "from an absence of arm's-length bargaining or from restraint of free and independent competition" and from "lack of economies in the raising of capital." We are directed by Section 1 (c) of the Act to interpret all of the provisions of the Act to meet the problems and eliminate the evils thus enumerated. One of the manifestations of these abuses was the monopoly exercised by investment bankers over financings of holding companies and their subsidiaries. That, in substance, is a situation which has been shown to exist between Morgan Stanley and Dayton by the facts in the record of the present proceeding.

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32 cont'd/ understand, that 'liable' meant the bare possibility of the wire breaking, but that the word was used in its common and ordinary signification, as understood by people in general. In *Roy* v. *Kansas City*, 224 S.W. loc. cit. 140, this court held:

> "'It is insisted that the word "liable" means "within the range of possibility," and that by reason of the use of such a word the instruction told the jury that the city was required to guard against all possible contingencies, and that it made the city practically an insurer of all persons using the viaduct. We think there is nothing in this contention.' . . .
>
> "In the general acceptation of the term 'liable' it is used as synonymous with the word 'likely'".

See also *Williams* v. *Southern Ry. Co.*, 119 N.C. 746, 749, 26 S.E. 32 (1896). *Cf. Pennsylvania Railroad Company* v. *Interstate Commerce Commission*, 66 F. (2d) 37, 38-39 (C.C.A. 3d, 1933), *affirmed*, 291 U.S. 651 (1934).

It appears that the word "liable" has a meaning ranging from "a mere possibility of" to various degrees of probability. It does not connote "certainty" or "actuality." This is clearly indicated by an early draft of the Bill in which the pertinent language of Section 2 (a) (11) provided that an affiliate is any person who is found "to stand in such relation to the specified company that there *is* an absence of arm's-length bargaining, etc." The phrase *"liable to be"* was added in the final conference committee amendments and emphasizes the Congressional intention that the standard does not require an actuality. Adopting a middle ground, we believe that Congress intended to provide for regulation of transactions in which absence of arm's-length bargaining is "reasonably probable" and not but a "mere possibility."

33/ This has been true, of course, only of the types of securities handled by Morgan Stanley.

The result of such a relationship may be that the bankers' advice will be relied upon by the issuer as regards the time, kind and price of security financing. The dangers inherent in reliance upon advice by a related investment banker spring from conflicting interests which prevail in negotiations with the favored investment banker. The issuer is or should be chiefly interested in the lowest possible cost for his capital consistent with a sound capital structure. The investor is also interested in a sound capital structure but, contrary to the issuer's interest, he seeks the highest possible return from the money invested. The underwriter, however, is primarily interested in buying the securities at a sufficiently low price so that quick resale, consistent with the highest possible spread for himself, is possible. The underwriter's business, of course, is dependent upon underwriting profits; these profits can be made only if there are securities for him to underwrite. The investment banker may thus be impelled to encourage numerous security issues, particularly refundings, by utilities so that he can make underwriting profits. Multiple security issues, profitable to the favored investment banker, may be detrimental to both issuer and investor. Moreover, the predilection of Morgan Stanley and other investment banking houses for debt financing may, when coupled with their influence in the financial affairs of utilities, prove detrimental in the long run to the capital structures and operations of utility companies, and thus be deleterious to investors and consumers. 34/ Because of these conflicting interests, absence of arm's-length bargaining between Morgan Stanley and Dayton may adversely affect the public interest and the interest of investors and consumers. Moreover, the statutory findings in Sections 1 (b) (2) and 1 (b) (5) as well as the references to the "maintenance of competitive conditions" contained in sections 12 (d), 12 (f), 12 (g), 13 (c), 13 (e) and 13 (f) of the Act strongly emphasize the connection between relations apt to result in an absence of arm's-length bargaining and Congress' conception of the public interest. We find, therefore, that the special relationship between Morgan Stanley and Dayton was such that there was liable to have been such an absence of arm's-length bargaining in the Dayton bond financing of 1940, that it is both necessary and appropriate in the public interest and for the protection of investors and consumers that Morgan Stanley be subject to the obligations, duties and liabilities of an affiliate of Dayton for the purposes of Rule U-12F-2. 35/

Validity of the Rule

As we have already noted, both Morgan Stanley and Dayton 36/ challenge the validity of Rule U-12F-2, on the ground that it goes beyond the rule-making powers granted to us under the Act. The Rule was adopted by us --

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34/ See Appendix to our opinion *In the Matter of Engineers Public Service Company* (El Paso Electric Company), ______ SEC ______, Holding Company Act Release No. 2535, February 4, 1941.

35/ Our finding is made in the terms of Section 2 (a) (11) (D) of the Act for reasons explained at length in a subsequent part of this opinion. See *infra*.

36/ Dayton has joined Morgan Stanley in challenging the validity of the Rule. It is worthy of comment that, if the Rule is valid, Dayton will be entitled to retain approximately $100,000 otherwise payable to Morgan Stanley as fees and commissions in respect of the bond issue. Thus Dayton is taking a position which, if it is successful, will cost it $100,000.

"Acting pursuant to the Public Utility Holding Company Act of 1935, and particularly section 20 (a) thereof, and finding such action necessary and appropriate to carry out the provisions of sections 6 (b), 7 (d) (4), 10 (b) (2), 12 (d), 12 (f), 12 (g), 13 (e) and 13 (f) thereof. . ." 37/

For the sake of clarity we shall divide our discussion of the validity of the rule into three general divisions: one under Section 6 (b) another under Section 12 (f), and the third under Section 2 (a) (11) (D).

(1) Validity of the Rule under Section 6 (b)

The Dayton application in respect of the bond issue in question was filed pursuant to Section 6 (b) of the Act. The issue directly before us, therefore, is whether the Rule is valid under the terms of Sections 20 (a) and 6 (b) of the Act. Section 20 (a) confers upon this Commission a general rule making power to carry out the provisions of the Act. 38/ Section 6 (b) authorizes this Commission to qualify exemptions granted thereunder by imposing "such terms and conditions as it deems appropriate in the public interest or for the protection of investors or consumers." We have hereinbefore set forth our reasons for believing that the policy embodied in the Rule, which strikes at an absence of arm's-length bargaining in underwriting transactions, is appropriate in the public interest and for the protection of investors and consumers, 39/ and we think it is clearly appropriate "to carry out the provisions of" Section 6 (b).

As we have already noted, an all-pervading provision of the Act is the mandate of the Congress that we construe every provision in accordance with the declared statutory policy of eliminating the evils and meeting the problems enumerated in Section 1, among which are those that exist "when subsidiary public-utility companies are subjected to excessive charges for services . . .or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition", and where there is a "lack of economies in the raising of capital." 40/

37/ Holding Company Act Release No. 1380.

38/ Section 20 (a) provides: "The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate to carry out the provisions of this title. . ."

39/ See the section of this opinion entitled "Application of the Rule to the Facts."

40/ The suggestion has been made that the phrases quoted in the text from Section 1 (b) (2) do not have reference to the issue and sale of securities, which are partially dealt with in Section 1 (b) (1), and that the word "transactions" must refer to service contracts and the like since the emphasis therein is upon service, construction and management charges. Section 2 (a) (19) defines "service contract" as meaning "any contract, agreement, or understanding whereby a person undertakes to sell or furnish, for a charge, any managerial, *financial*, legal, engineering, purchasing, marketing, auditing, statistical, advertising, publicity, tax,

(Continued)

The transaction in question was the original issue and sale of bonds by Dayton to a syndicate headed by Morgan Stanley, for resale to the public. Involved in the transaction were (a) "charges for services" -- the underwriting fees and commissions; (b) questions, hereinbefore discussed, concerning "arm's-length bargaining" and "restraint of free and independent competition", and (c) "economies (or a lack thereof) in the raising of capital."

Not only did Congress advert to these problems in the statute, but it also provided for regulation of investment banker relations with utilities. 41/ That Congress had banker relationships in mind when it dealt with the evils arising from financial transactions is made clear by the legislative materials on which the Act was based. 42/ For example, the report of The National Power Policy Committee to the President stated:

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40 Cont'd/ research, *or any other service*, information, or data." (Emphasis supplied). The foregoing argument overlooks the fact that in the evidence before Congress in the enactment of the Holding Company Act, numerous instances were given where service contracts included exclusive underwriting privileges in favor of holding companies, service companies and banking houses controlling or controlled by system managements, and that not infrequently subsidiary companies were caused to issue securities for the chief purpose of furnishing underwriting fees and commissions for the beneficiaries of such contracts. See, for example, the Federal Trade Commission's report, *loc. cit. supra*, footnote 3; and see *infra*, footnote 43. The suggested interpretation also would have the effect of making meaningless the words "or enter into transactions" in Section 1 (b) (2), and would involve the assumption that Congress was less concerned with any absence of arm's-length bargaining and free and independent competition in security underwritings than in other types of transactions - an assumption that is clearly untenable.

41/ This is illustrated by section 5 (b) (2) (C), which requires that every registration statement shall contain, among other things:

> "(C) the terms and underwriting arrangements under which their securities, during not more than the five preceding years, have been offered to the public or otherwise disposed of and the relations of underwriters to, and their interest in, such companies."

Further evidence of Congress' concern about the relations between investment bankers and companies subject to the Act, is found in section 17 (c) of the Act, which makes it unlawful for registered holding companies or their subsidiaries to have as officers or directors anyone connected with commercial or investment banking firms, "except in such cases as rules and regulations prescribed by the Commission may permit as not adversely affecting the public interest or the interest of investors or consumers."

42/ "The meaning to be ascribed to an Act of Congress can only be derived from a considered weighing of every relevant aid to construction." See *United States* v. *Dickerson*, 310 U. S. 554, 562 (1940); *United States* v. *American Trucking Association*, 310 U. S. 534 (1940).

"The growth of the holding company system has frequently been dictated by bankers' schemes for security profits. . . Fundamentally, the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry." 43/

The Federal Trade Commission, in its summary report on "Utility Corporations," stated:

"Professional managements apparently often give greater attention to the counsel of bankers than to the interests of widely scattered security holders who are the equitable owners of the companies so managed. . . In the heydey of the holding company exploitation which was prior to the depression, investment bankers not only furnished financial aid when requested by holding companies but solicited it and came to depend upon holding companies for business." 44/

Representative Rayburn, one of the two principal sponsors of the Act, during the course of debate in regard to this legislation on the floor of the House on June 27, 1935, said:

". . . the banking houses control the holding companies which control the operating companies. One big banking house, through a company called 'United Corporation', has an arrangement by which 8 or 10 of these big holding companies are tied together, so that more than one-fourth of the electric-light companies in the entire United States are subject to that banking influence." 45/

The Rule seeks to operate in the public interest and for the protection of investors in respect of each of these matters, by attempting to discourage transactions between interrelated issuers and underwriters in the absence of competitive bidding. The method used by the Rule is to limit severely the compensation that may be received by the related underwriter

"unless there has been competitive bidding or such bidding was not practicable. Such a limitation, it was assumed, would destroy the incentives of such affiliates to play an important role in negotiating for and arranging the terms and conditions of the financing, thereby leaving that role to underwriters who would bargain at arm's-length with the issuer." 46/

The Rule may be inadequate as a matter of practical regulation to accomplish its objectives fully, for it does not in terms prohibit such transactions between related issuers and underwriters, but it is not invalid for

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43/ The report was attached to and submitted with the report on S. 2796 by the Senate Committee on Interstate Commerce, Sen. Rep. No. 621 (74th Cong. 1st Sess.).

44/ Report of Federal Trade Commission made pursuant to S. Res. 83 (70th Cong. 1st Sess.) Part 72A, pp. 75-76. Section 1 (b) of the Act refers to the facts disclosed in this report as a basis for the legislation.

45/ 79 Cong. Rec. 10318.

46/ Chairman Frank in *In the Matter of Consumers Power Company*, 6 S.E.C. 444, 456 (1939).

that reason. The Rule represents a logical step in regulation toward the end in view, and is not without a "rational basis". 47/ Thus, as long ago as 1914 Congress enacted Section 10 of the Clayton Act after the Pujo Committee had recommended that steps be taken "in the direction of releasing interstate railroad corporations from the control of . . . issuing houses". 48/ We adopted Rule U-12F-2 in recognition of the fact that the policy of Sections 1 (b) (2), 1 (b) (5) and 12 (f) of the Holding Company Act was similar to that of Section 10 of the Clayton Act, and that the procedure adopted by Congress for effectuating that policy in the case of railroads was equally adapted to its fulfillment in the case of gas and electric utilities and holding companies.

That being so, it remains for us to inquire whether it is improper to impose such a condition under Section 6 (b). At the outset it seems clear to us that, whatever the limitations may be on our power to impose conditions under Section 6 (b), we may impose such conditions as we find have "substantial warrant. . . in the applicable standards. . . of the Act . . .". 49/ We think that the "arm's-length" and "economies" objectives of Sections 1 (b) (2) and 1 (b) (5) are standards which must be applied in determining the terms and conditions upon which an issue of securities shall be exempted under Section 6 (b). Dayton and Morgan Stanley point out that the terms of section 7 (d) require us to scrutinize the reasonableness of the fees and compensations paid to underwriters in transactions subject to section 7, and from this they argue that no similar scrutiny can be given by us to a transaction exempted under Section 6 (b). 50/ That matter, it is argued, is "one of the very subject-matters from which the exemption purports to exempt." In our opinion, the argument is based on a misapprehension of the scope of Section 6 (b), for a proper understanding of which that section must be examined in relation to Sections 6 (a) and 7.

47/ Such is the test of validity applied by the Supreme Court in *United States v. Lowden et al.*, 308 U. S. 225 (1939). The power to impose terms and conditions under section 6 (b) is, in fact, very similar to that of section 20 (a) of the Interstate Commerce Act, pursuant to which the Interstate Commerce Commission has required competitive bidding for equipment trust issues.

48/ Pujo Committee Report on Concentration of Control of Money and Credit, H. Rep. 1593, 62d Cong. 3d. Sess. (1913) 150-151.

49/ See *United States v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 282 U. S. 311, 324 (1931).

50/ We have had occasion in numerous cases arising under section 6 (b) to impose terms and conditions regarding fees and other compensation to be paid in connection with the sale of the securities involved. E.g., *In the Matter of North American Edison Company*, 3 SEC 1065 (1938); *In the Matter of Connecticut Light & Power Company*, 5 SEC 706 (1939); *In the Matter of Indiana & Michigan Electric Company*, __ SEC __ (1940, Holding Company Act Release No. 2156; *In the Matter of The Commonwealth & Southern Corporation*, __ SEC __ (1941), Holding Company Act Release No. 2586.

Section 6 (a) makes it unlawful for any registered holding company or subsidiary thereof to issue or sell securities or to alter the rights pertaining to outstanding securities except "in accordance with a declaration effective under section 7 and with the order (of the Commission) under such section permitting such declaration to become effective . . ." Section 7 prescribes certain requirements as to the form and content of such declarations and the procedure leading to our orders either permitting or refusing to permit them to become effective; and, in addition, it lays down substantive standards governing our action in the matter. Thus, we must not permit a declaration to become effective unless the proposed security is of a certain type or for certain purposes permitted by subsection (c); and if the security passes those tests and it does not appear that applicable State laws would be infringed, we must permit the declaration to become effective unless we find that the security fails to meet any one or more of six tests laid down by subsection (d).

Section 6 (b) is designed to limit the scope of our scrutiny of security issues meeting certain specified conditions: it automatically exempts the issue and sale of certain securities from the prohibitions of section 6 (a), and establishes a means for us to exempt others therefrom where (among other things) their issue and sale have been expressly approved by a State commission of competent jurisdiction.

Before any action was taken by us, Dayton applied to the Ohio Public Utilities Commission and received, subject to certain conditions, the approval of that body for the issue and sale of the bonds in question. 51/ Thus, the questions before us on the Dayton issue arose out of the third sentence of section 6 (b) which, so far as pertinent, reads as follows:

> "The Commission *by rules and regulations or order, subject to such terms and conditions as it deems appropriate in the public interest or for the protection of investors or consumers,* shall exempt from the provisions of subsection (a) the issue or sale of any security by any subsidiary company of a registered holding company, if the issue and sale of any such security are solely for the purpose of financing the business of such subsidiary company and have been expressly authorized by the State commission of the State in which such subsidiary company is organized and doing business . . ." (emphasis supplied).

An exemption from Section 6 (a) means that the securities need not be of the types or for the purposes specified in Section 7 (c), and need not

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51/ Order No. 11,237, January 19, 1940. The fact that the proposed transaction has been approved by a State commission does not militate against our imposing further conditions, and indeed no objection is raised on that ground. The statute amply justifies and even requires such action on our part. For a discussion of the relations between State commissions and this Commission see Frank, *SEC Respects State Jurisdiction,* 26 P.U. Fortnightly 259 (1940).

meet the standards of Section 7 (d) with respect to capital structure, earning power, appropriateness, reasonableness of fees, and the like, except to the extent that we deem terms and conditions in respect of these or other matters appropriate in the public interest or for the protection of investors or consumers. But if the respondents argue that no condition can be imposed under Section 6 (b) that touches on a matter dealt with in Section 7, then their argument becomes untenable; for Section 7 (d) (6) contemplates our refusing to permit a declaration to become effective if we find that the "terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers". It would therefore be a logical consequence of their argument that we could impose no requirement under Section 6 (b) that would prevent the terms and conditions of an issue or sale exempted thereunder from being "detrimental to the public interest or the interest of investors or consumers" -- in other words, that we are powerless to do what the express words of Section 6 (b) authorizes us to do. We cannot impute any such intention to Congress.

We think it is plain that the Rule is not invalid for lack of authority under Sections 20 (a) and 6 (b). That it is not an unreasonable or arbitrary exercise of the powers conferred by those sections is borne out, not only by the mandatory provisions of Section 1, but also by the express recognition by the United States Supreme Court of the "important bearing" of "any relationship between the buyer and seller which tends to prevent arm's-length dealing . . ." in a transaction. *Natural Gas Pipe Line of America* v. *Slattery*, 302 U.S. 300, 307 (1937); *cf. Taylor* v. *Standard Gas and Electric Company*, 306 U.S. 307 (1939); *Pepper* v. *Litton*, 308 U.S. 295 (1939).

(2) Validity of the Rule under Section 12 (f).

Other objections relate to the scope and form of the Rule. A principal question which was the subject of much discussion, but which we do not regard as of signal importance, was whether or not the Rule is an "affiliation" rule within the contemplation of Section 12 (f). That section makes it unlawful for any registered holding company or subsidiary thereof --

> "to negotiate, *enter into, or take any step in the performance of any transaction not otherwise unlawful under this title*, with any company in the same holding-company system *or with any affiliate of a company in such holding-company system* in contravention of such rules and regulations or orders regarding reports, accounts, costs, *maintenance of competitive conditions*, disclosure of interest, duration of contracts, and similar matters as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers . . ." (emphasis supplied).

While we numbered the Rule after this section of the Act, our authority for promulgating it stemmed from a number of other sections as already noted. The Rule applies to acquisitions of utility securities under Section 10, and the disposal of utility securities owned by registered holding companies, under Section 12 (d), as well as to the issue and sale of new utility securities under Sections 6 (b) and 7. Rather than make a separate rule under each section involved, it seemed logical to make one rule applicable to all of them and to give it a designation relating it to the general provisions of Section 12 (f).

But while we are of the opinion that the Rule is valid under Sections 20 (a) and 6 (b) without reference to Section 12 (f), we also think it is valid under that section. First, the Rule accords with the Congressional intent expressed in Section 12 (f) regarding "maintenance of competitive conditions"; and second, it is an "affiliate" rule within the purview of Section 12 (f).

Section 12 (f) has a wide scope, applying by its own terms to "any transaction not otherwise unlawful under this title . . ." between companies subject to the Act and their affiliates. This and other sections of the statute, when they were originally before Congress for debate, 52/ contained the words "competitive bidding" where the phrase "maintenance of competitive conditions" now appears.

This substitution of phrases was accomplished through amendments proposed by Senator Barkley, who in urging their adoption said in the course of debate:

> "The use of the words 'competitive bidding' is rather restrictive, and would apply only in cases where there was a process of bidding which was intended or supposed to be competitive. The amendments broaden the language so as to substitute 'maintenance of competitive conditions.' That may go beyond the mere bidding for contracts and one thing and another of that sort." 53/

And at a later time; Senator Barkley, in referring to this amendment, said:

> ". . . this is one of a series of amendments agreed to last Friday in order to make the language still broader. The language now written in the bill refers only to competitive bidding. This amendment would make it applicable to competitive conditions, and two other amendments of the same sort have already been agreed to." 54/

No further comment on the language in question is found in the debates or elsewhere. 55/ Thus it is plain that Congress not only contemplated rules

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52/ S. 2796, 74th Cong. 1st Sess.

53/ 79 Cong. Rec. 8846.

54/ 79 Cong. Rec. 8931.

55/ The Senate Report (Sen. Rep. No. 621, 74th Cong., 1st Sess.) summarizes the provisions and follows the original language of S. 2796, without commenting on the phrase, "competitive bidding." The House Report (H.R. Rep. No. 1318, 74th Cong., 1st Sess.) on the committee substitute bill, which was not submitted until nearly three weeks after the Barkley amendments had been agreed to in the Senate, contains comments indicating that the original phrase, "competitive bidding," in the affected sections, had been retained. This, however, was undoubtedly due to the fact that other matters, especially section 11, were the subject of more detailed consideration. The final Conference Report (H.R. Rep. No. 1903, 74th Cong. 1st Sess.) Of course, shows the text as affected by the Barkley amendments.

which would maintain competitive conditions generally in the utility industry 56/--certainly not excluding security transactions--but expressly contemplated competitive bidding as one of the means of achieving that end. We have sought by our Rule to maintain competitive conditions in security transactions of utilities by a means short of universal competitive bidding. Considering the various sections of the statute which contain the phrase "maintenance of competitive conditions", in relation to the general scheme of regulation revealed in the entire Act, it is apparent that in performing our broad duties in connection with security issues of determining terms and conditions that are necessary or appropriate in the public interest Congress intended to include, along with the more sweeping regulatory powers, the power to impose whatever requirement the Commission might find necessary or appropriate to secure the "maintenance of competitive conditions."

That the Rule is an "affiliate" rule under Section 12 (f) is clearly so with respect to the first two subparagraphs of paragraph (a) of the Rule, which regulate the payment of underwriters' and finders' fees to

> "(1) Any company in the same holding company system as the applicant or declarant, or
>
> "(2) Any affiliate of the applicant or declarant, or of a company of which the applicant or declarant is a subsidiary . . ."

But this proceeding arises under paragraph (a) (3), and respondents argue that the relationship contemplated therein is something other than affiliation, and is a relationship not recognized anywhere in the Act. This paragraph regulates the payment of an underwriter's or finder's fee to --

> "(3) Any person who the Commission finds stands in such relationship to the declarant or applicant . . . that there is liable to be or to have been an absence of arm's-length bargaining with respect to the transaction . . ."

It provides for notice and opportunity for hearing in any case, and for advisory opinions to be rendered by us after hearing in advance of any issue, sale or acquisition, upon application therefor by interested persons. The paragraph concludes:

> "Except for purposes of this Rule, a finding by the Commission under this paragraph shall not constitute a finding for purposes of Section 2 (a) (11) (D) of the Act."

The obvious implication of the concluding sentence is that for the purposes of the Rule, a finding that the described relationship exists is a finding of the relationship defined in Section 2 (a) (11) (D) of the Act, i.e., a finding of affiliation. Our finding in this case gives full recognition to the tests laid down in Section 2 (a) (11) (D).

56/ It is noteworthy that the maintenance of market competition is in the American tradition -- Congress having declared such a policy as long ago as 1890 when it passed the Sherman Antitrust Act.

(3) Validity of the Rule under Section 2 (a) (11) (D).

Respondents have argued that the Rule is invalid because of its failure to incorporate all of the standards laid down in Section 2 (a) (11) (d). 57/ Admittedly, the standards of Section 2 (a) (11) (D) for determining affiliation might have been spelled out in paragraph (a) (3) of the Rule, but that was unnecessary inasmuch as we incorporated such standards by reference therein to Section 2 (a) (11) (D). Not only does the Rule itself incorporate by reference the standards of Section 2 (a) (11) (D), but we have interpreted our Rule to the same effect by applying these standards in making our ultimate finding under the Rule. 58/ Although respondents suggested at the argument that they had not had adequate notice to this effect and that if such notice had been given them, they would have introduced further evidence, they subsequently, by letters addressed to this Commission, withdrew such objection and declined our offer to permit them to present further evidence.

In this connection respondents urge that paragraph (a) (3) is deficient because, if a finding thereunder is (for purposes of the Rule) a finding under Section 2 (a) (11) (D), we exceeded our authority in two respects: first, we have no right (it was argued) to limit the effect of such a finding by rule, but must make a finding of affiliation for *all* purposes or none; and second, paragraph (a) (3) does not provide for a thirty-day grace period such as is required by Section 2 (b) with respect to orders declaring persons to be affiliates under Section 2 (a) (11) (D). In our opinion, neither of these points is well taken.

In view of the last sentence of paragraph (a) (3) of the Rule, a finding that the described relationship exists is tantamount to a finding under Section 2 (a) (11) (D) except that the underwriter is made subject only to the obligations, duties and liabilities imposed by the Act and the Rule upon affiliates in respect of underwriting functions -- not affiliates for the general purposes set forth in the Act. In effect, therefore, the Rule operates so as to exempt an underwriter like Morgan Stanley from such obligations, duties and liabilities of affiliates as are not peculiar to the underwriting business or not pertinent to the problems which the Rule is designed to meet and the evils which it is intended to eliminate. Such partial exemption is not only fair and reasonable from a practical point of view; it is well within our powers under the Act. Section 20 (c) provides in part:

> "For the purposes of its rules, regulations, or orders the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters."

57/ These standards relate to the degree of absence of arm's-length bargaining between the person in question and the specified company. Section 2 (a) (11) (D) contemplates that affiliation shall not be found unless there is liable to be "such an absence" of arm's-length bargaining as to make it "necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon affiliates of a company."

58/ See *supra*. See also *In the Matter of Consumers Power Company*, 6 SEC 444, 456 (1939).

And Section 3 (d) provides:

> "(d) The Commission may, by rules and regulations, conditionally or unconditionally exempt any specified class or classes of persons from the obligations, duties, or liabilities imposed upon such persons as subsidiary companies or affiliates under any provision or provisions of this title, and may provide within the extent of any such exemption that such specified class or classes of persons shall not be deemed subsidiary companies or affiliates within the meaning of any such provision or provisions, if and to the extent that it deems the exemption necessary or appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this title."

Morgan Stanley also objected at the argument to another limitation, which we do not believe is in the Rule. This objection was that the Rule seeks to create a status for the purpose of one transaction only, rather than a status that continues until terminated by our further order. The scheme of the Act calls for the continuation of a status once found, in the case of an electric or gas utility, a holding company, a subsidiary company, or an affiliate, until this Commission acts by order (after notice and opportunity for hearing) to revoke the order which declared the status to exist. 59/ It was presumably the legislative intent to so provide in order to remove uncertainties as to status under the Act, and to avoid multiple proceedings for the redetermination thereof with respect to recurring transactions.

The Rule, however, does not purport to create an ephemeral status to be relitigated in recurring transactions. A finding which establishes the relationship of an affiliated underwriter of a specified company is, as we have pointed out, a finding under Section 2 (a) (11) (D) for the purpose of the Rule; and while it is based on the relationship existing at the time of the proposed underwriting transaction, the status thereby created does not terminate with the transaction. Once established, the status of affiliation continues in effect for purposes of subsequent transactions under the Rule, and is automatically operative as to such transactions under paragraph (a) (2) of the Rule, without any necessity to relitigate the question. The Rule, and Section 2 (b) itself, provide adequate machinery for terminating such a status by further order in the event that the circumstances which gave rise to the original finding and declaratory order no longer exist.

In regard to the thirty-day deferment period the objection, in substance, is that the Rule does not specifically incorporate the provisions of Section 2 (b) that the order issued upon the finding of a relationship under the Rule "shall not become effective for at least thirty days after the mailing of a copy thereof to the person thereby declared to be . . . (an) affiliate." We think, however, that it is neither necessary nor appropriate to copy into a rule all statutory provisions that are or might be applicable to its execution. If Section 2 (b) is applicable here, it is applicable by force of the statute itself and would not gain or lose force according to whether or not its terms are repeated in the Rule.

59/ E.g., Sections 2 (a) (3), 2 (a) (4), 2 (b), 5 (d), and 13 (d).

In this particular case the 30 days deferment required by Section 2 (b) and by our Rule has been waived by the respondents on the request of Morgan Stanley, in which Dayton concurred, that the issues raised in the Section 6 (b) application be considered and determined apart from this proceeding in order that the proposed bond issue might be made without delay. This request was accompanied by a so-called impounding offer whereby it was agreed that Morgan Stanley would pay over to Dayton that amount of underwriting fees, commissions or other compensation as defined by the Rule, to which it would otherwise be entitled in respect of the bonds in question, if a final order adverse to Morgan Stanley should be entered herein and sustained on any appeal taken therefrom. We granted the Section 6 (b) application on the express condition that the terms of such offer be observed. 60/ It is therefore apparent that our order herein will be operative as to the fees in respect to the Dayton bond issue of 1940. The respondents are, by their agreement, estopped to assert that the deferment provision is applicable in this case.

Nevertheless, it is argued by respondents that in the ordinary case, without such an arrangement, the Rule would be unworkable and is invalid owing to the deferment provision of Section 2 (b). 61/ We cannot agree that the Rule would be unworkable even in such a case. The Rule provides, as we have already noted, that application may be made for an advisory opinion on the status of an underwriter in relation to a specified company at any time and well in advance of any proposed transaction. 62/ Anticipatory determination of the affiliate status would enable 30 days notice without retarding the security issue itself. But even where this procedure is not followed the Rule can still operate. Suppose that, as in this case, the first official notice of an issuer's intention to employ a particular underwriter should come to us with the filing of the issuer's application under Section 6 (b): it would first be our duty to consider whether reasonable grounds existed for a proceeding under paragraph (a) (3). If thereafter, on the basis of our preliminary investigation, we issued an order to show cause under paragraph (a) (3), it would be our duty under the statute and the Rule (in the absence of an arrangement such as we have here) to withhold action on the Section 6 (b) application until the final decision on the relationship question under the Rule, and for thirty days after mailing a copy of the order thereon to the underwriter if the relationship in question were found to exist. This procedure would not disrupt any contract rights or obligations between issuer and underwriter. The proposed underwriting contract is drafted and submitted with the Section 6 (b) application, but is rarely, if ever, executed before the exemption order is entered. The thirty-day deferment period under Section 2 (b) was doubtless intended to afford time for the rearrangement of business affairs by the person whose status is declared by the order issued, but cannot be regarded as sanctioning the undertaking of new obligations or the acquisition of new contract rights which would circumvent our rules and orders under the Act.

60/ *In the Matter of Dayton Power and Light Company, supra,* footnote 2.

61/ There are many authorities to the effect that one can not object to the validity of a provision which has not subjected him either to injury or to embarrassment. E.g., *Heald* v. *District of Columbia,* 259 U.S. 114, 123-4 (1922); *Utah Power & Light Co.* v. *Pfost,* 286 U.S. 165, 186 (1932).

62/ E.g., *In the Matter of Halsey, Stuart & Co., Inc.,* 5 S.E.C. 865 (1939).

Indeed, the procedure suggested above would seem to be essential (in the absence of an advance application for an advisory opinion or an arrangement such as we have here) wherever a determination of the status of a proposed underwriter is involved. As a practical matter, it would not be feasible for us to institute wholesale proceedings under Section 2 (a) (11) (D) to determine relationships between all possible underwriters and issuers under the Act without reference to proposed financial transactions, and without knowing whether the issues so raised will ever be anything more than academic questions. And even if wholesale determinations of that character were feasible, they would impose an intolerable and needless burden on investment bankers and utility companies as well as on this Commission.

We conclude that the Rule is valid and is properly applied in this case.

An order will issue in accordance with this opinion. *Provided, however*, that the order shall not be entered for a period of ten days from the date of our findings and opinion herein in order to permit respondents, or either of them, to make application for a reopening of the hearing with respect to certain facts regarding the financing of subsidiaries of the Commonwealth and Southern Corporation, as hereinbefore indicated; 63/ and *provided further*, that if such an application is made, within the aforesaid ten days, the hearing will be reopened for such purpose, in which event the order shall not be entered until the reopened hearing has been closed and we have made a further determination, based upon the evidence, if any, then produced.

By the Commission (Chairman Frank and Commissioners Healy, Eicher, Henderson and Pike.)

(SEAL)

Francis P. Brassor,
Secretary.

March 27, 1941

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63/ See *supra*, footnote 25.