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SECURITIES AND EXCHANGE COMMISSION

Central Office:
18th and Locust Streets, Philadelphia, Pa

COMMISSIONERS

GANNON PURCELL, Chairman

ROBERT E. HEALY

SUMNER T. PIKE

ROBERT K. MCCONNAUGHEY

Vacancy

ORVAL L. DuBois Secretary

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SECURITIES AND EXCHANGE COMMISSION.
Philadelphia 3, Pa.
April 21, 1945.

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

In addition to reviewing the principal developments of the past fiscal year, the report includes a 10-year survey of the Commission's work. This survey sets forth the results of the Commission's operations under the various statutes committed to its charge. At the end of a decade it seemed most desirable that the Commission should render to the Congress such an account of its activities. Because of space limitations no attempt has been made to detail the entire development of practices and policies as reflected in our order, rules, and regulations as they have become established and exist today. Since this course has been followed in the historical exposition contained in the report, I think it only proper to point out that the survey is one of results and not one of step-by-step development. In reading these pages one should bear in mind that they do not describe all of the difficulties which have been encountered or all of the problems which remain unsolved. While I do not wish to minimize the importance of the results obtained during the 10 years of operation under these statutes, I should not like to give the impression that no mistakes have been made. Where they have been made, we have endeavored not to repeat them.

Let me assure you that the Commission will continue to review the steps already taken and, in dealing with new problems as they arise, will exert every effort to reach sound conclusions and results and perfect its administration of the tasks Congress has assigned to it.

Respectfully.

GANSON PURCELL
Chairman.

THE PRESIDENT OF THE SENATE.
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION

PHILADELPHIA, PA.
FOREWORD

The Securities and Exchange Commission was created by act of Congress in 1934. On June 30, 1934, the President appointed the original five members of the Commission. In its first year, the Commission was charged with administering two statutes: the Securities Act of 1933, which was administered by the Federal trade Commission until September 1934, and the Securities Exchange act of 1934. These two laws were the initial steps in a comprehensive program for the protection of investors in corporate securities. In the years that followed, the scope of the Commission's duties increased greatly as responsibility for the enforcement of new laws was lodged with the Commission. The Commission now administers six statutes:

Securities Act of 1933.

Securities Exchange Act of 1934.

Public Holding Company Act of 1935.

Trust Indenture Act of 1939.

Investment Company Act of 1940.

Investment Advisers Act of 1940.

and, in addition, performs various functions under Chapter X of the National Bankruptcy Act (the Chandler Act).

All of these laws and the principal developments under them are described in this report, in which we have given an account of the Commission's work over the past decade.

Reference is made in the report to the conditions which led to the enactment of the laws administered by the Commission long before the passage of the Securities Act in 1933 and the Securities Exchange Act in 1934, it had become clear to careful observers, including the more discerning elements in the business and financial community, that the lax financial and ethical standards which prevailed in the twenties were undermining the integrity end health of our capital markets, were destroying investor confidence, and were leading the business and financial enterprises of this country to disaster. Everyone who honestly appraised the situation appreciated the pressing need for the preservation of high standards of conduct if the American system of private capital and democracy was to survive. Promoters of now enterprises and those soliciting additional capital were seeking other people's money in increasing amounts. Corporate managements were controlling businesses financed by millions of investors who had little or no voice in the management. Insiders were using other people's money to manipulate markets for their own selfish ends to the detriment of innocent investors. It is trite but true that there was an orgy of speculation, which culminated in the disastrous stock market crash of 1929. Experience of a decade of feverish activity subjected to little or no regulation by the Federal Government clearly revealed the need for legislation that would curb financial malpractice and require those using and soliciting the use of other people's money to conform at least to the minimum standards of fiduciaries or trustees all to the end that investors might be protected and the public interest furthered. The several statutes entrusted, to the Securities and Exchange Commission were designed to accomplish these objectives in the respective fields to which they apply.

The primary objective of the Securities Act of 1933 is to protect investors by requiring full and fair disclosure of material facts concerning securities publicly offered for sale in interstate commerce or use of the mails and by preventing misrepresentation and fraud in the sale of securities. Under it, the Commission does not pass on the merits of securities. One can offer any security for sale if it is effectively registered and all the truth is told about it. While the necessity of disclosing the truth concerning prospective security offerings may and should affect both the determination to make the offering and the reception accorded it, the decision whether to take the risk rests with the investor and is not made for him by the Commission. Accordingly the Commission does not direct or control the flow of capital.

From the passage of the Act to June 30, 1944, 4,510 registration statements became effective with respect to securities aggregating more than $25 billion. In this period administrative procedures were adapted to the needs and practices of the business community. Registrations were expedited whenever possible. Since the August 1940 amendment of Section 8 (a) of the Securities Act, registrants who were able to comply with the standards of the Act and the rules of the

Commission have obtained effective registration of their securities in substantially less than 20 days after filing. Inadequacies in registration statements have been called to the attention of issuers through the medium of the flexible and informal “deficiency” letter rather than by stop order proceedings. That technique has had marked success end in no small measure it accounts for the fact that for more than two years, the Commission has not found it necessary to issue any “stop orders” as prescribed by the statute with respect to improper registration statements.

When the Securities Act was passed and shortly thereafter, there was widespread prediction that the civil liability provisions of the Act would result in a flood of lawsuits against companies and their officers, directors, and experts who had signed registration statements. A search of the court records covering a period of 8 years reveals that there were less than 2 dozen actions under all three of the civil liabilities of the Act. Moreover, so far as could be determined, not more than five suits resulted in recovery by the plaintiffs.

From the beginning of its administration of the Securities Act, the Commission, through its Securities Violation Service, has cooperated with the several State security authorities, better business bureaus, and chambers of commerce in establishing a national clearing house of information concerning fraudulent securities transactions. As of June 30, 1944, the Commission had assembled in its files data concerning an aggregate of 44,399 persons against whom Federal or State action had been taken with regard to securities violations. The Commission’s enforcement activities have resulted in the indictment of 2316 individuals and firms for securities frauds, manipulation, sales of unregistered securities, perjury, and fraudulent operations of brokerage firms. The types of fraud which the Commission has encountered have been as varied as human ingenuity could devise. Of the criminal cases which have been concluded, 95 percent were successfully prosecuted as to one or more of the defendants named in the indictments. In cases of appeal verdicts of guilty were reversed as to all defendants in only six cases, and in five of these convictions were obtained after retrial. In civil suits instituted by the Commission, permanent injunctions have been entered against 1,057 firms and individuals.

One of the important results of the disclosure requirements of the Securities Act and the Securities Exchange Act has been their effect on accounting practices. The administration of these statutes by the Commission has been instrumental in bringing about numerous important reforms in accounting and auditing techniques. It has also had a beneficial influence on the character of the financial statements included in annual reports to stockholders.

Under the Securities Exchange Act of 1934, significant achievements have been made in the regulation of trading in securities both on the organized exchanges

and in the over-the-counter markets. As developed in more detail in this report, these include the adoption by the exchanges of suggested rules for the regulation of various phases of trading; the reorganization of the administrative structures of the exchanges; control of the use of credit in security transactions; the systematic surveillance of the volume of trading and the movement of securities prices to eliminate manipulative practices; the control of short selling; the disclosure of transactions in a company's stock by its officers, directors, and principal stockholders; the registration of brokers and dealers; and improvement in the standards of conduct in over-the-counter business. Finally through the Commissions proxy regulations, affecting corporations with securities listed on exchanges, important advances have been made toward a fuller degree of corporate democracy.

The Securities Exchange Act was amended in several important respects in 1936 and in 1938. The amendments of 1935, known as the Maloney Act, permitted the formation and registration of national securities associations which would supervise the standards of conduct of their members under Commission regulation.. In August 1939, the National Association of Securities Dealers, Inc., which now has approximately 2,100 members, was registered under the Act. A major portion of its activities has been devoted to raising the business standards of over-the-counter brokers and dealers.

Part III of the report deals with the administration of the Public Utility Holding Company Act of 1935. Under that Act there are registered some 53 electric and gas utility holding company systems with aggregate consolidated assets of nearly $1.6 billion. A major part of the Commission's work for the past 5 years has been the task of passing upon the reorganization of the complex financial and corporate structures of these systems as required by Section 11 of the Act. By the end of the past fiscal year most of the long-protracted hearings to determine the nature of the Section II issues in the various systems had been held and substantially all of the more important orders specifying the action that must be taken to comply with the geographical integration requirements of that section had been issued. There has been a steady procession of applications by the holding companies to give effect to these outstanding orders. Sufficient progress has been made to indicate both the practicability and the beneficial effects of compliance with the simplification requirements of the Act. Of course the Commission will not order dissolution of any holding company which holds together what can realistically be regarded as a system the continued existence of which is justified by genuine economic or physical considerations.

Under this program complex capital structures are being replaced by simple capital structures. Holding company debts are being paid off, risky holding company preferred stocks, with their huge accumulations of dividend arrearages, are being converted to common stock so as to permit once again a flow of

income to the security holders. But what is more important, the holding companies are going through a shrinking process. They are being reduced in size because they must slough off their scattered holdings, and their security holders are receiving, either in exchange or as liquidating dividends, the common stocks of sound operating companies. This is a factor of great significance both to the operating companies themselves and to the investors who thought they had an equity interest in the utility industry but found that all they had was a speculative interest in a holding company. Under these conditions in the years to come, the operating utility industry will have a greater ability to raise equity capital on a sound basis to finance its ever-growing needs; and the investors who furnish that capital will receive their dividends direct, without being subjected to the expense and the risk of supporting an outmoded holding company organization. Also worthy of mention is the fact that management and supervision fees paid by the operating utility subsidiaries have been reduced many millions of dollars annually.

In addition to the program of reorganizing the holding companies, the Commission, acting under the Holding Company Act has passed upon the issuance of more than $6 billion of securities of registered holding companies and their subsidiaries. Under the applicable standards of the Act, this afforded the opportunity to improve the financial structures and policies of the operating utility companies. Inflation is being taken out of their balance sheets. Their debt is being reduced by every legitimate means to establish conservative debt ratios. Depreciation accruals have been increased and their depreciation reserves are being built up to good health. Among the more important benefits have been the steps taken by the Commission to eliminate banker domination of utility companies. One important measure to accomplish. that result was the adoption by the Commission in April 1941, of a rule requiring competitive bidding in the sale of public utility securities. These benefits are helping to build a better future for the operating utility companies, their investors and their consumers.

Chapter X of the Bankruptcy Act

Under a provision in the Securities Exchange Act, the Commission was directed to make a study of reorganization committees and to: report its recommendations to Congress. The Commission’s report on this matter, in eight volumes, described serious abuses in the functioning of these committees as well as other defects in existing reorganization procedures. These disclosures gave impetus to reform of the National Bankruptcy Act in 1938. Under that legislation, the Commission has the duty to serve as adviser to United States district courts in connection with proceedings for the reorganization of debtor corporations in which there is a substantial public interest. It participates as a party to these proceedings, either at the request or with the approval of the courts. It renders independent expert advice and assistance to the courts with respect to plans of

reorganization. Of primary importance is the Commission's assistance in. the financial rehabilitation of debtor companies and in the formulation of reorganization plans which will provide fair and equitable treatment to the various creditors and other security holders and which will assure that the corporations will emerge from bankruptcy in a sound financial condition. From September 1938 to June 1944, the Commission participated in 243 reorganization proceedings under Chapter X.

Another consequence of the Commission's investigation of reorganization procedures was the enactment of the Trust Indenture Act of 1939. Prior to 1939 most of the average indenture was devoted to exculpating the trustee. This Act aims to bring all indenture trustees up to a high level of diligence and loyalty and place them in a better position to protect security holders. The means adopted is a requirement that bonds, notes, debentures, and similar debt securities exceeding $1,000,000 in principal amount may not be offered for sale to the public unless they are issued under a trust indenture which conforms to specific statutory standards and has been duly qualified with the Commission. The emphasis is upon effective and independent trustee whose interests do not conflict with those of the investors. Under the Trust Indenture Act there has been no litigation and only two refusal order proceedings have been initiated. In each of these cases the indenture was qualified after appropriate amendment. From February 4, 1940 to June 30, 1944, 304 trust indentures, covering more than $4 and one quarter billion principal amount of securities, were qualified under this Act.

Investment Company Act of 1940

In the years 1936 to 1940, the Commission made an extensive study of investment trusts and similar companies as directed in Section 30 of the Public Utility Holding Company Act. The investigation confirmed widespread suspicions concerning existing abuses and revealed case after case in which investors" funds had been used to serve the selfish interests of investment company promoters. The Commission's studies indicated that the honest and respectable elements in the investment trust business recognized that these abuses had also cast discredit upon their operations and they joined in urging the passage of remedial legislation. Accordingly, the terms and provisions of the Investment Company Act were worked out in conference by representatives of the Commission and. of the investment trust industry and the Congress. The Act passed both houses of Congress without a dissenting vote.

As more fully set forth in Part VI of this report, the Act provides that investment companies must register with the Commission; their affairs must be conducted in accordance with the applicable provisions of the Act; and various transactions, including transactions between affiliates, are prohibited or made subject to

approval by the Commission. The Commission also is authorized to apply to the Federal courts for orders removing or suspending from office directors, officers and other fiduciaries of registered investment companies who have been guilty of gross misconduct or gross abuse of trust. The Commission has exercised the authority in a number of instances. At June 30, 1944, there were registered with the Commission 371 investment companies basing estimated assets aggregating approximately $3 billion.

The Investment Advisers Act of 1940 was enacted at the same time as the Investment Company Act. This statute provides for the registration of all persons engaged in the business of giving investment advice, requires investment advisers to make full disclosure of their interest in transactions executed for their clients, and makes unlawful practices which constitute fraud or deceit. At June 30, 1944, there were registered with the Commission 719 investment advisers.

The Commission's experience in the administration of the Investment Advisers Act over the past 4 years impels the conclusion that it cannot be enforced effectively in its present form. The cases of Robert J. Boltz and Albert K. Atkinson, outlined in Part VII of this report, illustrate the type of fraudulent activities in which certain unscrupulous investment advisers are able to engage at present without affording this Commission the slightest overt evidence of their occurrence. The Commission is unable to detect or prevent such activities principally because it lacks the power to inspect the books and records of investment advisers - a power which it has in the case of brokers and dealers under the Securities Exchange Act of 1934. To remedy this signal weakness as well as other related weaknesses in the Investment Advisers Act, the Commission submitted a report to the Congress Oh January 31, 1945 recommending certain amendments to the Act.

Since the substantive provisions of the several statutes are interrelated in many ways, it has been feasible to effect a high degree of standardization and uniformity of forms, procedures, and interpretations. For example, as more fully discussed in the Commission's Ninth Annual Report, the Commission has effected a comprehensive simplification of a number of registration and reporting requirements to eliminate duplicate filings by companies subject to more than one Act. Uniform regulations have been prescribed as to the form and content of financial statements filed under the Securities Act, the Securities Exchange Act amid the Investment Company Act. Similarly uniform. practices, interpretations, and forms apply to proxy solicitations under the Securities Exchange Act, the Holding Company Act, and the Investment Company Act; this is also true as to trust indentures under the Trust Indenture Act and the Holding Company Act. Further administrative advantages stem from the uniformity of procedures, law and interpretation under the reorganization provisions of Chapter X, Section 11 of the Holding Company Act and Section 25 of the Investment Company Act.

In the adoption of rules, regulations forms, and accounting principles and policies, it is the practice of the Commission to submit them prior to adoption to all interested persons and invite their criticisms and suggestions. This procedure is followed provided the subject matter is of general importance, is not of a temporary nature, and is not due to an emergency demanding early action. Often such matters are discussed with those affected or interested in informal conferences with the staff or the Commission, and sometimes in public conferences. When the Commission makes its decision under such circumstances, it usually states the reasons for its conclusions.

In carrying out its adjudicatory functions under the Acts it administers, the Commission has developed procedures designed to afford maximum information and assistance to all interested parties and to assure full safeguards of their rights. Interpretative and advisory services are rendered. by the Commission's staff to persons contemplating activity dealt with by those Acts, and preliminary consultation between members of our staff and interested parties is employed to expedite disposition of issues raised.

Most of the cases which the Commission decides involve applications by private parties seeking permission to undertake or continue specified activity, or seeking exemption from requirements imposed by the Acts or Rules and Regulations thereunder. The Commission also decides issues in various proceedings initiated by it pursuant to statutory direction and it reviews certain actions of a registered association of securities dealers.

In all cases to be decided by it, the Commission issues to the parties a notice and order for hearing summarizing the pertinent facts which are then before it and delineating the issues that appear to be involved. Unless confidential treatment is required, the notice and order for hearing is made public and provides that any interested person may seek leave to be heard or intervene.

Hearings are held before trial examiners designated by the Commission. The trial examiners have no other function than to preside at hearings and in certain cases to file an advisory report. They are instructed to and do observe strict impartiality. In all cases the parties and the interested division of the Commission's staff, where it takes a position, are afforded opportunity to file exceptions to a trial examiner's report, to file briefs and requests for specific findings and to present oral argument to the Commission.

Where the interested division of the Commission's staff has taken, no adversary position, the Commission will normally avail itself of the assistance of the division in the preparation of findings and opinion. However, where the division has taken an adversary position, and in other cases in which the Commission considers it

desirable, the Commission employs the assistance of its Opinion Writing Office, which reports directly to the Commission and functions independently, of the division which has participated in the proceedings. After thorough analysis of the evidence and the contentions of the parties, the Commission directs the preparation. of findings and opinions in which the Commission states its decision and its reasons for it. All final orders of the Commission are subject to judicial review.

The Commission's files have become a tremendous repository of information with respect to the corporate enterprises of the nation. This information is digested by representatives of financial and statistical services, banks and insurance companies, investment houses, industrial corporations, members of stockholders committees and by individual investors, and is passed on to the public in numerous ways. The Commission itself issues to all who are interested statistical releases and reports of surveys. At the request of a number of government war agencies, the Commission recently published a four volume report on the profits and operations of American corporations, and other work is being done on similar projects. The Commission also issues quarterly releases on savings by individuals and on the working capital position of corporations in the United States. The accumulation of financial information and the services of technical experts on the Commission's staff are available to and have been frequently employed by the Congress. In addition, the Congress has availed itself of the personnel of the Commission in connection with numerous investigations the most important of which was the investigation conducted by the Temporary National Economic Committee on which the Commission was represented.

During the first decade of its activities, the Commission issued more than 2,000 formal orders wider the several acts, and while all the acts provide for judicial review of Commission orders, only 100 Petitions for review have been filed. Of these 84 resulted in either denial of the objections raised on the merits or dismissal of the petition by stipulation or on motion of the petitioners. The decisions in 3 concluded cases set aside the Commission's orders in whole or in part and 13 cases were pending at the end of the past fiscal year. In addition to the proceedings for judicial review of Commission orders, the record of civil actions in Federal district courts instituted by or against the Commission (including cases in which the Commission appeared as intervener or participated as amicus curiae) comprised more than 500 cases, of which only 10, or less-than 2 percent, resulted in decisions adverse to the Commission.

An outstanding result of the enactment and administration of these statutes has been the establishment of a higher standard of ethics in the handling of other people's money. New standards prevail in the business of inducing investors to part with their money and in the business of managing that money once it has been, entrusted to a particular enterprise. There now prevail new concepts of fair

dealing, of adequate disclosure and of the duties of management and insiders. The general acceptance of these ethical standards by the business community is reflected not alone in the policies and outlook of those subject to the Commission's jurisdiction, but it is also evidenced in many respects in the practices of businesses not within the jurisdiction of the Commission.

Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934

In 1940 bills were introduced in both Houses of Congress to amend the Securities Act of 1933. [Footnote: S.3985, S. 4006, H.R. 9807, and H.R. 10013, 76th Cong., 3d sess.] The House Committee on Interstate and Foreign Commerce requested the Commission to comment on these bills. As a result of this request, and with the approval of the chairman of that Committee and the chairman of the Senate Committee" on Banking and Currency, the Commission undertook to study thoroughly with representatives of the securities industry and others the advisability of amending both the Securities Act of 1933 and the Securities Exchange of 1934.

In the course of this study the Commission conferred at length with representatives of the Investment Bankers Association of America, the National Association of Securities Dealers, Inc., the New York Curb Exchange and the New York Stock Exchange. The views of all the regional stock exchanges were also invited, and proposed amendments were discussed in detail with representatives of 13 of those exchanges. In addition, the Commission sought and received the views of executives of corporations which had had experience in registering securities with the Commission, executives of many life insurance companies, and numerous individuals from all parts of the country.

The results of this comprehensive study were submitted to the Committees of the two Houses in a report filed by the Commission on August 7, 1941. [Footnote: Report of the Securities and Exchange Commission on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934," House Committee Print, 77th Cong., 1st sess. (Aug. 7,1941). A separate report had been filed on July 30, 1941, by the representatives of the four groups of the securities industry referred above. "Report on the Conferences with the Securities and Exchange Commission and its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934 by the Representatives of Investment Bankers Association of America, National Association of Securities Dealers, Inc. New York Curb Exchange, and New York Stock Exchange" (July 30, 1941).] All of the proposals made either by the representatives of the securities industry or by the Commission were then combined in a comprehensive committee print for purposes of convenience.

[Footnote: “Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934” (Oct. 18, 1941).]

As to many of the proposals the Commission and the representatives of the industry were in agreement. In the area of disagreement, however, were some proposals which the Commission opposed as serious threats to the protection of the investing public and as a retrogression toward evils which had impelled the enactment of the two statutes in 1933 and 1934.

The nature of the proposals as to which there was disagreement was varied. For example, perhaps the two most important suggestions under the Securities Exchange Act involved the regulation of proxy solicitations under Section 14 and the provisions of Section 16 governing trading by corporate insiders. On one hand, the two New York exchanges proposed extending the coverage of those two sections generally to the securities of large national corporations not listed on exchanges. On the ether hand, the representatives of the securities, industry (including those exchanges) urged the repeal of Section 16 (b), which provides for the recapture of profits made by insiders from trading in the securities of their companies.

The House Committee on Interstate and Foreign Commerce began hearings to consider the proposed amendments on October 28, 1941. The hearings were conducted continuously until interrupted by the outbreak of war on December 7, 1941. Reconvening in January, the hearings were terminated during that month. [Footnote: The hearings are reported in a Committee print (77th Cong., 1st and 2nd sess., 1941-42 consisting of five volumes plus an index volume.] The proposals were then referred to a subcommittee of the House Committee and no further action was taken up to the close of the session.

Significant statistics concerning the work of the Commission and its activities during the past fiscal year and cumulative to June 30, 1944, are set forth on the last page of this foreword.

Since the Commission was organized the following Commissioners have held office for the period indicated (* served as Chairman):

Joseph P. Kennedy* - July 2, 1934 to Sept. 23, 1935

George O. Mathews - July 2, 1934 to Apr. 15, 1940

James M. Landis - July 2, 1934 to Sept. 15, 1937

Robert E. Healy - July 2, 1934 Term Expires June 5, 1946

Ferdinand Pecora - July 2, 1934 to Jan. 21, 1935

J. D. Ross (deceased) - Oct. 5, 1935 to Oct. 31, 1937

William O. Douglas* - Jan. 31, 1937 to Apr. 16, 1939

Jerome N. Frank* - Dec. 27, 1937 to Apr. 30, 1941

John W. Hanes - Jan. 3, 1938 to Feb 2, 1942

Edward C. Eicher* (deceased). - Dec. 3, 1938 to Feb 2, 1942

Leon Henderson - May 18, 1939 to July 8, 1941

Sumner T. Pike - June 4, 1940 Term expires June, 5 1948

Ganson Purcell* - June 17, 1941 Term expires June, 5 1947

Edmund Burke, Jr. - July 31, 1941 to Oct. 19, 1943

Robert H. O'Brien - Feb. 3, 1942 to Dec. 28, 1944

Robert K. McConnaughey. - Dec. 29, 1943 Term expires June 5, 1949

Staff Officers

Orval L. DuBois Secretary.

Baldwin B. Bane, Director of Corporation Finance Division.

Milton H. Cohen, Director of Public Utilities Division.

James A. Treanor, Jr., Director of Trading and Exchange Division.

Roger S. Foster, Solicitor.

William W. Werntz, Chief Accountant.

Robert M. Blair-Smith, Head of Opinion Writing Office.

Peter T. Byrne, the Assistant to the Chairman.

Leslie T. Fournier, Special Assistant to the Commission.

Hastings P. Avery, Director of Administrative Division.

James J. Riordan, Assistant Director of Administrative Division and Budget Officer.

Philipp L. Charles, Director of Personnel.

Regional Administrators

James J. Caffrey, New York Regional Office-Zone 1.

Paul H. Rowen Boston Regional Office - Zone 2.

William Green, Atlanta Regional Office - Zone 3.

Charles J. Odenweller, Jr., Cleveland Regional Office - Zone 4.

Thomas B. Hart, Chicago Regional Office - Zone 5.

Oran H. Allred, Fort Worth Regional Office - Zone 6.

John L. Geraghty, Denver Regional Office - Zone 7.

Howard A. Judy, San Francisco Regional Office - Zone 8.

Day Karr, Seattle Regional Office- - Zone 9.

William M. Malone, Baltimore Regional Office - Zone 10.

The States comprising the zones served by the respective regional offices are as follows:

Zone 1 - New York, New Jersey and Pennsylvania: Regional office - Room 2006, Equitable Building, 120 Broadway New York 5, N. Y.

Zone 2 - Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, and Maine: Regional office - Room 426, Shawmut Bank Building, 82 Devonshire Street Boston 9, Mass.

Zone 3 - Tennessee, North Carolina, South Carolina, Georgia, Alabama Mississippi, Florida, and the portion of Louisiana east of the Atchafalaya River:

Regional office - Room 415, Palmer Building, Forsyth and Marietta Streets, Atlanta 3, Ga.

Zone 4 - Ohio, Michigan, Indiana, end Kentucky: Regional office - Room 1608, Standard Building, 1370 Ontario Street, Cleveland 13 Ohio .

Zone 5- - Minnesota, Wisconsin, Iowa, Illinois, Missouri, and Kansas City, Kans.: Regional office - Room 630, Bankers Building, 105 West Adams Street, Chicago 3, Ill. Zone 6 - Oklahoma, Arkansas, Texas, Kansas (with the exception of Kansas City), and the portion of Louisiana west; of the Atchafalaya River: Regional office - United States Courthouse, Tenth and Lamar Streets, Fort Worth 2, Tex.

Zone 7---Wyoming, Colorado, New Mexico, Nebraska, North Dakota, South Dakota, and Utah: Regional office - -- Room 822, Midland Savings Building, 444 Seventeenth Street, Denver 2, Col.

Zone 8 - California, Nevada, Arizona, and Hawaii: Regional office - Room 1301, 625 Market Street, San Francisco 5, Calif.

Zone 9 - Washington, Oregon, Idaho, Montana, and Alaska: Regional office - 1411 Fourth Avenue, Seattle 1, Wash.

Zone 10 - Virginia, West Virginia, Maryland, Delaware, and District of Columbia.: Regional office - Room 2410 O'Sullivan Building, Baltimore 2, Md.

Washington, D. C. Liaison Office - Twelfth floor, Tower Building, Fourteenth and K Streets NW., Washington 25, D. C.

[Chart Omitted]

Part I
ADMINISTRATION OF THE SECURITIES ACT OF 1933

The Securities Act of 1933 provides for full disclosure of pertinent information regarding securities publicly offered for sale in interstate commerce or through the mails, but does not confer upon the Commission the power to approve or pass upon the merits of any security. The Act is also designed to prevent misrepresentation, deceit, and other fraudulent practices in the sale of securities. Issuers of securities to be publicly offered and sold in interstate commerce are required to file registration statements with the Commission. These registration statements must contain specified information on the proposed offering and are available for public inspection. An integral part of the require-merits of each

statement is a prospectus setting forth in condensed or summarized form the more essential information contained in the registration statement. The Act provides that the prospectus must be made available to investors to whom the securities are sold.

ENACTMENT AND SCOPE OF THE SECURITIES ACT OF 1933

The reasons for the enactment of the Securities Act of 1933 are stated in the President's message to Congress on March 29, 1933, as follows:

I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe bases through practices neither ethical nor honest on the part of many persons and corporations selling securities.

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation. upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring hack public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business. This is but one step in our broad purpose of protecting investors and depositors. It, should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct, unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other peoples money are trustees acting for others.

Following the first World War, the American People purchased corporate securities in unprecedented amounts. During the period from 1920 to 1933 approximately $50,000,000,000 of new issues were sold to American investors. In a majority of cases the public purchasers were not furnished adequate information upon which to base an informed judgment to buy or not to buy. By 1933, some $25,000,000,000 or 50 percent of those securities had become worthless.

State “blue sky” laws, which were on the statute books of practically all the States, had not fully met the situation, since it was difficult for a State to protect its citizens from the depredations of unscrupulous promoters operating across State lines in interstate commerce. Even if the limitations of the State’s own statutes and of the commerce clause of the Federal constitution presented no obstacle to the prosecution of such a promoter, he was physically outside the State’s jurisdiction and extradition was seldom feasible. Accordingly, responsible Federal protection of investors in corporate securities, supplementing that afforded by the State “blue sky” authorities, was an essential need.

As Louis D. Brandeis had emphasized so vigorously 20 years earlier, those who managed corporations were managing other people’s money and those who were seeking new capital were seeking other people’s money. There arose an insistent demand that in order to reduce hazards to investors, the fiduciary character of the financial process be accorded legal recognition. So, when President Roosevelt asked Congress, as part of the administration’s program of reform, to enact the Securities Act and the Securities Exchange Act, he initiated a series of conservative steps to cope with an unhealthy situation that had long festered and could no longer be ignored.

The Securities Act, often referred to as the “truth in securities” Act, was designed no t only to provide investors with adequate information upon which to base their decisions to buy and sell securities, but also to protect legitimate business seeking to obtain capital through honest presentation against competition front crooked promoters and to prevent fraud in the sale of securities. At the same time its purpose was to encourage the productive employment of capital which had been frightened into hoarding, and to aid in providing employment through the restoration of buying power. The Act was administered by the Federal Trade Commission from May 27, 1933, the date of enactment, until September 1, 1934, when responsibility for its enforcement was transferred to the Securities and Exchange Commission.

Registration

The principal objective of the Securities Act is to protect investors by requiring a full and accurate disclosure of the material facts regarding securities for sale in interstate commerce or by the use of the mails. In order to accomplish this, the Act provides that, before nonexempt securities may be offered or sold to the public through the mails or in interstate commerce, a registration statement must he filed with the Commission and must become effective. In general government and municipal securities and the issues of banks, railroads, and cooperatives are exempt from the provisions of the Act.

In order to register securities the issuer must file a registration statement on the particular form prescribed by the Commission as appropriate to the type of security proposed to be offered. When a registration statement is filed it becomes a public document designed to set forth all the material facts known to the issuer, and the underwriters with regard to the company and the securities to be sold. These include among other things, statements with regard to the character, size, and profitableness of the business, its capitalization, the purpose of the issue options outstanding against securities of the issuer, remuneration of officers and directors, bonus and profit-sharing arrangements, underwriters" commissions, and pending or threatened legal proceedings. Certified financial statements must be included. In order that investors may have in convenient form the basic material contained in the registration statement, the Act also requires that they be furnished a prospectus containing at least the more important information in the registration statement. In addition to providing the public information on which to reach an informed judgment with regard to whether or not to purchase securities, the registration statement and prospectus serve as a record of the representations made at the time the securities were sold, and thereby simplify the problem of proof in any legal proceedings which may arise with regard to whether the registration statement or the prospectus contains untrue or misleading statements or omits material information.

Experts were drafted from specialized classes of issuers to assist in the preparation of forms and rules suitable to the specialized needs of their particular fields. It has been the Commission's established practice from the outset to submit every proposed registration form to those persons to whom it would apply and to seek their comments and criticisms. Through this system improvement has been made from time to time in the process for registering securities. It has been the constant aim of the Commission to devise additional ways of simplifying the mechanics of registration that could be made effective without foregoing the protection of the public and investors. It should be borne in mind, however, when it is asserted that some of the disclosures required appear to be needlessly searching, that the evaluation of a corporate security by the public is difficult under the most favorable circumstances and it is rendered unnecessarily hazardous if it must be done without all the relevant facts. It is not a simple thing to draft a registration form to meet the needs of vast corporations which are not

simple, which have intricate capital structures, scores of subsidiary companies and far-flung and varied business activities. Late in 1942 the Commission effected a comprehensive simplification of a number of registration and reporting requirements under several of the statutes, including a new general form for registration of commercial and industrial corporate securities. This form, S-1, permits the filing of the prospectus as a principal part of the registration statement, thus eliminating much duplication between the prospectus and the registration statement proper.

The examination of a registration statement by the Commission's stall does not involve and is not concerned with an appraisal of the merits of the security as an investment since the Commission is not authorized to and does not pass judgment upon the soundness of any security. Under the Act, speculative or apparently unsound issues can be registered. and sold provided the whole truth is told. It follows that the Commission does not direct the flow of capital or try to do so, although, of course, the necessity of disclosing the truth concerning the security flotations may affect their reception. The basic policy is not to attempt to protect the investor by insulating him from risk but to make available to him the information with which to gage the risk.

The Commission has no authority specifically to require an amendment to the registration statement. However, it is authorized by Section 8 of the Act to issue an order preventing or suspending the effectiveness of a registration statement if, after notice and opportunity for hearing, it finds that the statement is inaccurate or incomplete in any material respect. Ordinarily this procedure is unnecessary and the Commission does not resort to it except in those cases where there has been a definite or intentional effort to conceal or mislead.

In the interest of good administration, fair treatment of registrants, and minimum interference with business, a procedure not specifically spelled out in the Act was adopted early in its administration. Registrants are informally advised of any material misrepresentations or omissions as promptly as possible after the statements are filed, thus affording an opportunity for the filing of correcting amendments before the statements become effective. Through this "letter of deficiencies" the Commission is able to advise the registrant of the information that must be corrected or supplemented in order to meet the disclosure standards prescribed by Congress. Another informal Procedure that has proved useful is the profiling conference in which representatives of registrants and underwriters discuss problems in connection with the proposed filing with the Commission's staff for the purpose of determining in advance what types or methods of disclosure would be necessary under the circumstances of the individual case. This informal method of handling cases lies injected an element of flexibility into the registration procedure which has proved so satisfactory that it has not been necessary to issue a stop order since 1941.

The time required to examine and clear a registration statement depends largely on whether a simple or complex situation is involved. The original Section 8 (a) of the Act required a 20-day waiting period after filing before the registration statement could become effective. Moreover, any amendment filed prior to the effective date starts the 20-day period running anew unless the Commission accelerates the amendment by dating its filing back to the original filing date of the registration statement. The principal objectives of the waiting period are to give the public an opportunity to absorb the information in the prospectus or registration statement and to get away from the hasty methods of distribution previously in vogue which practically compelled minor distributors and dealers to make commitments blindly.

The Commission has endeavored to adapt its procedures to the accustomed practices of businessmen and distributors of securities insofar as this is consistent with the intent of Congress and the protection of investors. When the Commission found, therefore, after a study of the needs of the business, that a 20-day waiting period after the filing of amendments would, in many cases involve an unnecessary hardship, it adopted the policy, when amendments are not too important and complicated, of permitting registration to become effective on the twentieth day after the original filing date or as soon thereafter as possible.

On August 22, 1940, Section 8 (a) was amended, with the support of the Commission, to give the Commission discretionary authority to accelerate the effective date under certain circumstances without regard to the original 20-day period. In other words, the amended section provides that the effective date shall be the twentieth day after the filing of a registration statement or such earlier day as the Commission may determine but the Commission is required to give due regard to such matters as the adequacy of the information respecting the issuer which has previously been made public and the case with which the rights of the holders of the securities to be issued can be understood. The Commission cooperates with registrants in expediting registration as much as possible consistent with the public interest and the protection of investors. Registrants who are able readily to meet the standards of the Act and the rules of the Commission obtain effective registration of their securities in substantially less than 20 days after filing.

Since Section 5 of the Act prohibits offers or sales to be made prior to the effectiveness of the registration statement, issuers and underwriters were, at first, reluctant to send out any information to potential investors during the waiting period for fear such circulation would be construed as an offer to sell securities. Early in its history, therefore, the Commission, in order to make information available to potential investors, published several opinions of its general counsel

to the effect that distribution of information contained in the registration statement prior to the effective date of the registration statement would not constitute an illegal offer provided it were very clearly explained that the circulation was not intended as an offer of the security. This has resulted in the more or less common practice of underwriters and dealers circulating, prior to the effective date of the registration statement, the so-called “red herring” prospectus which derives its name from the practice of printing in red letters either diagonally across or along the margin of each page a clear statement that the document is not intended as an offer of the security and directing attention to the prohibitions in the Act against offers prior to effective registration.

VOLUME OF REGISTRATIONS UNDER THE SECURITIES ACT

From the date of its enactment to June 30, 1944, there were filed under the Act 5, 420 registration statements, of which 4,510 became effective covering securities of a total value of $25,345,392,000. Of the statements which had become effective, 173 were later withdrawn or subject to stop order so that the ultimate disposition of the 5,420 registration statements filed was as follows: 4,337 became effective and were not subsequently subject to stop order or withdrawn; 855 were withdrawn; 182 were subject to stop or refusal orders; and 46 were pending at the end of the period. For the fiscal year ended June 30, 1944, 221 registration statements became effective, covering 301 issues of securities in the amount of $1,759,780,000, which was nearly three times the volume of that category in the preceding fiscal year. Approximately one-half of the new issues registered in the past fiscal year for cash sale were debt securities. Detailed statistics relating to new issues of securities offered for cash sale, the proposed uses of net proceeds from the sale of all new corporate issues, and the issues effectively registered under the Securities Act, including data on costs of flotation of equity issues registered by small companies, will be found in the Appendix, Tables 1 to 4, inclusive.

The following table indicates the disposition of registration statements filed under the Securities Act of 1933 as amended:

[table omitted]

A total of 734 amendments [Footnote: These amendments include 486 classed as “pre-effective” and 248 as “post-effective,” and do not take into account 361 others of a purely formal nature classed as “delaying” amendments.] to registration statements were also filed and examined during the past fiscal year, compared with a corresponding total of 471 during the proceeding year.

Certain registrants under the Securities Act of 1933 also filed during the year, pursuant to section 15 (d) of the Securities Exchange Act of 1934, 348 annual reports [Footnote: 76 of the above annual reports and the 250 quarterly reports were filed pursuant to Section 30 of the Investment Company Act of 1940 also.] and 47 amendments thereto, and 250 quarterly reports and 5 amendments thereto, all of which required examination.

In addition, the following supplemental prospectus material was filed and examined during the past fiscal year under the Securities Act of 1933:

Two hundred and twenty-two prospectuses pursuant to Rule 800 (b) which requires the filing of such information within 5 days after the commencement of the public offering.

One hundred and seven sets of supplemental prospectus material showing material changes occurring after the commencement of the offering.

Two hundred and twenty-two sets of so-called 13-months prospectuses pursuant to Section 10 (b) (1) of the Act.

Thus during the past fiscal year there were filed in the aggregate 551 additional prospectuses of these three classes.

At the same time, 213 supplementary statements of actual offering price were filed as required by Rule 970; and there were 11 instances where registrants voluntarily filed supplemental financial data.

EXEMPTIONS

Securities of the following issuers are exempted from registration under the provisions of the Securities Act: The United States, any State, Territory, municipality, or political subdivision thereof, a national bank or banking institution organized under the laws of any State or Territory or the District of Columbia and supervised by a State or territorial banking commission or similar official; railroads the issuance of whose securities is subject to approval by the Interstate Commerce Commission; persons organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit; building and loan associations and farmers" cooperative associations as defined in specified sections of the Revenue Act. Securities issued in the following transactions are also exempted from registration; securities which are part of an issue exchanged by an issuer with its existing security holders exclusively where no commission or other remuneration is paid or given for the solicitation of the exchange; securities issued in exchange for one or more outstanding securities, claims or property interests, or partly in

such exchange and partly for cash, where the terms and conditions of the issuance thereof have been approved by a court or regulatory body of the United States or any State which is authorized to approve the issuance after a hearing upon the fairness of the terms and conditions of the offer at which all parties have a right to appear; and securities which are part of an issue sold only to persons resident within a single State or Territory where the issuer of such securities is incorporated in and doing business within such State.

In addition, the Act provides exemptions from its registration and prospectus requirements for transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; and dealers" transactions made more than a year after a registered offering except in situations where the dealer is performing the functions of an underwriter of the securities.

Moreover, Section 3 (b) of the Act gives the Commission authority to exempt from the registration requirements any class of securities issued in an amount not exceeding $100,000, subject to such conditions as the Commission may prescribe. In accordance with this section, the Commission has issued rules and regulations which enable an issuer to sell securities without registration in an amount not exceeding $100,000. These rules merely require the filing of a brief letter of notification with the Commission at least 24 hours prior to the offering, together with copies of any prospectus proposed to be issued in connection with the offering.

Private Placements

For the 10-year period ended June 30, 1944, $22,272,641,000 of new corporate securities were offered for cash in the United States. Of that amount, approximately $14,757,530,000 or 66.3 percent were registered, and nearly $7,515,000,000 were exempt from registration under the Securities Act. Slightly over half of the exempt securities were privately placed, and most of the balance were issued under the authority of the interstate Commerce Commission.

The substantial amount of corporate bond issues sold privately to institutional buyers in recent years is attributed by some critics of the Securities Act to a desire on the part of issuers to avoid the registration requirements of the Act. In the Commission's opinion., however, the real causes for the growth of private placements will be found in the unfolding of certain broad economic forces totally unrelated to the registration requirements of the Securities Act. They include the combination of a great expansion in the assets of legal reserve life insurance companies with a material decline in the volume of corporate bonds available for investment. it was primarily the resultant pressure of institutional funds for investment which led to the large increase in private placements. Moreover, as a

result of the decline in interest rates in recent years, coupled with increasing individual income tax rates, high grade corporate bonds have been less attractive to individual investors and the market for corporate bonds has been predominantly among institutional investors. Since 1941, when the Commission adopted its rule requiring competitive bidding in the sale of securities by registered public utility holding companies and their subsidiaries, the relative volume of private placements of utility securities has greatly declined.

Small Financing

As a means of facilitating small financing, representatives of the securities industry have urged that the present exemption limit of $100,000 be raised and the Commission has given serious consideration to the suggestion. In the hearings before the House Committee on Interstate and Foreign Commerce in 1941 on various proposals for amending the Securities Act of 1933 and the Securities Exchange Act of 1934, the Commission stated that it would not object to raising the exemption limit specified in Section 3 (b) of the Act to $300,000, if the provisions giving the Commission authority to impose terms and conditions essential to protect the public interest and the interest of investors were retained. [Footnote: On January 6, 1945, Senator Vandenberg introduced S.62, to amend Section 3 (b) of the Securities Act of 1933, as amended, so as to permit exemption of security issues not exceeding $3000,000 from the registration provisions of the Act.]

The exemption permitted by Section 3 (b) of the Act is not complete exemption from all provisions of the Act. It is limited by express provisions in Section 12, which imposes civil liability on persons who sell securities in interstate commerce or through the mails by means of untrue statements or misleading omissions, and in Section 17, which makes it unlawful to sell securities by such means or by other types of fraud. Each of these sections by its own terms is applicable to transactions regardless of whether the securities involved have been exempted under Section 3 (b). The principal effect of a Section 3 (b) exemption is to permit the sale of securities on the basis of a less complete disclosure than that required by the Act in the case of a registered security. Moreover, civil liabilities will be incurred only by the seller and the person controlling the seller, while in the case of the sale of a registered security, the full and fair disclosure described in the Act is required to be made and the civil liabilities of Section 11 run against all the persons specified in that section. This latter sanction against practically all persons concerned in the distribution of a security is one of the most important of implements in carrying out the policy of the Act, since it results in a concerted effort on the part of all concerned to provide full and fair disclosure of the character of the securities offered.

It has been urged that the proposed amendment to broaden the exemption permitted by Section 3 (b) will be helpful to small businesses that seek financing through public offerings of securities and for that reason the Commission has concluded that it merits a trial. Yet the Commission's records of the cost of small flotations of issues indicate that the major part of such costs is compensation to underwriters and distributors, and only a relatively small part is represented by other expenses, including those affected by registration requirement. This would seem to indicate that the registration requirements of the Securities Act have very little to do with the high flotation costs of small issues.

Statistics showing the flotation costs of equity security issues of small companies during the period from January 1, 1938 to June 30, 1944 are presented in appendix Table 2. There are included all common and preferred issues filed separately for primary distribution by companies having less than $5 million of assets, other than issues of investment trusts and extractive industry companies. The analysis shows that the total flotation costs of equity issues of companies reporting less than $1 million of assets amounted to 21.6 percent of the expected gross proceeds, which included 19.7 percent as compensation to underwriters and dealers and 1.9 percent for other expenses. Comparable figures for the companies reporting assets of between $1 and $5 million were 15.8 percent total flotation costs, which included 14 percent as compensation and 1.8 percent for other expenses.

Of course only a part of the "other expense" category is attributable to registration. Such expense items as issuance taxes, registrar's fees, trustee's fees, the cost of complying with State securities laws, and the cost of printing certificates and the preparation of underlying documents such as charter amendments and mortgages must be paid even though securities proposed to be offered are exempt from registration. Furthermore, even though registration were not required, there would in most cases be certain fees for legal and accounting services and expenses for the preparation of selling literature. It seems clear, therefore, that any measure designed to diminish that portion of the 1.8 or 1.9 percent "other expense" figure attributable to registration costs alone may not afford very substantial relief to enterprises that must pay in addition from 15 to 20 cents out of every dollar as commission to underwriters for selling their securities.

In connection with security issues for which exemption from the registration requirements of the Securities Act of 1933 is provided by the Commission's rules and regulations promulgated under Section 3 (b) of the statute, there were filed with the Commission during the past fiscal year a total of 427 letters of notification, pursuant to regulation A, and 209 amendments thereto, representing an aggregate offering price of $21,933,994 of which 40 letters of notification with an aggregate offering price of $1,413,252 related to offerings of oil and gas leases and securities of companies engaged in various phases of the oil and gas

business. During the past year also the Commission received and examined 362 offering sheets, filed pursuant to regulation B, and 376 amendments to such offering sheets, relating to fractional, undivided interests in oil and gas rights. The following table indicates the action taken with respect to these offering sheets:

[chart omitted]

Also during the past year the Commission received and examined confidential written reports concerning sales from a broker-dealer or offeror to an individual, or from one dealer to another, required under Rules 320 (e) and 322 (d) of Regulation. B. Of these reports, 3,237 were on Form 1-G and 599 on Form 2-G, representing sales aggregating $1,739,153 and $957,731, respectively.

CHANGES MADE IN RULES DURING PAST YEAR

The principal change in rules and regulations of the Commission adopted under the Securities Act of 1933 during the past year consists of amendments to Rules 5-04 and 12-06 of Regulation S-X. On December 22, 1942, the Commission adopted comprehensive amendments to Regulation S-X designed to simplify and shorten reports required to be filed by registrants by permitting under designated conditions the omission or partial omission of certain schedules. The Commission's experience with those amendments had not been entirely satisfactory. The revisions of December 9, 1943, are designed to secure with a minimum burden and expense certain information deemed essential relating to property, plant, and equipment. While the rules as amended call for the filing under certain circumstances of information with respect to property, plant, and equipment not previously required, the new requirements relating thereto are less than those existing prior to December 22, 1942.

As amended, Rule 5-04 permits the omission of Schedule V, property, plant, and equipment, if the total of such assets at both the beginning and end of the period does not exceed 5 percent of total assets (exclusive of intangibles) and if neither the additions nor deductions during the period exceeded 5 percent of total assets (exclusive of intangible assets). The amendment to Rule 12-06 provides that, in case the additions and deductions columns are omitted from Schedule V, as permitted by note 3 of Rule 12-06, the total of additions and the total retirements and sales shall be given in a footnote to the schedule.

During the past year the Commission also amended the instruction book for Form A-2 for corporations so as to eliminate unnecessary and obsolete matter and to clarify several of its instructions.

ENFORCEMENT AND COMPLIANCE

The enforcement of the statutes which it administers is, of course, one of the Commission's most important functions. Prior to the reorganization of its staff in 1942, this duty was performed by a separate legal division.. Since the reorganization, the enforcement of the provisions of the Securities Act of 1933 has been conducted by the Office of Counsel to the Corporation Finance Division. That office also investigates violations of Sections 14 (a) and 16 (a) of the Securities Exchange Act of 1934, governing the solicitation of proxies and the disclosure of stockholdings of officers, directors and more than 10 percent owners, the various disclosure requirements contained in the Trust Indenture Act of 1939 and the Investment Company Act of 1940, Section 10 (h) of the Securities Exchange Act of 1934 and Rule X-10B-5 thereunder, prohibiting fraud in the Purchase or sale of securities, and of Section 12 (h) of the Public Utility Holding Company Act of 1935 which prohibits political contributions by utility holding companies or subsidiaries. The enforcement of these provisions and the litigation with respect thereto are discussed under the respective Acts.

Enforcement under the Securities Act of 1933 is generally of a twofold nature, i.e., the prevention of fraud and the enforcement of the disclosure requirements.

Section 17 (a) of the Securities Act of 1933 makes unlawful the use of any misrepresentations or fraudulent schemes in the sale of securities. A very considerable part of the Commission's litigation involves injunctive actions to restrain violations of this section. For example, in S.E.C. v. Timetrust, Inc., 39 F. Supp. 145 (N. D. Calif. 1941), an injunction was obtained where representations were made that Timetrust certificates were similar to a savings account, whereas the solicitation to purchase such certificates was merely a device for selling Bank of America stock on the installment plan.[Footnote: On appeal, the Ninth Circuit Court on July 31, 1942, remanded the case to the trial court for specific findings of fact as to whether or not the defendants devised a fraudulent scheme within the prohibitions of the statute. On October 24, 1942, the trial court returned its additional findings of fact in which it found that all of the defendants employed by Timetrust as a device, scheme, or artifice to defraud. The Circuit Court on May 8, 1944, affirmed the judgment as to Timetrust Inc., Parker, Wood, and Blanchett, and reversed the judgment as to Bank of America. A.P. Giannini and L. Mario Giannini.] In S.E.C. v Investors Syndicate (D. Minn. 1943), an injunction was obtained where representations were made that the certificates sold were better or safer than United States War bonds, that the purchase of such certificates was a patriotic duty and aided the war effort, that the yield was higher than war bonds, and that the certificates were guaranteed by the United States or the Securities and Exchange Commission. A detailed description of this ease will be found under the discussion of the Investment Company Act of 1940.

The disclosure requirements have been discussed in some detail above. Where it appears after investigation that any of such requirements has been or is about

to be violated, the necessary action is instituted by the Commission. It may be noted at this time that Section 23 of the Securities Act of 1933 (as well as Section 26 of the Securities Exchange Act of 1934 and Section 35 of the Investment Company Act of 1940) prohibits any representation that the Commission has passed upon the merits or given approval to any security for which a registration statement has been filed. Where such statements were made, the Commission has instituted the necessary injunctive action to halt such activities.

The provisions of the Securities Act authorize the Commission to refuse to permit a registration statement to become effective if it appears on its face to be incomplete or inaccurate in any material respect, and empower the Commission to issue a stop order suspending the effectiveness of any registration statement which at any time is found to include any untrue statement of a material fact or to omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading. These provisions of the Act have been construed by the courts in several important cases. In Jones v. S.E.C., 298 U. S. 1 (1936), a majority of the Supreme Court (Justices Cardozo, Brandeis, and Stone dissenting) held that the commencement of stop order proceedings by the Commission prevented Jones" registration statement from ever becoming effective and that since none of the securities sought to be registered had been offered or sold there was no public interest which could be prejudiced by its withdrawal in accordance with Jones" request. On this basis the court held that the Commission had erred in denying withdrawal of the statement. This decision has been considered as largely limited to the procedure which the Supreme Court deemed proper for the Commission to employ in connection with the suspension of the effectiveness of registration statements. In a later case in 1939, Oklahoma-Texas Trust v. S.E.C., 100 F. (2d) 888, the Circuit Court of Appeals for the 10th Circuit unanimously affirmed an order of the commission suspending the registration of securities because of fraudulent misstatements contained in the registration statement. There it appeared that all of the securities registered had been sold prior to the commencement of the stop order proceedings and the Trust contended that under the authority of the Jones case the Commission had lost its power to issue a stop order. The court distinguished the Jones case, however, on the ground that here the public interest would be prejudiced by permitting the registrant to withdraw its registration statement. Immediate and subsequent purchasers of the securities were entitled to be apprised of the fact that the registration statement, a matter of public record, upon which they had relied, was false and misleading, and to have the benefit of the civil liability provisions which gave them various remedies for the losses which they sustained on the securities. In other cases the courts have held that a stop order suspending the effectiveness of a registration statement is not reviewable by the courts after it has been lifted upon the filing of amendments in accordance with the stop order (Austin Silver Mining Co. v. S.E.C., 1 S. F. C. Jud. Dec. 732, App. D. C., 1939), and that an order denying a motion for

permission to withdraw a registration statement without prejudice to renewal at the conclusion of the hearing then pending in connection with the stop order proceedings is merely interlocutory and not reviewable under the Act (Resources Corporation v. S. E; C., 97 F. (2d) 788, C. C. A. 7, 1938).

The question of the enforceability of contracts relating to the issuance or sale of securities which have not been registered as required by the Securities Act has been considered in two cases. In Frost and Co. v. Coeur d'Alene Mines Corporation, 312 U. S. 38 (1941), the Supreme Court held that an option to sell securities in violation of the Securities Act was not void and could lawfully be the subject of an action for damages for its breach. In that case the Commission, without taking any position as to the disposition of the particular case, filed a brief as amicus curiae in the Supreme Court, urging that, as a general proposition, the question whether such agreements should be enforced ought to depend upon whether or not in the circumstances of the particular case the public policy in favor of the protection of investors would be served or hindered by enforcing the agreement between the parties. In a later case, Judson v. Buckley, 130 F. (2d) 174 (C. C. A. 2, 1942), the Commission filed an amicus curiae memorandum in the Circuit Court of Appeals for the Second Circuit, explaining its view of the principle enunciated in the Coeur d'Alene case and contending that the agreement in the instant controversy should not be judicially enforced because there was no investor interest, immediately or otherwise, to be served by enforcement. The second circuit accepted the reasoning of the Commission but held that on the basis of facts in the record which neither the district court nor the Commission had considered, the parties were not equally guilty of violating the Act and that, accordingly, recovery should be allowed.

It must be remembered that in enforcing either the fraud or disclosure provisions, it is necessary that a sale of a security be involved. Not only is the Commission presented with instances of flagrant disregard of the statute in the sale of ordinary securities without compliance with the statute, but more subtle efforts have been made to evade such provisions. Sales of securities have been disguised and camouflaged so as to appear to be simple sales of real or personal property. The scheme usually adopted is to execute to the investor what appears to be an ordinary bill of sale. Coupled with this is an oral or written understanding that the property sold is to remain in the possession and control of the promoter who is to distribute the profits to the purchaser. In S.E.C. v. Payne, 35 F. Supp. 873 (S. D. N. Y. 1940), the security was disguised as a purported sale of silver foxes. In S.E.C. v. Cultivated Oyster Farms, 1 S.E.C. Jud. Dec. 672 (S. D. Fla., 1939), it was oyster bottom acreage. In S.E.C. v. Tung Corporation, 32 F. Supp. 371 (N. D. Ill., 1940), and S.E.C. v. Bailey, 41 F. Supp. 647 (S. D. Fla., 1941), it was interests in tracts for the development of tung trees. Other cases of the same nature were S.E.C. v. Pyne, 33 F. Supp. 988 (D. Mass., 1940), shares in fishing boats; S.E.C. v. Bourbon Sales Corp., 47 F. Supp. 70 (W. D. Ky, 1942),

whiskey bottling contracts; S.E.C. v. Universal Service Corp.,. 106 F. (2d) 232 (C. C. A. 7, 1939) cert. den., 308 U. S. 622 (1940),. contributions to a scientific crop growing enterprise; S.E.C. v. Crude Oil Corporation, 93 F. (2d) 844 (C. C. A. 7, 1937) crude oil; S.E.C. v. Joiner, 320 U. S. 344 (1943), oil and gas leases; S.E.C. v. City Meter Service (D. N. J., 1939) and S.E.C. v. Parking Meter corp. (N. D. Ohio, 1939), parking meters; S.E.C. v. Sentenal (S. D. Ohio, 1941), popcorn machines; S.E.C. v. Gilbert, 29 F. Supp. 654 (S. D. Ohio, 1939), shares in cargo boats; S.E.C. v. George Washington Cemetery (D. N. J., 11142), cemetery lots; S.E.C. v. Monjar (D. Mass., 1942), "personal loans." Such efforts to evade the statute are due usually to the inherent unsoundness of the securities sold, in the case of the sale of tung tree land, for instance, it was shown that the acreage being sold was not suitable for such production.

The Commission, of course, does not take the position that an ordinary sale of real or personal property involves the sale of a security. But where a purchaser has no intention of assuming any control of the property purchased, but is really buying only an interest in a business enterprise and looks solely to the efforts of the promoter to earn a profit for him, the courts have sustained the Commission's position that the substance controls the form and that there is involved the sale of a security and in the use of misrepresentations and fraudulent schemes an injunction should be issued. As the Supreme Court recently said in the Joiner case:

* * * the reach of the act does not step with the obvious and commonplace, novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts" or as "any interest or instrument commonly known as a security"

In several cases the courts have defined the statutory term sale of security to include the stamping by a company of securities previously issued by it with a legend reciting an agreement of the holders to an extension of maturity (S.E.C. v. Associated Gas and Electric Co., 24 F. Supp. 899, S. D. N. Y., 1938), the solicitation of subscribers to an investment advisory service to sign statements that they would or "may" accept stock in a corporation not yet in existence (S.E.C. v. Starmont, 31 F. Supp. 264, E. D. Wash., 1939), and an exchange of property for stock (U. S. v. Riedel, 126 F. (2d) 81, C. C. A. 7, 1942), In (U. S. v. Kopald-Quinn and Co., 1 S.E.C. Jud. Dec. 371 (N. D. Ga., 1937), a dealer's confirmation slips were held part of the securities transactions and the final step in their sale for the purpose of determining whether the mails were used in the sale of a security. In National Supply Co. v. Leland Stanford Junior University, 134 F. (2d) 689 (C. C. A.. 9, 1943), the Commission's interpretative rule excluding from the definition of a sale the issuance in a statutory merger or

consolidation of new securities exclusively to the security holders of the constituent corporations was upheld.

In two criminal cases the courts have included within the definition of an issuer liable for using the mails to sell securities without a registration statement being in effect, promoters and stockholders who completely dominated the corporations concerned (Landay v. U.S., 108 F. (2d) 698 C.C. A. 6, 1939, and Shaw v. U.S., 131 F. (2d) 476, C.C.A. 9, 1942).

In S.E.C. v. Chinese Benevolent Assn., Inc., 120 F. (2d) 738 (C.C.A. 2, 1941, the court held that a benevolent association acted as an underwriter where it solicited offers to buy bonds of the Republic of China and received funds therefore which it transmitted to that country, and accordingly was not entitled to the benefit of the statutory exemption permitting the sale of unregistered securities by any person other than an issuer, underwriter, or dealer. So, too, in Merger Mines Corporation v. Grismer, 137 F. (2d) 335 (C. C. A. 9, 1943), it was held that the president of a mining corporation occupied the position of an underwriter in publicly offering stock issued to him in replacement of stock previously loaned to the corporation; and persons who purchased securities with a view to distribution from a corporation under common control with. the issuer were held to be underwriters as defined by the Act and their sales of stock through use of the mails and facilities of interstate commerce were in violation of the registration provisions of the Act (S.E.C. v. Saphier, 1 S.E.C. Jud. Dec. 291, S. D. N. Y., 1936).

While the Securities Act contains a number of provisions exempting various types of securities and securities transactions from the registration provisions of the Act, only a few of these exemptions have been considered by the courts. Perhaps the most important of the cases dealing with this problem is S.E.C. v. Sunbeam Gold Mines Co., 95) F. (2d) 699 (C. C. A. 9, 1938). That ease involved the interpretation of the provision of Section 4 (1) of the Act which excepts from the registration provisions “transactions by an issuer not involving any public offering.” The question was whether the solicitation of loans from stockholders of two mining companies for the purpose of completing the purchase by one of the assets of the other and of raising enough money to register a contemplated new issue of stock with the Commission involved a “public offering.” The total number of stockholders of both companies was 530. The court held that the distinction between “public” and “private” depends upon the circumstances under which the distinction is sought to be established and the purposes sought to be achieved by the distinction. In accordance with the legislative history of the Act, the court held that an offering to stockholders other than a very small number was a public offering. To the same effect is Corporation Trust Co. v. Logan, 52 F. Supp. 999 (D. Del. 1943).

The Securities Act, like the other statutes administered by the Commission, authorizes the Commission to conduct investigations for the purpose of determining, upon complaint or otherwise, whether any previsions of the Act or of any rule or regulation issued thereunder, have been or are about to be violated, For the purpose of such investigations, the Commission, any of its members, and any officers designated by it, are statutorily empowered to administer oaths, subpoena witnesses, take evidence and require the production of books, records, and other documents which the Commission deems relevant or material to the inquiry. Information disclosed through investigations may be made public by the Commission, and may serve as the basis for formal hearings conducted by the Commission, for injunction actions instituted by the Commission or for reference to the Department of Justice to institute criminal proceedings.

Considerable litigation has arisen from refusals to appear in response to Commission's subpoenas. In such situations, applications are made to the appropriate United States Court for enforcement. The subpoenaing of witnesses and documentary evidence in the course of investigations instituted by the Commission has resulted in nearly 50 legal actions brought for the most part by the Commission for the purpose of obtaining judicial enforcement of the subpoenas and in a few cases against the Commission for the purpose of enjoining enforcement of the subpoenas. The Jones case discussed above was actually a suit by the Commission to obtain judicial enforcement of a subpoena requiring Jones to appear and testify in the Commission's stop order hearing. Jones" challenge of the constitutionality of the registration and investigation provisions of the Securities Act was rejected by the New York District Court and by the second circuit, which upheld the Commission's right to obtain judicial enforcement of the subpoena in that case. Although the Supreme Court reversed the judgments of the courts below, for the reasons previously stated, it did not disturb their holdings sustaining the constitutionality of the Act. Noteworthy in this connection is the ease of Newfield v. Ryan, 91 F. (2d) 700 (C. C. A. 5, 1937), cert. den., 302 U.S. 729 (1937), a consolidation of 3 suits brought against the Commission's representatives and the Western Union and Postal Telegraph Companies to enjoin compliance with subpoenas calling for the production of certain telegrams. After the Supreme Court denied certiorari, the subpoenas were ordered enforced. A similar situation arose in McMann v. Engel, 16 F. Supp. 446 (S. D. N. Y. 1936), affd. McMann v. S.E.C., 87 F. (2d) 377. (C. C. A. 2, 1937), cert. den. 301 U. S. 684 (1937), where an effort was unsuccessfully made to prevent a brokerage firm from complying with a Commission subpoena. In these cases and in Consolidated Mines of California v. S.E.C., 97 F. (2d) 704 (C. C. A. 9, 1938), the courts unanimously upheld the propriety and legality of the Commission's investigations against charges of "snooping" and "fishing expedition," as being adequately justified by facts in the possession of the Commission; and found the subpoenas to be properly issued and reasonably limited so as not to constitute an unreasonable search or seizure or invasion of

privacy. In 3 recent cases, S.E.C. v. Penfield Co., 143 F,(2d) 746 (C. C.A. 9, 1944), S.E.C. v. Gulf States Royalty (S. D. Mass. No. 615, 1943), and S.E. C. v, McGarry (D. Colo. 1944), the courts in connection with Securities and Exchange Commission subpoenas have followed the rule in Endicott-Johnson v. Perkins, 317 U. S. 501, in which the Supreme Court held that the Secretary of Labor was entitled to enforcement of a subpoena upon a showing merely that it was not plainly incompetent or irrelevant.

The circumstances of the Penfield case have brought to the fore a weakness in the Commission's statutory investigation procedure which was undoubtedly not foreseen by the framers of the Commission's Acts. Although the Commission was doubtless given the power to conduct investigations for the purpose of discovering whether violations of the Acts have occurred, in order to provide a law enforcement weapon that would be more effective than the cumbersome grand jury investigation procedure, it has been the Commission's experience, drawn from the Penfield case and other cases, that suspected wrongdoers designedly may seek to delay the discovery of their violations by forcing the Commission to go through lengthy court proceedings to obtain enforcement of its subpoenas. The decision in the Penfield case illustrates the problem. As the court pointed out, the Commission began an investigation against Bourbon Sales Corp. and several individuals on May 14, 1942. The purpose of the investigation was to determine whether they had violated the registration and fraud provisions of the Securities Act in the sale of whiskey bottling contracts. A subpoena issued by the Commission was not obeyed, and the Commission was obliged to apply to a Federal district court for an enforcement order, which was issued on October 15, 1942. The enforcement of that subpoena disclosed a hitherto unknown relationship between Penfield and Bourbon Sales. The Commission found that Penfield had been acting as agent for the Bourbon Sales Corp. in selling bottling contracts through the mails to persons to whom Bourbon Sales or Penfield had previously sold whiskey warehouse receipts and that Penfield had subsequently sold its own bottling contracts through the mails in exchange for such receipts. The Commission also learned for the first time that stock of Penfield was being sold to the public in exchange for bottling contracts previously issued either by Penfield or Bourbon Sales. On April 8, 1943, the Commission its investigation to name the Penfield Co. and to cover the sale of Penfield stock. On April 9, 1943, a duly authorized officer of the Commission served a subpoena duces tecum upon one of Penfield's officials requiring the production of specified items contained in Penfield's books and records. Penfield refused to comply with the subpoena and the Commission was again obliged to resort to a Federal district court for its enforcement. The district court issued an order enforcing the subpoena on June 1, 1943. The appeal to the Ninth Circuit Court of Appeals followed, and on June 30, 1944 it affirmed the district court's enforcement order. Shortly thereafter the mandate of the Ninth Circuit was stayed to permit the Penfield Co. to apply to the United States Supreme Court.

Thus more than 2 years had elapsed and the Commission had not been able to obtain certain facts sought in its investigation. The fact that prosecutions are barred 3 years after the offense, makes it apparent that such delays may often prevent proper enforcement of the law. [Footnote: Since the close of the period covered by this report, the Penfield Co. and several of its officials have been indicted.] A possible remedy for this situation would be an amendment to the general statute of limitations tolling the statute for the period during which an administrative investigation is in progress with respect to enforcement proceedings or at the very least while proceedings to enforce subpoenas are pending in the courts.

As an offshoot to some of the above types of actions are the contempt actions brought by the Commission for violation of court decrees. These actions have been chiefly for disobedience to three types of decrees; these enjoining the illegal sale of securities; those relating to the improper solicitation of proxies, and those ordering enforcement of subpoenas.

At the direction of the President of the United States, investigations have been made of certain corporations holding important war contracts. Confidential reports of such investigations have been forwarded to the White House.

PROCEDURE

Thousands of complaints are received from the public each year in addition to matters brought to the attention of the Commission by the several State securities officials, Better Business Bureaus and other Federal and State authorities. All of these receive careful attention and where it appears that the statutes have been violated, an investigation is instituted. The bulk of the investigative work is performed by the 10 regional offices which are strategically located in financial centers throughout the country. Where violations have occurred legal action is instituted by the Commission. Such action may be either civil or criminal. The civil actions consist primarily of actions for injunctions against the continuance of the violations. Such actions are instituted in the appropriate United States District Court and permanent injunctions are obtained in the great majority of cases. These are usually preceded by preliminary injunctions, and in instances where serious and immediate violations are threatened, by a temporary restraining order. During the 10-year period ended June 30, 1944, the Commission had instituted a total of 508 civil proceedings and disposed of 475. Permanent injunctions had been obtained against 1,057 firms and individuals. Of 516 terminated eases brought by or against the Commission, it was successful in 98 percent of them, only 10 cases being adversely decided. [Footnote: There have been a number of private suits by investors to enforce the civil liabilities imposed by the Act for the sale of securities which were not

registered in violation of the Act, and for the sale of securities by means of registration statements or prospectuses containing false statements of or omitting to state material facts. The Commission has no statutory duties with respect to such suits and is not fully advised of their number or outcome. However, a search of the court records covering a period of 8 years reveals that there were less than 2 dozen actions under all three of the civil liabilities of the act. Moreover, so far as could be determined, not more than five suits resulted in recovery by the plaintiffs. See also 50 Yale Law Journal, 90, 1940, "Civil Liability under the Federal securities Act."]

The most stringent remedy possessed by the Commission is its power to refer cases for criminal prosecution to the Department Justice. When such action is warranted after a thorough investigation, a detailed report is made and submitted to the Attorney General. Members of the Commission's staff work in conjunction with the Department of Justice in preparing the case and presenting it to the grand jury and also frequently participate in the trial.

Recognizing the advantages to be realized from cooperating with other Federal and State agencies and certain private organizations such as better business bureaus, chambers of commerce, etc., interested in the prevention of fraud in the sale of securities, there has been established in the division, in connection with its enforcement duties, a securities violations file which serves as a clearing house for information concerning fraudulent securities transactions. Law enforcement officials and cooperating agencies throughout the Nation forward information and data to the counsel's office where it is classified and compiled and becomes available to such officials and agencies in the cooperative purpose of suppressing illegal practices in the sale of securities. As of June 30, 1944, these files contained data concerning 44,399 persons. During the past fiscal year alone, additional items of information relating to 4,069 persons were added to the files, including information concerning 960 persons not previously identified therein.

INVESTIGATIONS OF OIL AND GAS SECURITIES TRANSACTIONS

Because of the technical nature of securities representing oil and gas interests and the specialized knowledge necessary in order properly to apply the statutory requirements to offerings of such securities, the Commission established, on July 1, 1936, a separate oil and gas unit. It also adopted separate regulations, under Section 3 (b) of the Act, providing exemptions from registration for offerings of securities of this character not in excess of $100,000. The Oil and Gas Unit administers those regulations and registration statements covering the securities of oil and gas companies are referred to this Unit for examination and, where necessary, for field investigation.

During the past fiscal year investigations were made with respect to a total of 123 oil and gas properties or proposed securities offerings. Most of these investigations arise out of complaints received by the Commission and are conducted primarily to ascertain whether the transactions in question were effected in violation of either Section 5 or 17 of the Securities Act of 1933. An increasing number of such cases, however, relate to possible violations of Section 15 of the Securities Exchange Act of 1934. Where these investigations show evidence of criminal violation, the results are transmitted by the Commission to the Department of Justice, and criminal proceedings are instituted in the discretion of the Attorney General of the United States. In the event such proceedings are instituted, the Commission's attorneys and engineers who participated in the investigation leading up to the proceedings assist the United. States attorneys in the preparation of the cases for presentation to the grand jury and for trial. A tabular summary of the oil and gas investigations made last year follows:

(chart omitted)

ADVISORY AND INTERPRETATIVE ASSISTANCE

From its inception, the Commission has realized that the technical nature of the statutes administered by it requires the maintenance of an interpretative and advisory service to provide attorneys and the general public with prompt advice concerning problems arising under those statutes. These requests embrace a wide variety of subjects and often involve intricate factual situations. A knowledge of the legislative history of the statutes and the application of the statutes to practical business situations is required of the attorneys engaged in this work.

Many of the general inquiries pertain to small business enterprises seeking capital. The Commission is fully aware of the problems confronting such concerns and endeavors to assist them by furnishing upon request detailed advice as to the procedure for registration and the possibility of exemption from the registration and prospectus requirements. The more complicated situations are studied and an opinion by the counsel to one of the divisions is rendered as to the applicability of the various statutes administered by the Commission. These opinions are generally sought by careful attorneys and securities houses in situations which might involve duties under the various acts. Counsel's opinions are not rendered with respect to possible private civil liabilities since the Commission has no jurisdiction over these matters. Although a compilation of interpretations has been prepared to assist in according uniform treatment in recurring situations, the great variety of problems has not made it feasible to publish a glossary of annotations. Nevertheless, a number of interpretations of general application have been made public in release form as opinions of the

counsel to the division administering the statute to which the interpretation relates.

One of the problems frequently presented for interpretation is whether or not a stockholder who intends to offer a security to the public through an underwriter is in "control" of the company which has issued the stock. If a control relationship exists the securities may be required to be registered under the Securities Act. As there is no fixed statutory definition of "control," the determination often depends on a study of all the facts relating to the history and operation of the company, its officers and chief stockholders, and their business affiliations. If there is a dispute on this question, the only way to settle it is to go to court, for, while the Commission has the power of investigation, there is no provision in the statute for administrative proceedings to reach such determination. During a re-capitalization or reorganization the question is frequently asked at what point when, as, and if issued trading in the new securities may be commenced. Various types of option agreements and trusts for the benefit of close relatives give rise to questions with. respect to the duty of an officer, director or 10 percent equity stockholder of a listed company to file reports pursuant to the Securities Exchange Act showing changes in the beneficial interest of such officer, director, or 10 percent stockholder in the securities of the listed company.

In order to assure uniformity, the offices of counsel to the Corporation Finance Division and counsel to the Trading and Exchange Division review the interpretations rendered by the staffs of the 10 regional offices of the Commission. The New York Regional Office alone handles about 20,000 inquiries a year which it receives from attorneys, brokers, investment Companies, and other members of the public.

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

The status of this program has been described in the foreword to this report.

Part II

ADMINISTRATION OF THE SECURITIES EXCHANGE ACT OF 1934

The congressional investigations and hearings in 1934 had demonstrated that widespread and flagrant abuses, including the excessive use of credit, existed in the securities markets which materially impaired the economic usefulness of these markets and which adversely affected the stability and orderliness of the economic life of the Nation, precipitating, intensifying, and prolonging

emergencies in that area. In order to insure the maintenance of fair and honest securities markets, and to prevent the undue use of credit, the Securities Exchange Act of 1934 was promulgated. It is designed to eliminate manipulation and other abuses in the trading of securities both on the organized exchanges and in the over-the-counter markets, which together constitute the Nation's facilities for trading in securities; to make available to the public information regarding the condition of corporations whose securities are listed on any national securities exchange; and to regulate the use of the Nation's credit in securities trading. The authority to issue rules on the use of credit in securities transactions is lodged in the Board of Governors of the Federal Reserve System, but the administration of the rules and all provisions of the Act is vested in the Commission. The following is a review of the major phases of the Commission's administration of the Act.

REGULATION OF EXCHANGES AND EXCHANGE TRADING

Registration of Exchanges

Section 5 of the Securities Exchange Act of 1934 requires that all exchanges in the United States either register with the Commission or obtain exemption from such registration. Accordingly, the Commission's first task under the Act was to set up the machinery for registering securities exchanges and for handling applications for exemption.

Pursuant to the Act, 28 exchanges have filed applications for registration as national securities exchanges, practically all of them filing in 1934. Before granting registration to certain exchanges, investigators were sent into the field to examine them, and reports were filed by trial examiners before whom hearings were held. In connection with these applications for registration, the constitution, bylaws, and rules and regulations of each exchange were examined and analyzed. Moreover, as the statute required, agreements were obtained from each exchange to comply with the provisions of the Act and any rules and regulations thereunder, to enforce compliance with such provisions by its members, so far as is within its power, and to supply the Commission with copies of amendments to its rules. In conformity with the provisions of the Act, each exchange was also required to include in its rules provision for the disciplining of members for conduct inconsistent with just and equitable principles of trade, and to declare that any willful violation of the Act or the rules or regulations adopted thereunder shall be considered inconsistent with just and equitable principles of trade.

On October 1, 1934, 22 exchanges were registered as national securities exchanges. Three exchanges were registered on later dates after having operated as exempt exchanges for periods of time. These latter were the

Standard Stock Exchange of Spokane, the Chicago Curb Exchange Association, and the San Francisco Mining Exchange.

Since October 1, 1934, mergers and dissolutions have reduced the number of registered exchanges to 19. The Buffalo Stock Exchange, Denver Stock Exchange, Chicago Curb Exchange Association, and New York Real Estate Securities Exchange, in that order, were granted permission to withdraw from registration. The Los Angeles Curb Exchange merged with the Los Angeles Stock Exchange, and the San Francisco Curb Exchange merged with the San Francisco Stock Exchange. It is to be noted that all six of the exchanges which terminated their existence had opened for trading during the years 1928 - 29.

The following exchanges are now registered as national securities exchanges:

Baltimore Stock Exchange
Boston Stock Exchange
Chicago Board of Trade
Chicago Stock Exchange
Cincinnati Stock Exchange
Cleveland Stock Exchange
Detroit Stock Exchange
Los Angeles Stock Exchange
New Orleans Stock Exchange
New York Curb Exchange
New York Stock Exchange
Philadelphia Stock Exchange
Pittsburgh Stock Exchange
Salt Lake Stock Exchange
San Francisco Mining Exchange
San Francisco Stock Exchange
St. Louis Stock Exchange
Standard Stock Exchange of Spokane
Washington Stock Exchange

Section 5 of the Securities Exchange Act of 1934 provides that exemptions from registration may be available for in exchange when the limited volume of transactions renders it unnecessary and impracticable to require registration. Pursuant to this provision, 22 exchanges have applied for exemption since 1934. Ten exchanges have been granted permanent exemption from registration as national securities exchanges:

The Honolulu Stock Exchange
Milwaukee Grain and Stock Exchange
Minnesota-St. Paul Stock Exchange

Richmond Stock Exchange
Wheeling Stock Exchange
Colorado Springs Stock Exchange
Seattle Stock Exchange
Standard Stock Exchange of Spokane
Chicago Curb Exchange Association
San Francisco Mining Exchange.

The last 3 subsequently became, registered exchanges and the Milwaukee Grain and Stock Exchange and Seattle Stock Exchange subsequently suspended operations as securities exchanges, thus leaving but 5 exempted exchanges.

Most of the remaining exchanges withdrew their applications and dissolved. These exchanges were typically small, had a limited number of members, and had brief trading sessions. In some cases, the quotations arrived at and published en these exchanges were similar in character to those prevailing in the over-the-counter markets. In other cases, the rules of the exchanges were altogether inadequate.

The rules, practices, and organization of the various registered and exempted exchanges have been subjected to constant study by the Commission. The first of these studies was made pursuant to the direction of Congress, embodied in Section 19 (c) of the Securities Exchange Act of 1934 which directed the Commission to make a study and investigation of the rules of national securities exchanges with respect to the classification of members, the methods of election of officers and committees to insure a fair representation of the membership, and the suspension expulsion, and disciplining of members of such exchanges.

This report was made on January 25, 1935. [Footnote: “Report on the Government of Securities Exchanges,” H.R. Doc. No. 85, 74th Cong., 1st sess.] Numerous other studies have since been made which will be referred to from time to time below.

As a result of the Commission’s recommendations, as well as on their own initiative, the various exchanges have made many changes in their rules, practices, and organization which have been reflected in amendments to their application for registration or exemption. The exchanges have filed, on an average, about 230 amendments and supplements to these applications each year during the past 10 years. Each of these amendments and supplements has been studied and analyzed for its effects upon the public interest and its compliance with the relevant regulatory provisions.

Reorganization of Securities Exchanges

The Commission's early study of the rules and organization of the exchanges, referred to above, had disclosed certain serious defects which were hindering the exchanges" effective assumption of a substantial degree of responsibility for the conduct of their business. Therefore, the Commission's report to the Congress recommended that governing committees and other committees of the exchanges be more truly representative of the members and members" partners, that nominations be by petition instead of by nominating committees, that the public be represented on the governing committees and in executive offices, and that expenses of arbitration be reduced.

After numerous conferences with representatives of the exchanges, the Commission in 1937 publicly requested the New York Stock Exchange to work out a satisfactory plan of reorganization. In accordance with this request, the New York Stock Exchange appointed an independent committee to study and report on the need of reorganization. This committee, headed by Carle C. Conway, chairman of the board of directors of the Continental Can Co., submitted a report to the exchange on January 27, 1938. The report recognized the fact that national securities exchanges are public institutions, and it provided a plan for a modern administrative organization.

Six weeks later, Richard Whitney & Co. was suspended for insolvency. The facts regarding the administration of the New York Stock Exchange which were disclosed as an aftermath of the insolvency emphasized the pressing need for a thorough reorganization of exchange affairs; this case is discussed more fully below. On May 16, 1938, a radically revised constitution was adopted and a newly elected administration assumed office. The first paid president of the exchange, as provided for in the revised constitution, was elected on June 30, 1938. This reorganization provided, for direct representation of the public on the Board of Governors and increased the representation of exchange firms doing business with the public. It greatly simplified the administrative structure, reducing the number of standing committees from 17 to 7. It created a paid president, who must be a nonmember and executive staffs were created to carry out functions formerly conducted by the governors sitting as committee members.

The New York Stock Exchange's constitution was amended on January 1, 1939, to classify as "allied members" all general partners of member firms who do not individually hold seats on the exchange. This resulted in an extension of the exchange's direct disciplinary powers to such partners.

The Chicago Stock Exchange effected a revision of its constitution in 1938, and the Detroit Stock Exchange materially amended its constitution and rules in the same year following in various respects the revision undertaken by the New York Stock Exchange.

Effective February 23, 1939, the New York Curb Exchange adopted a plan of reorganization, following special committee reports and conferences with officials of this Commission.. This reorganization reclassified the constituency of the Board and altered the nominating procedure so as to give a more equitable representation to members and partners of member firms doing business directly with the public, to out-of-town firms, and to the public itself. This plan, too, provided for three governors not identified with exchange members to sit as representatives of the general public.

The fact that a thorough revision of exchange administration had been long overdue was illustrated not only by the Whitney case, which involved the New York Stock Exchange, but also by the so called Cuppia case, involving the New York Curb Exchange. In the latter case, the Commission reviewed disciplinary proceedings of the New York Curb Exchange with respect to violations of the exchange's rules by various of its members, including J. Chester Cuppia. [Footnote: For a review of the case. see "Report on investigation." The Disciplinary Proceedings of New York Curb Exchange pursuant to Section 21 (a) of the Securities Exchange Act of 1934, issued by the Commission in 1941.] Cuppia, a leading member of the New York Curb Exchange and active in the exchange government, had for a long period violated an important provision of the exchange constitution prohibiting the splitting of commissions. For 8 years, Cuppia pursued the demoralizing practice of soliciting floor brokers, whom he was in a position to favor with a share of his firm's extensive business, for rebates of their commission.

The Practice was not confined to one or two floor brokers but was pursued on an extensive scale and went unchecked until a falling out between Cuppia and one of the brokers led to litigation. It was only then that the New York Curb Exchange's Business Conduct Committee undertook to investigate time practice. The investigation took place in 1940, after the New York Curb Exchange had determined to reorganize but before the reorganization was completed.

Although Cuppia and his associates were found guilty of the charge of commission splitting, the punishments provided by the constitution for such an offense were not invoked. Cuppia was permitted to sell his seat and resign from the exchange. Punishment of his associates was confined to a private reprimand.

In the course of the Business Conduct Committee's investigation, various members made deliberate and proven falsifications to the Committee, an offense punishable by suspension or expulsion. Again, punishment was confined to private reprimand.

All of the exchange's proceedings were conducted with the utmost quiet and a complete absence of publicity. Indeed, so greatly concerned was the exchange with the possibility that publicity might be harmful that William J. Plate, the member who had instituted the litigation which "broke" the case, was severely condemned, in his first appearance before the Business Conduct Committee, for resorting to the courts and not to exchange arbitration.

The Commission's investigation of the affair disclosed facts which the Business Conduct Committee's investigation had failed to unearth and for the first time implicated a number of other members in the commission-splitting practice. In the light of these facts, the New York Curb Exchange stiffened its disciplinary practice by expelling five of the brokers involved. The Commission, in its report of the case said:

This Commission cannot help but question at least the efficacy of the Curb's investigatory procedure. The subsequent handling of this case by the Curb also compels us to doubt the adequacy of its disciplinary procedure.

The report concluded:

Existing legislation gives this Commission no express power to compel compliance with exchange rules. The record in this case, as well as its experience in the Whitney case, convinces the Commission, that in order that the public is safeguarded, there should be appropriate power for it to take direct action where an exchange fails to enforce its own safeguarding rules of such importance that their violation entails the penalty of suspension or expulsion.

On August 7, 1941, as a part of a joint program of the Commission and the industry for amendments to the Securities Act of 1933 and the Securities Act of 1933 and the Securities Exchange Act of 1934, the Commission proposed amendments to Clauses (1) and (3) of Section 19 (a) of the latter Act. These proposals, which have never been acted on, would empower the Commission to suspend or withdraw the registration of an exchange for failure to enforce compliance with the exchange's rules and would empower the Commission also to suspend or expel an exchange member from his exchange for willful violation of an exchange rule which subjects a member to suspension or expulsion.

The Whitney Case and Brokers' Solvency

On March 8, 1938, it was announced from the rostrum of the New York Stock Exchange that the firm of Richard Whitney & Co. had been suspended for insolvency. Whitney, senior partner of the firm, had been a member of the exchange since 1912. He had been a member of the governing committee of the exchange continuously since 1919 and its president from 1930 to 1935. At

various times, he had been chairman of the Committee on Business Conduct, a trustee of the Gratuity Fund of the exchange and a director of the Stock Clearing Corp., and had held numerous other positions of importance and responsibility. His position, prestige and power were enhanced by the fact that his brother, George Whitney, was a partner of J. P. Morgan & Co.

Investigation disclosed that the firm had been insolvent for at least 3 and one half years. The firm's insolvency had resulted largely from the personal speculations of Richard Whitney in ventures entirely unrelated to his brokerage business and involving such widely diverse products as applejack, peat humus, and mineral colloids. To meet the need for funds in these ventures, Whitney began misappropriating a customer's securities as far back as 1926; beginning in 1936, misappropriations became his regular practice. [Footnote: Shortly after his suspension from the exchange, Richard Whitney was arrested on two separate indictments returned by a New York Sate grand jury charging him with grand larceny in the first degree. He pleaded guilty to these indictments and was sentenced on April 11, 1938, to an immediate term of 5 to 10 years on each indictment.] Eventually, Whitney misappropriated not only the securities of his customers but also those of the exchange's gratuity fund, of which he was a trustee.

In the last 4 months prior to his suspension, Whitney's need for funds to cover commitments was so great and so continuous that he negotiated 111 loans aggregating $27,381,500. In addition to borrowing from commercial banks, he borrowed from exchange members, member firms, and partners of member firms on at least 42 occasions. On at least 21 occasions, he made futile efforts to negotiate loans from individuals or firms connected with the exchange.

Many persons highly placed in the exchange administration, including a former president, were aware of Whitney's financial difficulties for a considerable time before his suspension. Two partners of J. P. Morgan & Co., were also aware of Whitney's embezzlement of gratuity fund securities. Adhering to an unwritten code of silence, none of them reported his knowledge to the exchange authorities. [Footnote: "Report on Investigation," In the Matter of Richard Whitney, et al., Government Printing Office (1938).]

These circumstances, coupled with the fact that no disciplinary action was taken by the New York Stock Exchange against Richard Whitney until March 1938, made it apparent that there should be a reconsideration of the adequacy of the then existing machinery of the exchange for the supervision and surveillance of its members. The Commission and the new management of the exchange jointly considered the entire problem. Round-table conferences were held by officials of the Commission with officers and representatives of the New York Stock Exchange, and certain other representatives of that exchange. These

conferences, begun in June 1938, were continued at frequent intervals during the summer and fall. Although the statutory powers of the Commission were also reexamined in the light of the Whitney case, the discussions primarily emphasized the need of the exchange to be more vigorous in the enforcement of its own rules and the regulation of its members.

The Board of Governors of the New York Stock Exchange approved on October 26, 1938, a program of immediate reforms which had been drafted in. cooperation with this Commission. This program proposed to permit member firms of the exchange to organize "affiliated companies" which would carry on dealer and underwriting activities separately from brokerage activities, in order to reduce the risk to customers inherent in the combination of brokerage and underwriting business in the same organization. The program also provided for more frequent filings by members with the exchange of financial statements, and for an annual audit by independent accountants of all member firms doing business with the public. The extent and frequency of the exchange's surprise examinations of its member firms and partners were to be increased. The minimum capital requirements to be met by member firms were to be strengthened and methods were to be studied whereby, to some extent at least, customers might be insulated against risks incident to the dealer business conducted by many brokerage firms for their own account. The program further provided that all members, member firms, and partners, with certain exceptions, must report to the exchange all substantial loans.

Furthermore with but minor exceptions, all loans by and between officials of the exchange and its members were to be prohibited. Weekly information as to underwriting positions was also to be filed with the exchange by its members.

The program provided also that the exchange was to undertake to study the feasibility of a central securities depository which the president of the exchange had then anticipated could serve as the first step toward the ultimate formation of a "Central Trust Institution." Such an institution would constitute a depository into which customers' credit balances and securities could be placed in such a manner as to remove them from the hazards of brokerage insolvencies. Following the disclosures of the Whitney case, the creation of such an institution had been proposed by William O. Douglas, then chairman of the Commission.

Some months later, the president of the exchange appointed a committee of nonmembers to study the broad problem of adequate financial protection to customers and particularly the question of the feasibility of a "Central Trust Institution." On August 31, 1939, the committee published its report, [Footnote: Report of Public Examining Board on Customer Protection, August 31, 1939.] urging a number of detailed improvements in brokerage practice, but, expressing the view that certain objections to the suggestion 'for a central institution made it

“undesirable in the present situation.” Many of the specific recommendations were reiterations of proposals previously agreed upon between the exchange and the Commission which had yet to be carried out. Some of the proposals were subsequently adopted, but many have not as yet been carried out. As pointed out in the Commission’s Sixth Annual Report, although the exchange raised the minimum capital requirements of member firms carrying customers’ accounts and required that the annual independent audit of member firms be made on a surprise basis, no action has been taken to require segregation of free credit balances of customers, or the separation of underwriting risks from brokerage business, or fidelity insurance. The Commission is giving consideration to the question whether present conditions in the securities markets require that additional steps be taken to protect customers’ funds and equities in the hands of brokers and dealers who are also engaged in underwriting or day-by-day trading for their own account.

The Whitney case gave rise to a suit by former customers of Richard Whitney and Co. against the New York Stock Exchange to recover damages allegedly sustained as a result of the exchange’s failure to enforce its rules governing the conduct of its members. [Footnote: Baird v. Franklin, 141 F. (2d) 238 (C.C.A. 2, 1944), cert. den. U.S.(Oct. 9,1944).] The Commission filed an amicus curiae brief in that case, taking no position on the facts but pointing out that the New York Stock Exchange, as a national securities exchange, is under a duty to enforce its own rules, that civil liability may exist as a result of the breach of a statutory duty even in the right of such action is not specifically granted under the Act, and that the purpose of the Act is to protect investors not only against abuses in security market transactions but also against insolvent and embezzling brokers. The court’s decision established the legal liability of the exchange under such circumstances although it held also that the plaintiffs in the suit were unable to prove damages.

Not content with the adequacy of the measures adopted by the exchanges for the protection of customers’ securities, the Commission promulgated two rules in November 1940, Rules X-8G-1 [Footnote: Rules promulgated pursuant to the Securities Exchange Act of 1934 are designated by an “X” followed by the section and subsection of the act pursuant to which they are promulgated, and by a number designating the chronological order of the particular rule in relation to other rules adopted pursuant to the same section and subsections.] and X-15C2-1 under the Securities Exchange Act, governing the pledging of customers’ securities the two rules are substantially identical. [Footnote: Section 8 (c) of the Securities Exchange Act gives the Commission authority over “any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member.” Section 15 (c) (2) applies to brokers and dealers who use the mails or any instrumentalities of interstate commerce to effect the over-the-counter transactions in other than exempted

securities or commercial paper. In order to give the widest possible coverage to the new measures for protecting customers' securities, it was deemed advisable to promulgate rules under both sections.] Generally speaking, the rules prohibit brokers and dealers from risking their customers' securities as collateral to finance their own trading, speculating, or underwriting ventures. First, brokers and dealers are forbidden to commingle the securities of different customers without the consent of each customer. Second, a broker or dealer may not commingle customers' securities with his own under the same pledge. And finally a broker or dealer may not pledge customers' securities for more than the total amount which such customers owe him.

This rule was followed in November 1942 by the adoption of Rule X-17A-5 requiring brokers and dealers to file with the Commission annual reports of their financial condition. This rule arose out of the request of representatives of the industry for assistance from the Commission in the development of uniform financial statements to be used by oil members of the security industry for reporting their financial condition to regulatory bodies such as the Commission the various State commissions, national securities exchanges, and the National Association of Securities Dealers, Inc. It was the consensus of everyone who worked on the subject that the most feasible way to get a uniform statement would be for the Commission to promulgate a rule and adopt a form which others might adopt. After extended conferences with representatives of all the interested bodies, a forum was agreed upon and is now in use.

Margin Regulations

For the purpose of Preventing the excessive use of credit for the purchase of carrying of securities, the Federal Reserve Board was directed by Section 7 of the Securities Exchange Act of 1934 to prescribe rules and regulations on the extension and maintenance of credit on, registered securities. Under this section the Board adopted Regulation T governing the extension of credit by members of national securities exchanges and brokers or dealers transacting a business in securities through such members; and Regulation U which governs loans by banks for the purpose of Purchasing or carrying stocks registered on a national securities exchange. The Commission cooperated closely with the Board in the formulation of these regulations.

Although the Board formulated these rules, the Commission has undertaken to conduct routine inspections of the books and records of brokers and. dealers for the purpose, among others, of assuring proper compliance with Regulation T. During the initial stages of this work time efforts of the Commission's inspectors were directed largely to studying the effect of such regulation on the extension of credit on registered securities and assisting dealers in arriving at a better understanding of the requirements of Regulation T. Later these inspections were

directed toward the enforcement of the regulation and, of the rules and regulations promulgated by the Commission. In the first several years, most margin inspections were of firms which were members of national securities exchanges since firms in this category more commonly extend credit on securities than do others. However, beginning in 1938 more emphasis was placed on the inspection of nonmember firms and the inspection of member firms was left largely to the exchanges. This was in conformity with the Commission's policy of delegating to exchanges insofar as practicable the supervision of their own members.

The margin requirement provisions of the act were held constitutional in a criminal case, United States v. McDermott, discussed in the section on criminal proceedings.

Inspections of the books and records of over 4,000 firms have been made during the 10 year period through June 30, 1944. Numerous violations of Regulation T have been found. Where these violations were of a minor nature they were merely called to the attention of the firm. However, where these violations have been more serious, other remedial steps have been taken. The cooperation of exchanges in this enforcement activity has resulted in a number of disciplinary actions by the exchanges against member firms for violations of Regulation T. By arrangement, the exchanges report such cases of disciplinary action periodically to the Commission.

Trading Rules Recommended to the Exchange

Early in 1935 a comprehensive survey was undertaken by the Commission of the activities of specialists, floor traders, and odd-lot dealers on the New York Stock Exchange and the New York Curb Exchange and of trading on other exchanges. On the basis of this study, 16 suggested rules for the regulation of trading on exchanges were formulated, and in April 1936 these were sent to all national securities exchanges with the Commission's recommendation that they be adopted as exchange rules. This course permitted greater flexibility in the adaptation and administration of the rules according to the varying circumstances of each exchange, and was pursuant to the Commission's policy of permitting the cooperation of the exchanges in their own regulation to the greatest degree possible.

The rules placed certain restrictions upon trading for their own account by members of national securities exchanges. [Footnote: After the close of the past fiscal year, the Trading and Exchange Division recommended to the Commission the prohibition of floor trading in stocks on the New York Stock Exchange and the New York Curb Exchange. See "Report on Floor trading," January 14, 1945.] These restrictions included a prohibition against effecting transactions which are

excessive in view of the financial resources of the member or in view of the market for the security; a prohibition against joint accounts in which both members and nonmembers were interested, without the prior approval of an exchange; and a requirement that transactions effected for joint accounts and interests in joint accounts be reported to the exchange. Moreover, members on the floor were prohibited by the proposed rules from effecting discretionary transactions in which the discretion exceeded the right to choose the time and price of the security involved. Other provisions of the proposed rules limited the right of a member, while acting as a broker, to effect transactions for his own account in a security for which he held a customer's order. At the same time, the rules provided that members holding options in a security should not effect transactions in a Security on the exchange.

Six of the proposed rules dealt specifically with specialists and provided that no member shall act as a specialist in any security unless registered as such by the exchange; that a specialist's transactions should be limited to those reasonably necessary to permit the specialist to maintain a fair and orderly market; that the specialist should not participate in any joint account except with a partner or another member; that the specialist should keep a legible record of his orders for a period of at least 12 months; and that the specialist should not hold puts, calls, on other options in any security in which he is registered as a specialist. Similar rules were proposed to govern the conduct of odd-lot dealers.

All national securities exchanges adopted the rules either in their entirety, as recommended or in a form modified to meet the individual trading practice of some of the exchanges.

Short Selling

Problems relating to short selling received particular attention from the Commission after its organization in 1934. It was not until the sharp drop in stock prices in the fall of 1937, however, that an opportunity was afforded to study at first hand the effects of short selling in a rapidly declining market. The study made at that time included a detailed analysis of transactions in 20 selected stocks traded on the New York Stock Exchange during 2 separate periods in September and October 1937.

As a result of this study, the Commission issued Rules X-10A-1, X-10A-2, and X-3B-3, effective February 8, 1938. The effect of these rules was to prohibit any short sale of a security except at a price above the last preceding sale price. Odd-lot transactions and certain round lot transactions of odd-lot dealers were exempted from the rules. On February 10, 1938, the Commission exempted certain short sales on a domestic exchange effected for that purpose of equalizing prices between that exchange and another national securities

exchange. On April 8, 1938, certain short sales effected in arbitrage transactions between securities were exempted.

In order to check the adequacy and effectiveness of these rules, the Commission conducted another detailed study of the trading in the same 20 stocks during the period of price decline from March 21 to April 2, 1938. Following the study, and upon the recommendation of the New York Stock Exchange the Commission effective March 20, 1939, modified the short selling rules so as to permit short sales at the price of the last sale instead of above time last sale price, provided that the last sale price was itself higher than the last different price which preceded it. The rules were further amended at that time to exempt certain short sales made in the course of international arbitrage.

Special Offering Plans

Prior to the enactment of the Securities Exchange Act of 1934 distributions to the public of large blocks of stocks which were listed on exchanges were frequently accompanied by a manipulation of the market. The object of such manipulation would be two-fold-to raise the price of the security and to stimulate activity to the point where, a demand would be created large enough to allow the sale of the offered security. After passage of the Act, a method was developed and widely used whereby comparatively large blocks of listed stocks were distributed to the public over the counter. These blocks, which emanated from estates, investment companies, corporate officials and others, were offered to the public through organized distributing groups after the close of the exchange market. The offerings were almost invariably made at 3 p. m., immediately after the close of the exchange market, and the securities involved were offered at or about the closing exchange price on that day. Most of these offerings were completed prior to the opening of the market on the succeeding day; if not completed by that time, they were usually withdrawn. Since member firms participated in these distributions along with nonmember firms, the exchanges - particularly the New York Stock Exchange exercised a measure of control over the distributions. [Footnote: For a detailed account of these operations, see “Report to the Commission by the Trading and Exchange Division on Secondary Distributions of Exchange,” published by the Commission on February 5, 1942.]

These offerings became especially frequent and large after September 1, 1939, as the British Government sought to dispose in this country of the American securities which it had sequestered from its nationals. The New York Stock Exchange and New York Curb Exchange, concerned with the growth of “off-the-board” sales” of securities which had trading privileges on their respective floors, sought for ways and means to facilitate offerings of comparatively large blocks of stock directly on the floors of their respective exchanges. In 1941, after

numerous conferences with representatives of the Commission, the "special offering" was evolved.

On February 6, 1942, the Commission amended its Rule X-10B-2 to permit special offerings of blocks of securities on national securities exchanges where such offerings are effected pursuant to a plan filed with and declared effective by the commission. Briefly, these plans provide that a special offering may be made when it has been determined that the auction market on the floor of the exchange cannot absorb a particular block of a security within a reasonable time without undue disturbance to the current price. The offering is made at a fixed price which is set within the framework of the existing auction market. Members acting as brokers for public buyer's are paid a special commission by the seller which ordinarily exceeds the regular commission. Buyers obtain the securities without paying any commission. Full disclosure is made to the buyer of all of the details relating to his purchase, including the commission paid to his broker by the seller.

Pursuant to the terms of the exemption, the Commission declared effective as of February 14, 1942, a plan submitted by the New York Stock Exchange. Similar action was taken subsequently with respect to plans of six other exchanges. These plans varied in minor respects from one another and from the New York Stock Exchange plan. The plans of the San Francisco Stock Exchange, New York Curb Exchange, Philadelphia Stock Exchange, Detroit Stock Exchange, Chicago Stock Exchange, and Cincinnati Stock Exchange were declared effective in that order. Several exchanges have, since amended their original plans in the light of experience.

The first special offering was effected on the New York Stock Exchange on February 19, 1942. Since that time, through June 30, 1944, a total of 182 offerings have been effected on that exchange involving 2,325,522 shares at a value of $68,406,000. During the same period a total of 23 special offerings have been effected on the other exchanges having plans. These offerings involved 141,253 shares having a value of $2,019,000.

In the year ended June 30, 1944, special offerings were effected on only 4 of the 7 exchanges with special offering plans, the, number of such offerings totaling 80.

The "Multiple Trading Case"

Section 19 (b) of the Securities Exchange Act of 1934 empowers the Commission under certain conditions to alter or supplement the rules of an exchange in respect of certain matters, if the exchange itself refuses to make such changes. The only proceeding under this section was instituted on January

2, 1941. In this case, the Commission served notice on the New York Stock Exchange of a hearing on the so-called “multiple trading rule” of that exchange.

Over the years, various regional exchanges had developed so-called “multiple trading” methods for effecting transactions upon their floors in securities which also were traded on the New York Stock Exchange. By these methods, the prices established on the floors of the regional exchange are determined by the prices on the floor of the New York Stock Exchange as reported upon the ticker of the latter exchange. In this connection, various members of the New York Stock Exchange who also are members of the regional exchanges have undertaken to participate in “multiple trading” by setting themselves up as odd-lot dealers or specialists on the regional exchange floors in the issues in which such trading is effected, The New York Stock Exchange, by interpretation of Section 8 of Article XVI of its constitution [Footnote: This section provided that “whenever the Board of Governors, by the affirmative vote of 17 governors, shall determine that a member or allied member deals publicly outside the Exchange in securities dealt in or on the Exchange such member or allied member may be suspended or expelled as the Board may determine.”] barred its members from such activities. The staff of the Trading and Exchange Division undertook an analysis of the effects of the New York Stock ‘Exchange’s action, and recommended to the Commission that the exchange be required to rescind its action. [Footnote: For a description and history of multiple trading, see “Report to the Commission by the Trading and Exchange Division on the Problem of Multiple Trading on Securities Exchanges,” published by the Commission in November 1940.]

On December 20, 1940, the Commission formally requested the exchange to:

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

The President of the New York Stock Exchange, by letter dated December 27, 1940, informed the Commission, that the exchange refused to comply with this request. Thus it followed that on January 2, 1941, the Commission instituted a proceeding to determine whether the Commission should by rule or regulation or by order alter or supplement the rules of the exchange insofar as necessary or appropriate to effect the changes requested on December 20, 1940. Pending a final determination of the question, the New York Stock Exchange extended, exemption from the rule’s provisions to those of its members who would have been directly affected by its provisions.

Hearings were held from January 21 to January 30, 1941. Witnesses from the regional exchanges, called by the Commission, offered testimony on the history, methods, and extent of “multiple trading” and on the consequences of the “multiple trading rule.” At the same time the New York Stock Exchange availed itself of the opportunity to cross-examine such witnesses and to present its own case in full. On March 17, 1941, the trial examiner’s report was filed and on May 8 oral argument was held before the Commission. The proceeding was closed by an order of the Commission on October 6, 1941, and no appeal was taken by the exchange. This order required that Section 8 of Article XIV (formerly Article XVI) of the Constitution of the New York Stock Exchange be amended to contain the following proviso:

* * * nothing herein contained shall be construed to prohibit any member, allied member or member firm from, or to penalize any such firm for, acting as an odd-lot dealer or specialist, or otherwise publicly dealing for his or its own account (directly or indirectly through a joint account or other arrangement) on another exchange located outside the city of New York (of which such member, allied member, or member firm is a member) in securities listed or trailed on such other exchange.

REGISTRATION OF SECURITIES ON EXCHANGES

Section 12 of the Securities Exchange Act forbids trading in any security on a national securities exchange unless the security is either registered or exempt. The purpose of this provision is to make available for the investor adequate and current information regarding the affairs of the companies whose securities are listed, or are to be listed, on a national securities exchange. These include most of the nationally known companies as well as many whose activities are of a sectional or local character.

Section 12 also specifies the general nature and scope of the information to be furnished The initial task of getting the securities registered was a strenuous one both for the companies concerned and the Commission. Specific requirements for registration were adopted after lengthy conferences with representatives of those to be affected thereby. Valuable ideas were received from representatives of exchanges, Corporation officials, accountants, and others on how to carry out the purpose of the statute without unduly burdening industry.

Several forms have been developed and adopted for basic registration. Each registrant is required to file an application on the form appropriate to the particular type of issue or issuer involved. Non-financial as well as financial information is required. Pertinent information must be revealed with regard to the history of the company, the control and management of its affairs, and the remuneration of its officers and directors. Data are required concerning the

capital structure of the company and of its affiliates, the amount of securities of other corporations that it may have guaranteed, its position with reference to outstanding stock options and the full terms of the securities being registered, together with financial statements and supporting schedules breaking down the more significant accounts reflected therein.

The continuance of registration upon an exchange is dependent upon the filing of (1) current reports in the event that certain material changes occur in the affairs of the company and (2) annual reports within, 120 days (unless an extension is granted) after the close, of the company's fiscal year. These reports are designed to bring up to date the information contained in the application for permanent registration.

A detailed examination is made of each of these applications for registration, annual reports, and current reports to determine whether or not they provide adequate disclosure of the required information. When it is discovered that material information has been omitted or that sound accounting practices have been violated, the registrant is so informed and correcting amendments are required. Such amendments, in turn, are examined as were the original applications or reports. If the examination reveals omissions of an immaterial nature only, the Commission may not insist upon the filing of a clarifying amendment but merely offer suggestions to be followed in the preparation of future reports. The Act provides that, in general, an application for registration shall become effective 30 days after the Commission receives a certification of approval from the exchange, except when the Commission grants a request for acceleration. In practice, most of the applications are accelerated.

Pursuant to the registration requirements of the Act, the securities of 2,196 issuers are listed and registered on national securities exchanges. During the fiscal year ended June 30, 1944, 218 applications for registration, 1943 annual reports [Footnote: A major part of the difference between the number of issuers whose securities are listed and those from whom annual reports were received is accounted for by issuers located in enemy and occupied countries.] 2, 572 current reports, and 632 amendments to applications and reports were filed with the Commission.

Pursuant to Section 24 of the Act, the Commission has prescribed procedures whereby persons filing any document with it any apply for confidential treatment of the document. Shortly after the passage of the Act, the Commission's denials of confidential treatment of various reports gave rise to a group of more than 30 petitions by various corporations for court review of the Commission orders involved. Objections to disclosure for the most part related to sales end itemized break-down of the cost of sales and, in many other instances, to the publication of salaries and other remuneration paid to officers and directors. In nearly all

instances the petition for review challenged the general constitutionality of the Securities Exchange Act, as well an the validity of its registration requirements Most of the review proceedings were later dismissed on motion of the petitioners and the material involved was made public. Only one case, American Sumatra, Tobacco Corporation v. Securities and Exchange Commission, 110 F. (2d) F. (App. D. C. 1940), was actually decided on the merits. In that case the Court sustained the Commission's order denying confidential treatment on the ground that the purpose and intent of the statute require a full and complete disclosure of each registrants financial condition in order to protect public investors against the manipulation of securities by "insiders." The Court held that the Commission had properly exercised its discretion by considering the claimed danger of harm and by weighing it in the scale of public interest.

Pursuant to Section 19 (a) (2) of the Securities Exchange Act, the Commission has the power, if in its opinion such action is necessary or appropriate for the protection of investors, to suspend or withdraw the registration of a security if the issuer fails to comply with any provision of the Act or the rules and regulations promulgated thereunder.

A realistic approach to the administration of the Act has caused the Commission to recognize that in many cases the effect of de-listing securities held, by the public and actively traded on a national securities exchange is to penalize primarily the public security fielders rather than the management which is responsible for the failure to meet the standards of the Act. On the other hand, the Commission cannot permit its files to contain materially false and misleading information which would serve as a snare for present and prospective investors. Accordingly, in cases where the Commission finds that the reports are materially deficient or misleading, its practice thus far has been to order the security de-listed unless the issuer corrected the defect. In the great majority of instances, however, once the deficiency has been pointed out, it has been corrected.

During the period from July 1, 1935 to June 30, 1944, inclusive, 76 proceedings of this kind were instituted. Approximately 99 percent of such proceedings was started as a result of the failure of issuers to file required reports and the remainder resulted from the filing of reports containing material deficiencies. In, 25 instances the required report or amendment correcting indicated deficiencies was filed and the proceeding was dismissed, in 49 instances no such report or amendment was filed with the result that the Commission issued orders withdrawing registration, and two proceedings were pending at the end of the period. Substantially all of the 49 cases in which registration was withdrawn involved small companies possessing negligible assets and commanding little or no investor interest.

Registration of the securities of six issuers was ordered terminated by time Commission during the past fiscal year because of e failure of these issuers to file annual reports in accordance with the requirements of Section 13. There were six such proceedings pending at the beginning of the fiscal year and two instituted during the year. While seven were terminated during the year, two of these involved securities of the same issuer. One proceeding was pending on June 30, 1944.

Proceedings involving the Missouri Pacific Railroad Co., 6 S.E.C. 268 (1939) A. Hollander and Son, Inc., 8 S.E.C. 586 (1941) and Transamerica Corp., are illustrative of Section 19 (a) (2) proceedings pertaining to reports containing deficiencies.

Early in 1931 Missouri Pacific (MOP) entered into contracts to purchase certain securities for a consideration of $15,965,201 plus interest, and an additional $4,369,062, the latter amount to be derived from the income and, liquidation of part of the securities. Moreover, even if the Interstate Commerce Commission withheld approval, MOP was to be liable for the purchase price, to the extent that a sale of the securities after MOP’s failure to complete the purchase resulted in the seller receiving less than the price at which MOP had agreed to make the purchase. No attempt was ever made by MOP to obtain the approval of the Interstate Commerce Commission for the acquisition of the securities under the agreement and on March 31, 1933, MOP filed a voluntary petition in bankruptcy under Section 77 of the Bankruptcy Act.

Financial statements filed in 1935 by MOP in support of its application for registration of securities and those filed in 1935 and 1936 in connection with annual reports for 1935 and 1936 failed to mention the fact that MOP had contracted to pay any deficiency arising out of a sale of the securities in the event that MOP did not complete the purchase. Since, in the opinion of the Commission, the contingent liability had material implications with respect to the financial and operating conditions of MOP, registration and annual reports were appropriately amended within 30 days. MOP filed the appropriate amendments and the proceeding was dismissed.

The Hollander case was concerned among other things, with whether Puder & Puder, who certified the financial statements of A. Hollander & Son, Inc. were independent of the registrant. The record indicated that certain important items had been handled in a questionable manner in financial statements prepared for the public record in contrast with complete and accurate explanation of the items in an audit prepared for private distribution to registrants management and to banks and other financial institutions but not made available to the public security holders; that two principle members of the accounting firm and their wives owned substantial amounts of stock of the registrant; that one of the Puders, through

various brokerage accounts in his name, had effected transactions for members of the Hollander family and had helped a Canadian company which was owned entirely by three members of the Hollander family to conceal its market operations in the registrant's stock. In addition time Puders had loaned to and borrowed from the Hollanders. The Commission found Puder & Puder were not independent public accountants with respect to financial statements filed by the registrant and registration of the Hollander stock was ordered withdrawn unless, within 90 days the issuer flied amendments making the public record accurate and complete mailed a copy of the Commission's opinion to each of its stockholders of record, and undertook to file quarterly reports which would be available to the public summarizing the material transactions effected during the preceding 3 months between the registrant on the one hand, and its officers and directors and the controlled corporations of such officers and directors. The company complied with the Commission's order.

Proceedings, In the Matter of Transamerica Corporation, were commenced by the Commission on November 22, 1938, by the issuance of an order for hearing under Section 19 (a) (2) of the Securities Exchange Act of 1934 to determine whether Transamerica Corp. had failed to comply with certain sections of time Act and the rules, regulations, and forms promulgated thereunder and, if so, whether it was necessary or appropriate to suspend or withdraw the registration of Transamerica stock on the New York, San Francisco and Los Angeles Stock Exchanges upon which exchanges such stock is registered. On January 16, 1939, public hearings began on the above order and continued with some interruption until March 28, 1939, on which date they were indefinitely adjourned for the purpose of enabling the Commission's staff to examine the relevant books and records of Transamerica, the latter company having offered the Commission access to such books and records.

While numerous auditing investigations had been made of brokers and dealers charged with violating the Securities Exchange Act of 1934, this was the first case of any magnitude in which the Commission made an independent investigation of the affairs of a company having securities listed on a national securities exchange. The examination, which was made to the offices of Transamerica, principally in San Francisco, involved approximately 40 companies for a period of several years and required the services of a number of members of the Commission's staff for more than 6 months. As a result of this examination, the Commission, on November 22, 1940, amended its order or hearing and public hearings were resumed on December 9, 1940, and continued, until December 16, 1940, when once again they were indefinitely adjourned. [Footnote: Securities and Exchange Act No. 2718]

On March 10, 1941, agreement was reached by representatives of Transamerica and the Commission as a result of which Transamerica filed, on September 29,

1941, certain amendments to its application for registration and the Commission's order was amended to eliminate the items affected by the amendments. Thereafter, representatives of Transamerica and the Commission were engaged in preparing stipulations of facts as to the principal issues and on November 29, 1943, public hearings were resumed on those charges in respect of which stipulations were not arrived at. The hearings were completed on February 4, 1944, and the case is under consideration by the Commission.

From time to time, the Commission has found it necessary to amend its rules and regulations under Section 13 of the Act in order to provide for the publication of more timely or more detailed information with respect to the affairs of the issuers of registered securities. On July 7, 1944, the Commission announced the promulgation of rules X-13A - 6 (e) and X-15C2-2. The new rules were based largely on the trading experiences in the stocks of several liquor manufacturers which had recently declared dividends payable in whisky. They were intended to prevent potential abuses in trading before adequate information was available as to the nature and amount of the whisky to be distributed.

Rule X-13A-6 (e) provides that, whenever a company with a security registered on a national securities exchange declares a dividend or distribution in a forum other than cash or securities, it shall promptly file a telegraphic report with, the Commission, containing a full and accurate description of the contemplated dividend or distribution. If the Commission finds that the available information with respect to the contemplated dividend or distribution is inadequate to permit investors to make a proper appraisal of the value of the security, it may exercise its authority under Section 19 (a) (4) of time Act to order a temporary suspension of trading in the security on, the exchange on which it is registered, pending the availability of more adequate information.

Ride X-15C2-2 provides that whenever exchange trading is summarily suspended by the Commission under Section 19 (a) (4), and such suspension is for the purpose of preventing fraudulent, deceptive, or manipulative acts or practices, any act of a broker or dealer designed to effect or induce an over-the-counter transaction with a customer in the security during the period of suspension is a fraudulent, deceptive or manipulative act.

OWNERSHIP REPORTS

Prior to the enactment of the Securities Exchange Act, profits from "sure thing" speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading. Partly to cope with this situation and partly to inform other stockholders as to the transactions of insiders, Section 16 of the Securities

Exchange Act provides that (1) each officer and director of a corporation whose securities are registered, and each beneficial owner of more than ten percent of any class of registered equity security, shall file with the Commission and the exchange initial reports showing his holdings in the company's equity securities and reports for each month thereafter in which changes occur in his holdings; and (2) profits obtained by army of these persons from transactions completed within 6 months in equity securities of corporations with which they are so associated may be recovered by the corporation or by any security holders in its behalf. The latter provision is based on the principle that the confidential information which a corporate insider automatically obtains by virtue of his position belongs, in a real sense, to the corporation, since he acquired it confidentially in his capacity as an official or principle stockholder of the corporation. There is no doubt but that short-term trading by insiders has become very much less common than formerly.

Corresponding ownership reporting requirements are included in Section 17 (a) of the Public Utility Holding Company Act of 1935 and Section 30 (f) of the Investment Company Act of 1940. The reports filed during the past year are classified below.

(chart omitted)

By the end of the Commission's tenth fiscal year an aggregate of more than 35,000 persons closely identified with the management or control of industrial, utility, and investment enterprises had filed altogether about 215,000 security ownership reports under these three statutes.

In Smolowe v. Delendo Corporation, 136 F. (2d) 231 (C.C.A. 2, 1943), cert. den., 320 U.S. 751 (1943), the court upheld the constitutionality of that portion of Section 16 of the Act which allows the recovery for the benefit of the corporation of profits realized by officers and directors from in-and-out trading in the corporation's securities. In that case the United States intervened to defend the constitutionality of the statutory provision and the Commission filed a brief as amicus curiae dealing with the question of the method of determining the amount of profits recoverable.

PROXIES

Under three of the Acts it administers - the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940 - the Commission has the duty to prescribe rules and regulations concerning the solicitation of proxies, consents and authorizations in connection with securities of companies subject to those Acts.

Prior to the development of the Commission's proxy rules, the average shareholder received annually from his company a proxy card in small type which he was urged to sign and return. Ordinarily, the proxy authorized some person or persons to vote the stockholders' shares to elect a board of directors and to take any other action which was considered desirable. Too frequently the owner of the shares was given no assurance that the items mentioned in the notice of meeting were the only ones which the management expected to bring up for consideration at the meeting. The stockholder was merely invited to sign his name and return his proxy without being furnished the information essential to the intelligent exercise of his right of franchise.

The Commission proceeded slowly in its development of rules which would place the solicitation of proxies on a sounder and more equitable basis. The first set of rules, which was not adopted until September 24, 1935, required only a brief description of the matters to be acted upon at the meeting and that the proxy material should not contain false or misleading statements. While the Commission realized that these rules were not specific enough to supply security holders with the information necessary to formulate an informed decision on how to east their votes, additional study of the problem was needed before a more detailed set of rules could be successfully formulated. As a result of such study and of its experience in the supervision of proxy solicitation, the Commission, on August 11, 1938, announced rules of a more positive nature, effective October 1, 1938, substantially increasing the amount of information to be furnished the persons solicited, the specifications as to such information varying according to the character of the matters improved. The rules were amended slightly, effective February 15, 1940, to require that proxy soliciting material be filed with the Commission at least ten days before the beginning of solicitation. Previously, the rules did not require the filing of the material until solicitation started and marry corporations were seriously embarrassed when required to send out supplemental material to correct deficiencies which the Commission's staff could readily have pointed out in advance. The 10-day waiting period, which may be shortened by the Commission upon a showing of unusual circumstances has virtually eliminated this difficulty.

The most recent amendment to the proxy rules was announced on December 18, 1942, and made effective January 15, 1943. These changes were designed to correct deficiencies revealed by additional experience. [Footnote: Hearings on the revisions were held before a subcommittee of the House Committee in Interstate and Foreign Commerce in connection with a bill to repeal the revisions but no further action was taken. In the opinion of the Commission, the rules are operating successfully.]

The essence of the rules now in force is that it is unlawful to make a solicitation which is false or misleading as to any material fact or which omits to state any

material fact necessary to make the statements already made not false or misleading. Each person solicited must be furnished the information which will enable him to act intelligently upon the matter in respect of which his vote or consent is sought. For example, if a proxy is solicited for the election of directors, the person soliciting the proxy must state whom he represents and must furnish, among other information, the name and security holdings of each nominee, the amount of the nominee's remuneration and any "inside" transaction between the nominee and the company. Furthermore, when the management of a company solicits proxies for use at an annual meeting at which directors are to be elected, it must send out its annual report with the solicitation or beforehand if the solicitation is with regard to other corporate action, the proposal which is to be acted upon must be fully described, its purpose and effect stated, and the interest of the officers and directors and their associates in the proposal - whether because of their position in particular classes of securities or otherwise must be disclosed. The rules also enumerate certain specific information which must be given for specified types of proposals and in certain cases where intelligent action on the proposal depends upon the financial condition of the company, financial statements are required to be furnished.

The rules also require that the form of proxy permit the person solicited to indicate his desires on each separate matter upon which action is to be taken so that he will be able to approve certain proposals while disapproving others, if he so wishes.

The proxy rules contain provisions which enable security holders who are not allied with the management to communicate with other security holders when the management is soliciting proxies. Under the rules, no management may make a solicitation unless it undertakes to transmit, at the expense of the security holder involved, any soliciting material which the security holder may submit for transmission to the security holders being solicited by the management. This provision eliminates the difficulty which security holders formerly encountered in attempting to obtain a stock list - a difficulty which was often overcome too late for any action to be taken.

Non-management stockholders may also have included in the management's proxy soliciting material the text of a proper proposal which they intend to submit to the meeting as well as a brief statement in support of the proposal. Under this requirement, it is no longer possible for the management to vote proxies obtained from security holders in opposition to a proposal of minority security holders, without first affording the body of security holders an opportunity to decide whether the minority proposal should be approved or disapproved.

The Commission's proxy rules under the Securities Exchange Act were first brought before the courts in Securities and Exchange Commission v. O'Hara Re-

election Committee, 28 F. Supp. 523 (D. Mass., 1939). There the court preliminarily enjoined a proxy committee from using the mails to. solicit proxies from stockholders by means of letters of solicitation which did not comply with the rules promulgated by the Commission under authority of the statute and from exercising proxies thus obtained at the annual meeting of the corporation.

In another case, involving the American Beverage Co., proxy material distributed by the management in connection with an election of directors had failed to disclose that the president, a majority stockholder, had given an option on his stock to a third person with knowledge that the holder of the option intended to assume control of the corporation to its detriment. The Commission in an amicus curiae brief, without going into the merits of the private litigation, argued that the proxy material used had not met the disclosure requirements of the Commission's proxy rules, and this view was upheld by the lower court, which gave judgment for the plaintiff. On appeal the judgment of the lower court was reversed without however, disturbing the ruling as to the disclosure which the Commission deemed to have been required by the proxy rules.

Recently, in an election contest between the management and an outside group of stockholders of Certain-Teed Products Corp., the Commission participated in various State and Federal court suits instituted by the opposing parties to contend that the management, having solicited proxies under the Commission's proxy rules for the stated. purpose of fielding a meeting to elect a board of directors could not properly direct its proxy agents to refrain from attending the corporate meeting in order to avoid having their proxies counted for the purpose of determining whether a quorum existed. The litigation culminated in a State court decision. upholding the Commission's view. Thereafter, the management's proxy agents attended the adjourned corporate meeting, the voting at which resulted in the defeat of the management's nominees and the, election of the directors proposed by the outside group.

In another case, Securities and Exchange Commission v. National Rubber Machinery Co. (N. D. Ohio, 1944) , a temporary restraining order was secured which is in effect enjoining the use of proxies illegally obtained. by a minority group.

From its experience in reviewing proxy filings, the Commission has been able to obtain a broad view of the effect amid operation of its rules. For example during the fiscal year ending June 30, 1944, the staff of the Commission examined preliminary and definitive material with respect to some 1,501 proxy solicitations. Of these, 1,472 were made by the management of the corporation and 29 by security holders not connected with management. It is the Commission's conclusion that the rules have already made a contribution to a revitalization of the democratic process in the conduct of corporate affairs. The protection

received by investors under these rules and the opportunities afforded them for active participation in the affairs of the company may well be the occasion for the development among stockholders themselves of the leadership necessary for further advance along these lines.

AMENDMENTS OF REGISTRATION AND OWNERSHIP FORMS AND RULES

In line with its program of simplifying filing requirements, the Commission during the year adopted an amendment to Form 18, the form for applications for registration under the Securities Exchange Act of 1934 of securities of foreign governments and political subdivisions thereof. Under this amendment, if securities of such a registrant are currently registered under the Securities Act of 1933 the registrant is permitted to file its Securities Act prospectus in lieu of supplying information in response to the various items of Form 18. If a description of the securities being registered is not contained in the prospectus, such description must be furnished with the prospectus.

The Commission also adopted during the past year minor amendments to its annual report Forms 12-K and 12A-K. Companies which report to the Interstate Commerce Commission on Form A are permitted in connection with reports to the Securities and Exchange Commission on Forms 12-K and 12A-K, to file certain selected schedules in lieu of a complete Form A. The purpose of the new amendments is to revise the selected schedules so as to conform to certain changes made in Form A of the Interstate Commerce Commission for the year ended December 31, 1943.

The Commission also announced during the year an amendment to Rule X-24B-3 under the Securities Exchange Act of 1934 and the repeal of Rule X-24B-4. Rule X-24B-4 required each national securities exchange after the receipt of a summary, prepared by the Commission, of security ownership reports filed under Section 16, to make available to the public a copy of such summary and the reports filed with the exchange which are included in such summary. By repealing Rule X-24B-4 and amending Rule X-24B 3 it is made plain that the original reports filed with the exchange are public when filed.

Rule X-24B-3 as amended requires exchanges to make public reports filed under Section 16 in the same manner as they make public reports filed with them under Sections 12 and 13 of the Securities Exchange Act of 1934. The Commission will continue to prepare official summaries of reports filed with it under Section 16 and will make such summaries public as soon as possible after the tenth day of each month. Copies thereof will be furnished by the Commission without charge to each national securities exchange. It is anticipated that such exchanges will, after receipt thereof, make and keep them available to the public. Copies of these

summaries are also available for public inspection at all regional offices of the Commission.

DELISTING OF SECURITIES FROM NATIONAL SECURITIES EXCHANGES

Securities Delisted by Application

Section 12 (d) of the Securities Exchange Act of 1934, defines the Commission's powers with respect to applications by an issuer or an exchange to delist securities from an exchange. It provides that a security may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and upon such terms as the Commission may deem necessary to impose for the protection of investors.

Pursuant to this section, and in accordance with the procedure prescribed by Commission rules, delistings of 158 issues were effected upon application of issuers and delistings of 268 issues were effected upon application of exchanges from July 1, 1936, to the close of the 1944 fiscal year. [Footnote: Strictly comparable data are not available for the earliest year's of the Commission's existence because applications for delistings were required for a wider area of cases during the earliest period.] During the 1944 fiscal year, 18 issues were delisted upon application of issuers and 26 upon application of exchanges. In some cases the same issue was delisted from several exchanges, so that the total removals including this duplication numbered 169 upon application of issuers and 277 upon application of exchanges during the eight fiscal years reviewed.

Applications by exchanges to delist securities almost invariably are occasioned by an event which has had the effect of practically terminating public interest in the security involved. The most frequent reasons given in applications filed by exchanges for delisting an issue are that the greater part of an issue has been exchanged for other securities of the same issuer; that the issuer is in process of liquidation; or that the security is greatly reduced in amount outstanding, or has become nearly worthless. In such cases the public interest in the continuation of listing is negligible.

Of the 158 issues delisted during the past 8 years upon issuer application, about 62 are no longer traded to any degree, by reason of liquidations, redemptions, concentrated holdings, or fractional values, and about 41 retain a status on some other exchange. Most of the remaining 55 issues which have lost their exchange status by delisting remain actively quoted in over-the-counter market. At current quotations, about 28 of these 55 issues are valued at over $1,000,000 each, the largest being valued at about $43,000,000; shareholders of these 28 issues number well over 500 in most cases and run into several thousand in some

instances. In such cases, the public interest is often materially involved, in applications by issuers to delist securities, and, as a result, Commission policy in this field has undergone considerable development. Changes have occurred both in the Commission's formal rules with respect to such applications and in its policy with regard to their disposition.

On February 12, 1935, pursuant to Section 12 (d) of the Act, the Commission adopted Rule JD-2, paragraph (b) of which was as follows:

(b) An application for withdrawal or striking from listing, pursuant to Section 12 (d), if made by the issuer, shall be made to the Commission, in triplicate, copies of which shall be furnished the exchange, setting forth the regions for such withdrawal * * *

Pursuant to this rule, Allen Industries, Inc., whose stock was listed on the New York Stock Exchange and the Detroit and Cleveland Stock Exchanges, applied to delist its stock from the two latter exchanges. In granting the application, on January 19, 1937, the Commission wrote its first opinion setting forth its views on the subject of delisting. [Footnote: Allen Industries, Inc., 2 S.E.C. 15 (1937)] In this opinion the Commission, held that, even where certain demonstrable advantages existed in retaining an exchange market for stockholders, the Commission had no power to deny the application to relist. No term was imposed upon delisting other than a week's delay. It will be noted that in this case the granting of the application left the applicant's stock listed and registered on the New York Curb Exchange.

In all those cases, it should be noted, the Commission either dismissed the application of the issuer or granted the application without terms, except for a term delaying the effective date of the delisting for a brief period. Up to 1944, it had never imposed any material term upon a delisting.

However, in Fuller Manufacturing Company, - S.E.C. - 1943), Securities Exchange Act Release No. 3513, the Commission indicated that it had under consideration proposals for affording more adequate protection for stockholders. While it granted the application of the issuer, it said:

It may well be that our present rules under that section [Section 12 (d) of the act] do not provide adequate protection to stockholders. The problems presented in this and similar cases have prompted us to direct our staff to study the question, and to make recommendations.

In Shawmut Association, - S.E.C. - (1944), Securities Exchange Act Release No. 3564, the Commission for the first time required that the applicant submit the delisting proposal to its stockholders for their consent and that such submission

should be accompanied by the Commission's "Conclusion" in the matter as carried in its opinion. Since the case sets a precedent in the Commission's administration of section 12 (d), the Commission's findings in the case should be reviewed.

The management of Shawmut Association, a Massachusetts trust, had applied to delist its stock from the Boston Stock Exchange on the following grounds:

For a considerable period of time there has been, in the opinion of the trustees, much too great a discrepancy between the asset value of the shares and their quoted market value. The asset value today is approximately $19.65 per share and the market price only $11.75. It is felt that if the shares were dealt in over the counter a broader market would be provided and that, under the sponsorship of high-grade security dealers the market value of the shares would be increased and brought materially closer to the asset value, which would of course be to the advantage of the existing shareholders.

The Commission found that a portion of the apparent discrepancy between asset value and market value was due to the method whereby the applicant had determined its asset value. The Commission also set forth in its opinion the results of a study which showed that the discrepancy in the case of the applicant's stock was not large by comparison with that existing for the stocks of comparable companies whose securities were traded over the counter.

The Commission also summarized the results of a study of the over-the-counter market for the applicant's stock. The opinion said in part:

The study further revealed that members of the public usually were obliged to pay more for the shares when purchasing from or through dealers over the counter than current, Exchange prices; and that in selling, they received less * * *

In some of the over-the-counter transactions where members of the public sold, it was found that in the course of one day the shares passed through the hands of two, three or four dealers (at successive profits) before being finally sold to other members of the public.

In conclusion, the Commission said:

In considering the application for withdrawal we must determine what terms should be imposed for the protection of investors. We have determined to require the Association to submit the question of withdrawal to stockholders for their consent.

Several factors in the case have led us to this conclusion. Most significantly, there are presented grave questions as to whether the withdrawal of the trust shares from listing and registration would deprive the shareholders of substantial advantages without giving them or the trust itself compensatory benefits. The shareholders are the persons whose interests would be affected, and the choice should be put up to there together with adequate information enabling them to make an intelligent choice.

The Association filed a petition to review the Commission's order in the Circuit Court of Appeals for the First Circuit, which was pending at the close of the fiscal year. [Footnote: The court handed down an opinion affirming the Commission's decision, Shawmut Association v. Securities and Exchange Commission,-- F. (2d)-- (C.C.A. ,Jan. 15, 1945), rehearing denied, - F. (2d) (Mar. 12,1945)]

Securities Delisted by Certification

The Commission early Promulgated a rule, now designated Rule X-12D2 -2 (a), whereby a security which has been paid at maturity or otherwise redeemed or retired in full may be delisted upon certification by the exchange to the Commission that this retirement has occurred. Delisting becomes effective automatically, after the interval of time set forth in the rule.

Effective May 29, 1943, this rule was amended to permit an exchange also to remove by certification issues exchanged for other securities, such as occurs in stock splits, recapitalizations, and mergers.

During the past fiscal year, delistings of 198 issues were effected upon certification by exchanges under this rule. Some of these issues were delisted front more than one exchange, the total number of removals including duplications, being 218. In numerous cases, the successor issues became listed in due course.

UNLISTED TRADING PRIVILEGES ON SECURITIES EXCHANGES

On Registered Exchanges

As originally enacted, Section 12 of the Securities Exchange Act of 1934 prohibited trading in securities, other than exempted securities, on national securities exchanges unless such securities were duly listed and registered in accordance with the provisions of that section. In subsection (f), however, a limited exemption was made for certain securities already admitted to unlisted trading privileges. [Footnote: As originally proposed, the Act contained no provision for unlisted trading. Several exchanges, and prominently the New York

Curb Exchange, whose interests in maintaining unlisted trading were very strong, attacked the bill on that score. As a result, Section 12 (f) as originally passed was in reality a compromise. See Securities Exchange Act Release No. 3658 (1945)] That exemption authorized the Commission to prescribe terms and conditions under which an exchange might continue until June 1, 1936, unlisted trading in securities which had been admitted to such trading on that exchange prior to March 1., 1934, The Commission was also empowered to permit unlisted trading privileges upon an exchange until July 1, 1935, provided such security was registered on another exchange and had been listed there on March 1, 1934.

In addition the original Section 12 (f) directed the Commission to make a study of trading in unlisted securities on exchanges. At the conclusion of this study, [Footnote: See "Report on Trading in Unlisted Securities upon Exchanges," Jan. 3,1936] the Commission presented its proposals to Congress. The proposals were adopted with some modifications by Congress and, were embodied in the form of an amendment to the Securities Exchange Act of 1934. [Footnote: See "Trading in Unlisted Securities upon Exchanges," Hearings before the Committee on Banking and Currency on S. 4023. 74th Cong., 2d sess. (1936), and "Unlisted Securities." Hearings before Committee on Interstate and Foreign Commerce on S. 4023, 74th Cong., 2d sess. (1936).] On May 27, 1936, Congress amended Section 12 (f) of that Act to provide, among other things, for three categories of unlisted trading privileges. Clause 1 of Section 12 (f) permits a national securities exchange to continue unlisted trading privileges to which a security had been admitted on such exchange prior to March 1, 1934; Clause 2 permits an exchange to extend such privileges to a security listed and registered on another national securities exchange; and Clause 3 permits extension of such privileges to a security in respect of which there is available, from a, registration statement and periodic reports or other data filed under either the Securities Act of 1933 or the Securities Exchange Act of 1934, information substantially equivalent to that available in respect of a security duly listed and registered. There is no time limitation on the effectiveness of privileges continued under Clause 1. Privileges extended under Clause 2, however, may last only so long as the security remains listed and registered on a national securities exchange; and Clause 3 privileges may last only so long as the registration statement remains effective and the periodic reports are filed.

Under all three clauses, an exchange may act only on application to the Commission, and the Commission's approval may not be given unless it is found to be necessary or appropriate in the public interest or for the protection of investors. Moreover, the Commission may approve Clause 2 and Clause 3 applications only after appropriate notice and opportunity for hearing have been given to all persons having a bona fide interest in the proceedings. In applications under Clauses 2 and 3, certain conditions principally as to the

adequacy of public distribution and public trading activity in the vicinity of the exchange, must be satisfied.

In determining the adequacy of distribution and trading in the vicinity of an applicant exchange under Clause 2 or 3, the Commission necessarily makes a finding as to the area which constitutes that exchange's "vicinity." The Commission also looks into the trading mechanics and practices of applicant exchanges to the extent that they may have a bearing on how public interest would be effected by the grant of trading privileges. Thus, in a number of early cases, the Commission approved unlisted trading privileges in odd lots but not in round lots on the ground that the rules of the applicant exchange were not adequate for trading in round lots.[Footnote: Applications of Pittsburgh Stock Exchange, 2 S.E.C. 178 (1937); Applications of Boston Stock Exchange, 2 S.E.C. 513 (1937); Applications of Philadelphia Stock Exchange, 2 S.E.C. 566 (1937)] However, after the applicant exchanges had adopted rules permitting and encouraging the maintenance of an independent market for round-lot trading on their floors, the Commission .... permitted unlisted trading in both round lets and odd lots. [Footnote: Applications of Boston Stock Exchange, 3 S.E.C. 693 (1938); Applications of Philadelphia Stock Exchange, 4 S.E.C. 364 (1939)]

In Clause 3 cases, in addition to the conditions mentioned above, Section 12 (f) prohibits the approval of an application by the Commission except upon such terms and conditions as will subject the issuer, its officers, directors and owners of more than 10 percent of the security in question to duties substantially equivalent to these which would arise if the security were duly listed and registered on an exchange. These duties arise from Sections 13, 14, and 16 of the Act, dealing respectively with corporate reports, solicitation of proxies, and inside's trading. Section 12 (f) provides further, however that such terms and conditions need not be imposed if it appears to the Commission that the public interest and the protection of investors would nevertheless best be served by approval of the application.

At the close of the period covered by this report unlisted trading privileges had been granted under Clause 3 to five equity securities, all of them preferred stocks. [Footnote: Application of the New York Curb Exchange. 4 S.E.C. 560 (1939). Application of New York Curb Exchange, 7 S.E.C. 672 (1940). Applications of the New York Curb Exchange, 9 S.E.C. 349 (1941), involving two securities. Application of New York Curb Exchange, 9 S.E.C. 877 (1941).] At that time six consolidated applications were pending which had been filed by the New York Curb Exchange. They were the first Clause 3 applications to involve common stocks and they were opposed by the National Association of Securities Dealers Inc., an association of over-the-counter brokers and dealers registered with the Commission under Section 15 A of the Act. On February 10, 1945, the Commission handed down an opinion in which it considered at length the

provisions of Clause 3. [Footnote: Application of the New York Curb Exchange, Securities Exchange Act Release No. 3658 (1945).] The opinion concluded that, absent duties substantially equivalent to those imposed by Sections 13, 14 and 16 of the Act, a Clause 3 application could be approved only if the case presented unusual, exceptional or emergency features. In the case of the single application which was approved, that relating to the common stock of Northern Natural Gas Co., the Commission found that, by virtue of Northern 's status as a holding company registered under the Public Utility Holding Company Act of 1935, the test of "substantially equivalent duties" was completely satisfied except for the prohibition of short selling by officers, directors, and 10 percent stockholders (Section 16 (c)) and the insider trading provisions of Section 16 generally as to 10 percent stockholders (as distinct from officers and directors). Northern's only 10 percent stockholder was itself a registered holding company, all of hose sales, short or otherwise, were subject to the Holding Company Act, and compliance with the prohibition against short; sales was imposed upon the, officers and directors of Northern by a condition in the Commission's order. As to the other five applications the Commission found that there was failure to meet the test of substantially equivalent duties to a greater or lesser degree and that the exchange had not made out a sufficiently exceptional case to justify waiver of the requirements.

As of June 30, 1944, the number of stock issues admitted to unlisted trading on the several national securities exchanges under Clause 1 was 908 and the number of bond issues so admitted was 173. Of these, the number of stock issues that listed and registered on any other national securities exchange was 453, and the number of bond issues was 151, comprising respectively 382,436,309 shares and $1,357,978,046 principal amount of bonds. About 80.4 percent of the 453 issues and 81.9 percent of the shares were traded only on the New York Curb Exchange; 3.3 percent of the issues and 8.5 percent of the shares were traded on this and other registered exchanges; and the remaining 16.3 percent of the issues and 9.7 percent of the shares were traded only on the other registered exchanges. All of the 151 bond issues, with the exception of 4 small issues, were traded only on the New York Curb Exchange. Canadian stocks and American depositary receipts for foreign stocks comprised 105 of the 453 issues and about 37 percent of the shares; nearly all such stocks are listed and have their principal markets on Canadian or British stock exchanges. A few of the issues are those of companies having other issues listed, on registered exchanges.

The reduction, since June 30, 1937, in unregistered securities admitted to trading privileges under Clause 1 has been substantial, amounting to 284 stock and 399 bond issues. This has occurred partly through the dissolution of several stock exchanges and partly through reorganizations, recapitalizations and consolidations of issuers. Since 1934, many issues have become listed or have

been exchanged for listed securities, and a much smaller number (or their successors) have become the subject of active trading in the over-the-counter markets. Some have become worthless or have been extinguished in liquidation. This reduction in securities admitted to unlisted trading privileges only is in line with the expectation of Congress when it authorized the continuance of such privileges under Clause 1. [Footnote: Sen. Rept. No. 1739, 74th Cong., 2d sess. (1936) and H.R. Rept. No. 2601, 74th Cong., 2d sess. (1936).]

On June 30, 1944, 168 stock issues and 1 bond issue were admitted to unlisted trading privileges pursuant to Clause 2. Of the 168 stock issues, 80 had already been admitted to unlisted trading privileges on one or several exchanges under Clause 1, and 88 have been admitted exclusively under Clause 2. A number of the stock issues have been admitted to trading on more than one exchange under this clause so that the total number of extant grants under this clause pursuant to which stocks were being traded on June 30, 1944, amounted to 280. Applications for 409 stock and 11 bond issues were filed pursuant to Clause 2 up to June 30, 1944, [Footnote: See appendix table 15] a period of 8 years since the amendment of Section 12 (f).

Unlisted trading privileges under Clause 3 existed on June 30, 1944, with respect to 5 preferred stock issues and 27 bond issues, the shares numbering 1,106,071 and the bonds amounting to $620,038,900 in principal amount.

Most of the stocks admitted to trading under Clause 2 are on regional exchanges, only five issues being on the New York Curb Exchange while all of the bonds and stocks under Clause 3 and the bond issue under Clause 2 are on the New York Curb Exchange.

The total stock and bond issues admitted to unlisted trading on the registered exchanges under Clauses 1, 2, and 3, were 1,001 and 201, respectively, at the close of the last fiscal year. [Footnote: See appendix table 14] This total of issues s exclusive of all duplication arising out of situations in which a given issue is admitted to unlisted trading privileges on more than one exchange.

The termination or suspension of unlisted trading privileges may be brought about either by application of a person having a bona fide interest in the security, upon motion of the Commission, or by the exchange in accordance with its own rules. In considering an application to remove a security from unlisted trading privileges, the Commission must take into consideration not only the adequacy of trading and distribution but also the operating mechanics of the exchange.

Since May 27, 1936, when the amendment of Section 12 (f) became effective, there have been nine proceedings for termination of unlisted trading privileges. Three were on applications by issuers, one of which was granted; four were on

applications by broker-dealers making a market for the security, three of which were granted; and two were instituted by the Commission both of which were dismissed after hearing.

Where certain changes occur in a security admitted to unlisted trading privileges, as in title, interest rate, par value, or amount outstanding, the exchange may continue such privileges upon notification to the Commission pursuant to subsection (a) of Rule X-12F-2. Where the changes are more fundamental however, the privileges may be continued only if the Commission determines, upon application by the exchange pursuant to subsection (b) of that rule, that the altered or substituted security is “substantially equivalent” to the security previously admitted to unlisted trading, during the past fiscal year, applications under subsection (b) were filed by registered exchanges with respect to 11 issues. Of these, 7 were granted, 1 was denied, and 3 involving more than 1 class of security, were granted in part and denied in part.

The past fiscal year also marked the first; court test of a Commission decision in any unlisted trading case. On a petition by the National Association of Securities Dealers Inc., for review of an order of the Commission approving the grant of unlisted trading privileges to two bond issues upon application of the New York Curb Exchange, the United States Circuit Court of Appeals far the Third Circuit sustained the Commission’s action. [Footnote: National Association of Securities Dealers, Inc. v. Securities and Exchange Commission et al., 143 F. (2d)]

On Exempted Exchanges

On June 30, 1944, 47 stocks and 3 bond issues had unlisted trading privileges on the Honolulu Stock Exchange under Clause 1, of which 1 stock issue was listed and 1 was traded unlisted on a registered exchange. There were 2 stock issues under Clause 1 on the Minneapolis-St. Paul Stock Exchange, of which 1 was listed on a registered exchange. There were 4 stock issues admitted to unlisted trading privileges under Clause 2 on the Wheeling Stock Exchange, 1 of the issues having been admitted during the past fiscal year.

THE SEGREGATION STUDY

Pursuant to Section 11 (e) of the Securities Exchange Act of 1934, the Commission conducted a study of and prepared a report to the Congress on the feasibility and advisability of the complete segregation of the functions of dealer and broker the so-called “Segregation Report.” [Footnote: Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, June 30, 1936.]

Through the medium of special report forms which the Commission devised for the purpose, detailed analyses were made of the trading activities of members and partners of the members of the New York Stock Exchange and the New York Curb Exchange during the period from June 24, 1935, to December 21, 1935. Supplemental information with respect to trading practices on other exchanges and the broker and dealer functions as exercised in over-the-counter markets was derived from the examination of the applications filed by exchanges for registration as national securities exchanges or for exemption from registration and from the examination of the registration statements filed with the Commission by over the-counter holders and dealers. Information for the study also was obtained through conferences with members of the investing public, over-the-counter brokers and dealers, investment bankers, exchange officials and members, and other persons engaged or interested in the securities business.

The report submitted under date of June 30, 1936, presented the results of the Commission's study of the broker and dealer functions as exercised on exchanges; a survey of the broker and dealer functions as exercised in over-the-counter markets; a survey of the power of the Commission to deal with the problems arising from the combination of functions; an appraisal of the economic implications of segregation; and a statement of conclusions and recommendations.

The report included no recommendation for new legislation.. It was concluded, that under existing law the Commission could take substantial steps to develop an administrative program directed toward the improvement of certain aspects of dealer activity and, trading by members on exchanges. Some of the steps in this program have been discussed above, namely, those embodied in the 16 trading rules.

In the development of the program, the Commission instituted a series of weekly reports, beginning with the week ended April 4, 1936, on the volume of trading in stocks by exchange members. Through the cooperation of the New York Stock Exchange and the New York Curb Exchange, reports were furnished weekly of the daily volume of all purchases and sales made for their own account by specialists, odd-lot dealers and by other members while on the floor and while off the floor. This series also provided, for the first time, figures on the total round-lot volume of trading in stocks on the two exchanges as distinguished from the some what less than complete volume reported by the tickers. Beginning with the week ended September 9, 1939, for the New York Stock Exchange and January 13, 1940, for the New York Curb Exchange, figures on the total short sales of stocks, except sales exempted from restriction by the Commission's rules, were added to this series of published data.

As another part of the program and to further the Commission's policy of affording the exchanges an opportunity to cooperate in regulating the trading activities of their own members, the Commission in February 1937 sent to all national securities exchanges a series of suggested, rules designed to put into effect the recommendations of the "Segregation Report'" that trading by members of the exchange and firms and their partners be, fully margined at all times. In essence, the rules require members of the exchange to deposit at the close of each trading day an amount which should represent sufficient margin, under the terms of the Federal Reserve Board's Regulation T, for the maximum position taken by the member during the trading day.

In March 1937, the Commission acted to effectuate another of the proposals contained in the segregation report concerning member trading. This took the form of an interpretation by the Director of the Trading and Exchange Division of the specialist rule adopted in 1935 on the recommendation of the Commission by all exchanges having a specialist system. The interpretation sought to make more specific the general limitations which had been placed upon specialist's trading by the earlier rule.

STABILIZATION AND MANIPULATION

Sections 9, 10 and 15 of the Securities Exchange Act of 1934 prohibit or empower the Commission to prohibit manipulation and to regulate manipulative devices. Section 9 of this Act prohibits certain specifically described forms of manipulative activity. Transactions which create actual or apparent trading activity or which raise or lower prices, if they are effected for the purpose of inducing others to buy or sell, are declared to be unlawful. Certain practices designated as "wash sales" and "matched orders" effected for the purpose of creating a false or misleading appearance of active trading or a false or misleading appearance with respect to the market for a security are declared to be illegal. Persons selling or offering securities for sale are prohibited from disseminating false information to the effect that the price of the security will, or is likely to, rise or fall because of market operations conducted for the purpose of raising or depressing the prices of a security. Persons selling or purchasing securities are prohibited from making false or misleading statements of material facts, with knowledge of their falsity, regarding securities for the purpose of inducing the purchase or sale of such securities. Sections 10 and 15 empower the Commission to adopt rules and regulations to define and prohibit the use of new forms of manipulation which the Commission might encounter from time to time. However, there is one type of activity, commonly referred to as "stabilizing," which is not prohibited per se by the Securities Exchange Act but is left to regulation by the Commission.

Pursuant to statutory authority, the Commission has adopted rules and regulations to aid it in carrying out the expressed will of Congress. The three above mentioned sections, as augmented by rules and regulation, attempt to free the security markets from artificial influence, thus insuring the maintenance of fair and honest markets and allowing prices to be established by supply and demand.

The Commission's purpose in its administration of the provisions of the Securities Exchange Act of 1934 against stock market manipulation is to provide policing of the stock exchange markets and the over-the counter markets sufficient to accomplish the elimination of manipulative practices without interfering with the legitimate functioning of these markets. In order to accomplish this, the Commission has continuously modified and sought to improve its procedure for the systematic surveillance of trading in securities. The methods used to detect manipulation have, of necessity, been elastic in character since techniques employed by manipulators have changed constantly, increasing in subtlety and complexity.

In order to keep a breast of all situations, the Commission's staff scrutinizes price movements in approximately 6,000 securities, 3,500 of them traded, on exchanges, and 2,500 in the over the counter markets. The information maintained with respect to those securities includes not only data reflecting the market action of such securities but also includes news items, earnings figures, dividends, options, and other data which might explain price and volume changes. When no plausible explanation can be found for an unusual movement in any security, the matter may be referred to the appropriate regional office of the Commission for a field investigation. For reasons of policy, the Commission keeps confidential the fact that trading in a given security is under investigation, lest knowledge of the existence of such investigation unduly effect the market or reflect unfairly upon individuals whose activities are being investigated. As a result, the Commission occasionally receives criticism for failing to investigate situations when in fact it is actually engaged in intensive investigation of those very matters.

The Commission's investigations in respect of matters involving unusual market activity take two forms. The "flying quiz" or preliminary investigation is designed to detect and discourage incipient manipulation by a prompt determination of the reason for unusual market behavior. Often the results of a "flying quiz" or preliminary investigation point to a legitimate reason for the activity under review and the case is closed. Frequently facts are uncovered which require mere extended investigation and in these cases formal orders of investigation are sought of the Commission by the staff in a formal investigation members of 'the Commission's staff are empowered to subpoena pertinent material and to take testimony under oath. In the course of such investigations, data on purchases

and smiles are often compiled for substantial periods of time and trading operations involving considerable quantities of shares are scrutinized.

The Commission operates on the premise that manipulation should be suppressed at its inception. Many of the cases investigated never come to the attention of the public because the promptness of the Commission's investigation, through the 'flying quiz" technique, stops the manipulation before it is fully developed. It is believed that the investigatory methods adopted not only afford greater protection to the public but also save the time and money of security dealers and the Commission.

In the early years of the Commission's existence, a few large scale manipulations were detected. Some of these resulted in jail sentences or other penalties for the operators. The manipulation of the Bellanca Aircraft Corp. common stock on the New York Curb Exchange in 1935 was an outstanding example. M. J. Meehan, a well-known figure on Wall Street, controlled 30,550 shares of this stock. Between June 8 and June 18, 1935, Meehan succeeded in raising the price of that stock from 4 to 5 and one half percent by a process of matching orders and broadcasting advice to others to buy the stock. While raising the price, he managed to sell 29,150 shares on the exchange. Moreover, he sold 16,000 additional shares over the counter at $5 per share. Meehan maintained the price of the stock at a comparatively high level from June 18 to October 24 by various legal and illegal transactions, but on October 25 Meehan withdrew his support from the market, and the next day the stock fell to 2 and three quarters. As a result of (be Commission's action, Meehan was expelled from the New York Stock Exchange, the New York Curb Exchange, and the Chicago Board of Trade.

Another illustration, of a manipulative operation was that effected in the class "A" stock of Tastycast Inc., in the latter part of 1935 and early part of 1936 which is summarized in the section on criminal proceedings.

In another case, the Commission found that Charles C. Wright had manipulated the common stock of Kinner Airplane and Motor Corp Ltd., and ordered his expulsion from the New York Stock Exchange and other national securities exchanges of which he was a member. Wright appealed to the 'Second Circuit Court, [Footnote: Wright v. S.E.C., 112 F. (2d) 89 (C.C.A. 2, 1940) which sustained the constitutionality of the anti-manipulative provisions of the Securities Exchange Act as well as the Commission's finding that Wright had violated Section 9 (a) (2) of that Act. The court held, however, that, the evidence was insufficient to support a finding that Wright had violated Section 9 (a) (1) of the Act, as charged. The case was remanded in order that the Commission might determine in its discretion whether its order should be modified. After reconsidering, the Commission again ordered Wright's expulsion from the

various exchanges on which he held membership and the order was subsequently affirmed on a second appeal. [Footnote: Wright v. S.E.C., 134 F. (2d) 733 (C.C.A. 2, 1943]

During the years of the Commission's operation, the Commission and its staff have rendered formal and informal opinions regarding the anti-manipulative provisions which have aided in the elimination of artificial and fictitious forces responsible for excessive market activity and unwarranted price changes. It is believed that the Commission's vigilance, together with this gradual process of education of persons involved in security dealings, has effectively curbed pool operations and large-scale manipulations.

During the period between July 1, 1934, and June 30, 1944, the Commission's staff conducted 1,137 "flying quizzes," In a large number of cases, manipulations were "nipped in the bud" and in many cases references of the activities were made to the Department of Justice or to the exchanges where such securities were traded. During this same period, the Commission commenced 166 formal investigations resulting in many instances in injunctions, jail sentences, and suspensions from activities as security dealers.

One of the outstanding cases in which the Commission sought an injunction to restrain persons from violating various provisions of the Securities Exchange Act involved the dealings of the firm of Torr & Co. in the stock of the Translux Daylight Picture Screen Corp., listed on the New York Curb Exchange. The Commission sued to enjoin the secondary distributions of that stock on the exchange on the ground that the defendants had employed manipulative practices to ruse the market price of the stock to a point at which it might profitably be distributed to the public and had employed tipsters to recommend time purchase of the stock without disclosing their financial interest. The District Court sustained the Constitutionality of the anti-manipulative provisions of the Act as a valid exercise of the Federal power and issued a preliminary injunction.

On appeal, the Second Circuit Court set aside the preliminary injunction issued by the District Court; on the ground that, although the defendants had not halted their practices until after the Commission's Investigations had begun, they had stopped before the hearing on the preliminary injunction and it did not appear that there was any likelihood of renewed violation in the future. [Footnote: S.E.C. v. Torr, 87 F. (2d) 446 (C.C.A. 2, 1937)] However, following the hearing on the merits before the District Court, a permanent injunction was granted which the defendants accepted without further appeal. [Footnote: S.E.C. v. Torr, 22 F. Supp. 602 (S.D.N.Y., 1938)]

The problem raised by the Torr and several other early cases arising under the Securities Exchange Act of 1934 and the Securities Act of 1933 as well, as to

whether and under what circumstances the Commission is entitled to an injunction on the basis of evidence as to violations which have ceased before the filing of the complaint, was considered by the Circuit Court of Appeals for the Sixth Circuit in Otis and Co. v. Securities and Exchange Commission. In that case the Court of Appeals held that the trial court did not lack authority to issue an injunction merely because the defendant had discontinued the prohibited activity before the Commission brought suit, since, as the Court observed:

A dealer who saw the challenge of his activities that is implied in an investigation would probably discontinue them pending the investigation. It would seldom, if ever, be possible to show that a dealer was engaged in or about to engage in prohibited acts or practices when suit began, since the necessary investigation would nearly always have warned the dealer to desist. [Footnote: 106 F. (2d) 579 (C.C.A. 6, 1939) A similar result was reached in the Court of Appeals for the Tenth Circuit in Securities and Exchange Commission v. Thomasson Panhandle Company, 145 F. (2d) 408 (1944)]

Although the Securities Exchange Act contains a general prohibition against manipulation, it does not prohibit certain kinds of manipulation. Thus, Section 9 (a) (6) forbids the "pegging, fixing, or stabilizing'" of security prices only if in contravention of such rules and regulations as the Commission, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The Senate Committee on Banking and Currency in discussing the regulatory powers conferred on the Commission stated:

Practices such as pegging, fixing, or stabilizing the price of a security are subjected to regulation by the Commission, which is authorized to prescribe such rules as may be necessary or appropriate to protect investors and the public from the vicious and unsocial aspects of these practices. [Footnote: "Stock Exchange Practices," Sen. Rep. No. 1455, 73rd Cong., 2d Sess. (1934) 55.]

In March 1940, time Commission issued a release on this subject in which it stated, in part:

The Commission is unanimous in recognizing that stabilizing is a form of manipulation. The statute itself so recognizes. The Commission also agrees that stabilizing in many respects is undesirable. That, too, is implicit in the statute. Nevertheless, the majority of the Commission considers that merely to point to the evils attendant upon stabilizing poses the problem but does not answer it. The question of how to deal with stabilizing as it exists today cannot be answered by theory alone. It is an intensely practical problem which, for the present, must be solved in terms of the existing financial machinery*** the Commission is not now prepared to say that, under existing conditions, all stabilizing should be

wholly prohibited. Nor is the majority of the Commission content to allow stabilizing to continue unregulated. ***

Preliminary studies by the Commission's staff led to the adoption on March 15, 1989, of rules and regulations of the Commission requiring the filing of detailed reports respecting all stabilizing operations conducted to facilitate the distribution of security offerings in respect of which a registration statement has been filed under the Securities Act of 1933.***

The area in which abuses have been and can again become most prevalent is stabilizing in connection with so-called "market offerings" where the price is represented to be at, or based upon, open market prices established by the ebb and flow of supply and demand. Before the Act, operations to facilitate this type of "pool manipulations" saw outlawed by Section 9 (a) (2) of the statute. Since 1934, stabilizing of the type now covered by Regulation X-9A6-1 [adopted February 15, 1941] continued to be subject to various abuses not otherwise prohibited by the Securities Exchange Act. It was because of the very susceptibility of this kind of stabilizing to grave abuses that the Commission determined to apply the first test of substantive regulation of stabilizing to this field. [Footnote: Securities Exchange Act Release No. 2446, March 18, 1940, pp. 2, 3, 13-14. Commissioner Healy's separate statement appears at pp. 19-33]

Commissioner Healy, in a separate statement, was, of the opinion that the Commission was at liberty to prohibit stabilizing and was opposed to permitting stabilizing in connection, with an offering at the market.

Regulation X-9A6-1 prohibits any "mark-up" of prices. It also prohibits any rigid "pegging" of the market. Since stabilizers on each day can buy only on a scale down until the price has dropped by a fixed amount, the rules in effect permit no more than the maintenance of an orderly market during the distribution. The regulation requires stabilizers to give notice of their intention to stabilize. If stabilizing has actually been commenced, that fact must also be disclosed. Stabilizers may neither support the market nor profit from its independent rise beyond any price which is more than one point above the level at which stabilizing is commenced. Of course, the regulation also prohibits any stabilizing at prices to which the stabilizers have reason to believe the security has been previously raised by illegal manipulation.

Persons required by Rule X-17A-2 and Rule X-9A6-6 to file reports with the Commission, have filed approximately 70,000 stabilizing reports during the past 5 years. Each of them reports has been analyzed, thereby enabling the staff to follow the progress of a distribution and to determine whether the stabilizing activities were lawful.

In November 1943, an order to assist underwriters and, distributors of securities to adhere to the provisions of the Securities Exchange Act, two releases were issued by the Trading and Exchange Division, clarifying the distinction between legitimate stabilizing transactions and unlawful activities of underwriters prior to the termination of stabilization or distribution. [Footnote: Securities Exchange Act Release Numbers 3505 and 3506, November 16, 1943. See also Securities Exchange Act Release No. 3056, October 27, 1941.] The releases have had a, salutary effect in providing the securities industry with guides developed in the course of 9 years" experience under the Securities Exchange Act.

OVER THE COUNTER REGULATION

The Original Statutory Provisions and Their Administration

As originally enacted, Section 15 of the Securities Exchange Act of 1934, dealing with the Commission's power to regulate the over-the-counter markets, was couched in the most general and broadest terms. It stated:

It shall be unlawful, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges, (1) for any broker or dealer, singly or with any other person or persons, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of making or creating, or enabling another to make or create a market, otherwise than on a national securities exchange, for both the purchase and sale of any security (other than an exempted security or commercial paper, bankers acceptances, or commercial bills, or unregistered securities the market; in which is predominantly intrastate and a which have not previously been registered or listed), or (2) for any broker or dealer to use any facility of any such market. Such rules and regulations may provide for the regulation of all transactions by brokers and dealers on any such market, for the registration with the Commission of dealers and/or brokers making or creating such a market, and for the registration of the securities for which they make or create a market and may make special provision with respect to securities or specified classes thereof listed, or entitled to unlisted trading privileges, upon any exchange on the date of the enactment of this title, which securities are not registered under the previsions of Section 12 of this title.

To contrast to other areas in which the Commission commenced its administrative duties in June 1934, there were little or no reliable data concerning the scope or nature of the abuses to which the directives of Section 15 of the Securities Exchange Act of 1934 were intended to apply. The long legislative

history of the Securities Act of 1933 provided a rich source of information concerning the practices of underwriters and the evils encountered in connection with public offerings of new securities. The hearings before Committees of Congress and the Committee reports on bills to regulate securities markets, resulting in the enactment of the Securities Exchange Act, contained a wealth of basic data concerning the practices and abuses which had permeated the exchange markets during the preceding decade. But, as to over-the-counter markets the legislative history of the Securities Exchange Act yields little information and sheds little light on the directives of Section 15 relating to over-the-counter regulation, beyond the obvious facts that unique opportunities for abuse existed in that market and that regulation of exchange markets made, necessary the regulation of counter markets, since business tends to flow from regulated to unregulated areas.

Thus the Commission's first task was to obtain the requisite data from which a program might be developed. Surveys were initiated on numerous subjects bearing on problems of the over the counter markets. Because Section 15 expressly authorized rules requiring registration of over-the-counter brokers and dealers and registration of "securities for which they make or create a market," the feasibility of such rules became the first, subjects of intensive study. Commencing in November 1934, frequent conferences were hold with representatives of the industry on the general problem and many interrelated questions.

Concurrently with these studies, the Commission's investigating activities yielded valuable information concerning fraudulent operations of bucket shops and tipster sheets as well as concerning the more subtle types of fraudulent practices rampant in over-the-counter markets.

From these beginnings the program for regulation of over-the-counter markets has developed gradually; no important step which would affect the industry generally has been taken without affording its representatives opportunity to express their views.

In the study of the feasibility of a rule to require registration of brokers and dealers a comprehensive survey was made of all State securities laws and of rules and regulations promulgated by State agencies administering them, with special emphasis on broker-dealer licensing provisions and standards. After careful consideration the Commission tentatively decided to follow the general pattern of the State regulatory acts, and the proposed rules, released to the industry on March 16, 1935, for comments and suggestions included qualifications for registration and also proposed standards of business conduct. There was little opposition to the general scheme of registration. After full consideration of all comments received, the final rules were promulgated on May

6, 1935. Registration became the keystone of over-the-counter regulation. On January 1, 1936, when this requirement became effective, 5,325 brokers and dealers were registered. A tabulation reflecting broker-dealer registrations for the fiscal year ending June 30, 1944, and for the entire period from May 6, 1935, to June 30, 1944, will be found on a subsequent page.

Section 15 (d) of the Securities Exchange Act

It will be recalled that Section 15 of the Securities Exchange Act of 1934 as originally enacted specifically authorized the Commission to adopt rules and regulations providing for the registration of securities for which over-the-counter dealers made or created a market. Although the Commission recognized from the beginning that registration of over-the-counter securities was extremely desirable, it realized that such registration involved vastly greater difficulties than the registration of over-the-counter brokers and dealers.

This problem was discussed at length by the Commission in its "Report on Trading in Unlisted Securities upon Exchanges," transmitted to Congress on January 3, 1936, pursuant to Section 12 (f) of the Securities Exchange Act of 1934. In that report a number of suggestions were considered for achieving the registration of securities which were traded exclusively in the over-the-counter market as well as those which were admitted to unlisted trading privileges upon certain national securities exchanges. The Commission did not recommend any of these suggestions as the solution for the problem. It presented the to Congress in the hope that public discussion thereof would make judgment as to the desirability of the various suggestions, both by Congress and the Commission, more certain. Following the making of this report Congress adopted one of the suggestions contained therein by enacting Section 15 (d) of the Securities Exchange Act of 1934 which provides in part:

Each registration statement hereafter filed pursuant to the Securities Act of 1933, as amended, shall contain an undertaking by the issuer of the issue of securities to which the registration statement relates to file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to Section 13 of this title in respect of a security listed and registered on a national securities exchange; but such undertaking shall become operative only if the aggregate offering price of such issue of securities, plus the aggregate value of all other securities of such issuer of the same class (as hereinafter defined) outstanding, computed upon the basis of such offering price, amounts to $2,000,000 or more.

The provisions of this section have served to make available to investors periodic information concerning many issuers of securities who have registered under the Securities Act of 1933. Nevertheless, there are many securities now dealt in the over-the-counter market concerning which very little public information is available anywhere. Moreover, there is substantial evidence that the number as well as the importance of unregistered securities dealt in the over-the-counter market has increased in recent years. The problem of obtaining adequate information on over-the-counter securities is being actively considered by the Commission.

Subsequent Regulation of Brokers and Dealers

At the same time that it adopted Section 15 (d) of the Securities Exchange Act, the 74th Congress also adopted new subsections (a), (b), and (c) of Section 15 to replace the former text of that Section. [Footnote: Approved May 27, 1936.] The first two subsections deal with registration of over-the-counter brokers and dealers and in effect codify the "schematic device for the registration of these brokers and dealers" developed by Commission rule under the original statute. Under the amendment, brokers and dealers, other than those whose business is exclusively intrastate, must register with the Commission in order legally to make use of the mails or other instrumentalities of interstate commerce in connection with over-the-counter transactions in any security, except an exempted security.

In the revision of Section 15 the rule-making powers of the Commission were made more definite by the enactment of subsection (c), which makes unlawful, in over-the-counter transactions, the use of manipulative, deceptive, and other fraudulent devices and contrivances, and grants to the Commission the authority to define such devices and contrivances. While the criterion of affording to investors in these markets protection comparable to that provided in exchange trading was dropped physically from the Act, the history of subsequent amendments to Section 15 shows that it was the intent of Congress that this standard should nevertheless be followed.

Two years later Section 15 (c) of the Securities Exchange Act was amended. The amendment extended the Commission's powers so that it was not only empowered to define and prohibit acts of fraud and deceit in the over-the-counter markets but was also empowered to prescribe means reasonably designed to prevent such acts, except if exempted securities were involved. The rule-making power of the Commission was also extended to afford protection against fictitious quotations and safeguards with respect to financial responsibility of over-the-counter brokers and dealers.

The initial rules of business conduct directed against fraudulent practices in over-the-counter transactions, adopted in May 1935, were repealed upon the

enactment of the 1936 amendments to the Securities Exchange Act, and attention was thereupon directed to rules under the new Section 15 (c) defining manipulative, deceptive, and other fraudulent devices and contrivances. The fair practice rules established by the Investment Bankers Code Committee which had operated under the National Industrial Recovery Act and the rules of various State securities commissions were examined to determine the extent to which the underlying principles of such rules could be employed. After discussing preliminary drafts with the industry and weighing the comments and suggestions received, the final rules, eight promulgated under Section 15 (c), complemented by two under Section 10 (b) and one under Section 17 (a), were announced on August 4, 1937, to become effective October 1, 1937. [Footnote: These rules under the numbering system subsequently adopted were designated as X-1501-1 to X-15C1-8, X-10B-2, X-10b-3, and X-17A-1, however, was repealed upon adoption of the comprehensive bookkeeping rules X-17A-3 and X-17A-4] The new rules, while retaining the substance of the 1935 rules, extended the principle of disclosure to additional phases of business conduct. Subsequently, seven additional rules affecting over-the-counter brokers and dealers were promulgated, one under Section 10 (b); one each under Section 15 (c) (1), (2), and (3) and three under Section 17 (a).

Broker-Dealer Inspection Program

Even before the Commission had adopted the over-the-counter rules effective October 1, 1937, the need for the exercise of visitorial power granted under Section 17 (a) of the Securities Exchange Act had become manifest. The adoption of comprehensive rules emphasized this need. A limited program of inspection of brokers and dealers on an experimental basis was commenced in 1937. The data assembled in these inspections determined the scope of the broader program commenced in 1940. Broker-dealer inspections, made by accountants attached to the Commission’s regional offices, are designed in general to educate brokers and dealers in the legal requirements of the Federal securities laws and the Commission’s rules promulgated pursuant thereto as well as to check compliance therewith, and to detect and prevent fraudulent practices. They are also an aid in the correction of practices which, though not fraudulent, fall short of representing good business standards. Moreover, they afford information useful in appraising the need for new regulations or for changes in existing regulations in order to carry out the purposes of the Act. The following is a tabulation of inspections by fiscal years made under the definitive program.

June 30, 1940: 646
June 30, 1941: 1,087
June 30, 1942: 1,054
June 30, 1943: 830
June 30, 1944: 746

The decline in the number of inspections in 1943 and 1944 is due largely to limited personnel and to the need to shift inspection personnel to the examination of reports of financial condition filed under Rule X-17A-5 during each of the last two fiscal years. It is worth noting that on only three occasions has it been necessary to institute actions in United States District Court for mandatory injunctions to compel firms to make their books and records available. In each case consent judgments were obtained. [Footnote: S.E.C v. Gerber Corporation, S.D.N.Y., April 1, 1942, unreported. S.E.C. v. Harlow Kays and Co. D. Mass., March 15, 1943, unreported. S.E.C. v. Moonan, D. Mass., March 15, 1943, unreported]

The improper practices discovered in inspections range from relatively minor infractions of rules to serious violations of law. Failure to keep adequate records, to make the required disclosures in confirming transactions, or to comply with the requirements of Regulation T with respect to extension of credit is usually due to unfamiliarity with the rules; corrective measures are generally taken by the firm when the infractions have been discussed with it. But with respect to more serious situations the Commission has frequently found it necessary to invoke the sanctions of the Act; thus, in the public interest, the Commission has from time to time moved to enjoin fraudulent practices, to revoke registration, or to suspend or expel a firm from membership in the National Association of Securities Dealers, Inc., or from membership on a national securities exchange. It has moved to invoke criminal sanctions by referring the facts to the Department of Justice for consideration of criminal prosecution, and to State authorities in some instances where violation of State law is involved. Without enumerating all of the types of improper practices which have been discovered in these reports, attention is directed to the more flagrant abuses.

Improper Use of Customer's Property

Although under the statute the commingling of customers' securities without the consent of the customers is unlawful, such commingling is occasionally discovered. Many instances of even more serious misuse of customers' securities have been uncovered - for instance, their unlawful hypothecation. Such wrongful use of customers' securities is often directly related to a poor financial condition and under such circumstances customers' losses have sometimes been substantial. [Footnote: For instances involving improper use of customers' property, see Seventh Annual Report, p. 156 and Eighth Annual Report, pp. 13-14.]

Secret Profits

Another type of fraudulent conduct sometimes discovered involves the taking of secret profits by brokers. This is accomplished by misrepresenting to the customer the price paid for the securities purchased, or the price received for securities sold, for his account. For example, the registration of Hope & Co. [Footnote: 7 S.E.C. 1082 (1940). See also Geo. W. Byron, 9 S.E.C. 158 (1941); Bond and Goodwin, Inc., S.E.C. (1944), Securities Exchange Act Release No. 3543.] was revoked for such unlawful conduct. Its secret profits in such transactions had exceeded $9,000 in a relatively short period of time.

Transactions at Unreasonable Prices

Among the most serious violations of law discovered in the course of inspections are cases involving the sale of securities by dealers to customers at prices which bear no reasonable relation to the prevailing market price. The doctrine that it is fraudulent for a dealer to sell securities to customers at prices bearing no reasonable relation to the prevailing market, without disclosing the market, was first established in a proceeding in which the registration of Duker & Duker was revoked; [Footnote: Duker and Duker, 6 S.E.C. 386 (1939)] in a long senses of subsequent proceedings involving similar business conduct, the Commission has reiterated and clarified the law in such cases. [Footnote: See Jansen and Company, 6 S.E.C 391 (1939); G. Alex Hope, 7 S.E.C. 1082 (1940); Allender Company, Inc. 9 S.E.C. 1043 (1941); Jack Goldberg 10 S.E.C 975 (1942); Scott McIntyre and Co., S.E.C (1942) Securities Exchange Act Release No. 3235; William J. Stelmack Corp., S.E.C. (1942) Securities Exchange Act Release No. 3261; Trost and Co., Inc., S.E.C. (1942), Securities Exchange Act Release No. 3345; Theodore T. Golden,-S.E.C. (1943), Securities Exchange Act Release No. 3404; Lawrence R. Leeb, S.E.C. (1943) Securities Exchange Act Release No, 3450; Guaranty Underwriters, Inc., S.E.C. (1943), Securities Exchange Act Release No. 3481.]

In substance, the holding of the Commission is that special obligations upon the dealer flow from certain inherent characteristics of the business of dealing in securities. The dealer holds himself out as one with specialized knowledge and skill in securities markets and investment matters generally. He cultivates his customer's trust and confidence in him and invites reliance on his skill and honesty. That there is an inherent representation that he will deal fairly is plain from the confidential relationship which he establishes, and the very price at which he sells or buys a security, in the absence of express representation to the contrary, carries with it the implied representation that the price is closely related to the current market, The duties of the dealer, under such circumstances, are not to be measured by the same rules which apply to arm's length bargaining; he is bound to higher standards because of the unique position which he occupies.

This view of the doctrine of fraud has been applied chiefly in cases involving fraudulent pricing of corporate securities, but with some modifications it was also applied in a revocation proceeding in which sales of oil royalties were the subject of the Commission's complaint. In that proceeding the Commission's order revoking registration was based on the finding that the firm, in its transactions with two women customers, was charged with the high fiduciary obligation of an agent and that this obligation had been violated repeatedly in taking secret profits at the expense of these customers. In the same case the Commission also held that the duty of fair dealing at fair prices rests on dealers in oil royalties as it does on dealers in the more conventional types of securities. Since oil royalties do not have a market comparable to that which exists for corporate securities, it was necessary for the Commission to resort to other tests to determine the fairness of retail prices charged for oil royalties; and the Commission concluded, with certain reservations, that "the least required of a dealer by the standards of fair dealing is that, unless special circumstances appear, be must charge a price bearing a fair relation to the current wholesale price." The Commission held that in charging retail prices having no fair relation to the current wholesale prices, without disclosing the magnitude of its mark-ups, the firm omitted to disclose material facts necessary to make its general representation as a dealer not misleading and that its conduct operated as a fraud on the customers.

Litigation Arising Out of Enforcement

During the past 9 years the Commission has issued 218 orders involving denial, suspension or revocation of registration of brokers and dealers, or expulsion or suspension from membership in the NASD. Only two of these orders have been taken to a Circuit Court of Appeals for review, and in each ease the Commission's order has been affirmed. [Footnote: The Commission became a part in other litigation, however, brought by Guaranty Underwriters, Inc. in an attempt to stop hearings in the proceedings instituted under section 15 in August 1942 against that company to determine whether its broker-dealer registration should be revoked and whether the firm should be suspended or expelled from membership in the NASD. This litigation, which included an action before the Circuit Court of the Fourth Judicial Circuit of the State of Florida, another section before the Supreme Court of Florida, and various actions before the United States District Court for the Southern District of Florida and the Circuit Court of Appeals, Fifth Circuit, is described in the Ninth Annual Report.]

The most significant case was an appeal by Charles Hughes & Co., Inc., from a Commission order revoking its registration for violating the Securities Exchange Act. In this case, the Commission's application of the fraud doctrine to sales of securities at prices bearing no reasonable relation to current market prices was subjected to judicial review for the first time. [Footnote: Charles Hughes and Co., Inc. v. S.E.C., 139 F. (2d) 434 (C.C.A. 2, 1943), cert. den. 321 U.S. 786 (1944).]

The Commission had found that this firm had violated the fraud provisions of the Securities Act and the Securities Exchange Act in its dealings with certain women customers to whom it had sold securities at prices from 16.1 percent to 40.9 percent in excess of the prevailing market, without disclosing the prevailing market prices to them. In its opinion the Commission said:

In the setting in which respondent effected the foregoing and other transactions with these customers, the approach and entire conduct of respondent were intended to induce an atmosphere of trust and confidence, of which the respondent took gross advantage.

Fundamental to the issue before us is the premise that any person, regardless of his knowledge of the market or his access to market information, is entitled to rely on the implied representation, made by a registered dealer in securities, that customers will be treated fairly.

The Circuit Court sustained the Commission's order on an independent interpretation of the statutes and the Commission's rules. In reaching its conclusion, the Court did not have recourse to the doctrine that the consistent and contemporaneous construction of the statute by an administrative body should control unless plainly erroneous. In its opinion. the Court said:

An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those which petitioner charged here must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level. Even considering petitioner as a principal in a simple vendor-purchaser transaction *** it was still under a special duty, in slew of its expert knowledge and preferred advice, not to take advantage of its customers' ignorance of market conditions. The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in the customers. Once that confidence was established, the failure to reveal the mark--up pocketed by the firm was both an omission to state a material fact and a fraudulent device. When nothing was said about market price, the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. The law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other ***

Concluding that the Commission had "correctly interpreted its responsibilities to stop such abusive practices in the sale of securities," the Court placed special emphasis on the importance of price in securities transactions.

The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities. Indeed, it is the purpose of all legislation for the prevention of fraud in the sale of securities to preclude the sale of "securities which are in fact worthless or worth substantially less than the asking price." People v. Federated Radio Corp., 244 N. Y. 33, 40, 154 N. E; 655, 658. If after several years of experience under this highly publicized legislation we should find that the public cannot rely upon a Commission-licensed broker not to charge unsuspecting investors 25 percent more than a market price easily ascertainable by insiders, we should leave such legislation little more than a snare and a delusion.

The Commission's order of June 13, 1942, revoking the registration of W. K. Archer & Co., and expelling that firm from membership in the NASD and on the Chicago Stock Exchange, was taken to the Eighth Circuit Court for review and the Commission's findings and order were sustained.

There have been several cases holding that Section 29 of the Securities Exchange Act gives a purchaser of securities the right to rescind the purchase or to recover damages for fraud in an over-the-counter sale of securities. In each case the commission appeared as amicus curiae to argue that the statutory right to rescind the transaction was clear.

Criminal Proceedings Arising Out of Enforcement

From time to time, criminal proceedings have been instituted by the Department of Justice which have been based upon Commission investigations of violations of Section 15 (c) of the Securities Exchange Act. These cases are discussed in the section on criminal proceedings.

The Maloney Act and the NASD

On November 27, 1933, the President of the United States, acting pursuant to the provisions of the National Industrial Recovery Act, approved a code of fair competition for investment bankers. This code embraced all brokers and dealers who transacted business in the over-the-counter market. By an amendment to the code, approved by the President on March 23, 1934, certain rules of fair practice became a part thereof. After the National Industrial Recovery Act was declared unconstitutional in the spring of 1935, representatives of the industry discussed with the Commission the feasibility of a new organization of over-the-counter brokers and dealers which would undertake to perpetuate the objectives sought to be attained by the code of fair competition by regulating brokers and

dealers in a manner comparable to the regulation by exchanges of their members .

On January 5, 1938, the late Senator Maloney introduced in the Senate a bill, jointly sponsored by the Commission and the Investment Bankers Conference, Inc., to amend the Securities Exchange Act of 1934 in order to provide for the establishment of a mechanism for the regulation of over-the-counter brokers and dealers. This amendment, which added a new Section 15A to the Act, gave legislative sanction to the formation and registration of national securities associations which would supervise the conduct of their members under Commission regulation. Thereafter, the National Association of Securities Dealers, Inc., applied to the Commission for registration as a national securities association. On August 7, 1939, after a public hearing, the Commission granted the application of the Association on findings that the statutory provisions were satisfied. Membership in the NASD, which was about 1,500 at the time registration became effective, subsequently rose to a high of approximately 3,000 in mid-1941 but thereafter declined to a current figure of approximately 2,100 members. It is the only national securities association registered with the Commission. The following tables show the record of broker-dealer proceedings since 1935 and registrations revoked in the past year.

(charts omitted)

The major portion of the NASD's activities has been devoted to raising the business standards of over-the-counter brokers and dealers. In that connection, the NASD adopted rules of fair practice which, among other things, prohibited certain unfair and fraudulent acts and required various disclosures under certain circumstances. In general, the fraud and disclosure provisions of the rules are patterned after the Commission's rules under the Securities Exchange Act of 1934.

To enforce its rules of fair practice, the NASD has put into operation a method providing for the annual questionnaire examination of the business practices of each of its members. By the close of the fiscal year, this program had resulted in the institution of more than 330 formal disciplinary complaints against members, the majority of which were concluded by the imposition of a penalty such as censure, fine, suspension or expulsion from the membership. A tabulation summarizing the disciplinary activities of the association follows:

(charts omitted)

Another phase of the NASD's work has been devising a uniform practice code designed to eliminate disputes and misunderstandings between members. For the most part, the code gave sanction to practice, custom, and usage in technical

matters, such as deliveries of securities, computation of interest, claims for dividends or interest, and similar matters. Early in its history the association concerned itself with the development of uniform methods for the compilation of over-the-counter quotations for newspaper publication which theretofore had been handled in different ways in each locality. The Commission has had recent occasion to study and criticize the methods employed by the association in this field and has advised the association that, in its opinion, improvement in the character of such quotations is both desirable and necessary. Discussions between the Commission's staff and the association's national quotation committee were in progress at the close of this fiscal year.

Commission Supervision of NASD Activity

Section 15A of the Securities Exchange Act requires the Commission to exercise general supervision ever certain of the activities of a national securities association. [Footnote: One of the first such matters to come before the Commission concerned the application of J. A. Sisto and Co. for an order approving or directing admission of the firm to membership in the NASD. The application was denied. See J. A. Sisto and Co., 7 S.E.C. 647, 1192 (1940), and Securities Exchange Act Release No. 3614, November 2, 1944]. Examples of the Commission's supervisory activities are the following:

The Proposed Capital Rule

In June 1942, the board of governors of the NASD proposed and the membership approved a substantial revision of its bylaws and the rules of fair practice, including a requirement that members maintain a minimum net capital of $5,000 or $2,500, depending upon the character of the member's business. Because of the controversial nature of a minimum capital requirement, the Commission held a public hearing to determine whether the proposal was in the public interest or for the Protection of investors and whether it was consistent with the purposes of the Maloney Act.

In its consideration the Commission affirmed the necessity of rules on solvency and recalled that, in approving registration of the NASD, it had pointed to the lack of such provisions. It stated that when the proposed rule had first been informally discussed, the Commission had been inclined to view it favorably. These factors to the contrary, the Commission found the proposed amendment inconsistent with the general purpose of the Act. [Footnote: Securities Exchange Act Release No. 3322] Recognizing the gravity of the problem for which this proposal was designed, the Commission promulgated its own Rule X-15C3 - 1, referred to above.

The Mark-Up Policies

On October 25, 1943, the board of governors of the association announced to the membership that it had approved an interpretation of Section 1 of Article III of the rules of fair practice that:

It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security.

In making this announcement the board referred to statistics on the pricing practice of the membership. Specifically, the board referred to a finding that, of more than 50,000 over-the-counter transactions reported by the members as a part of the 1943 inspection program for which some computation could be made, 71 percent had been effected at a gross spread or mark-up over the current market of not over 5 percent. Subsequently, on November 9, 1943, a letter was sent to the district business conduct committees of the association which stated among other things:

The general import of this statement and the construction that should be placed upon it is that, when transactions show a mark-up of over 5 percent on the part of a member, it raises the question as to whether there is a violation of the rule and interpretation. In such a situation, a duty is imposed upon the member to show to the satisfaction of the business conduct committee that no violation has occurred.

By subsequent letters and briefs it was made plain that the November 9 statement did not intend to impose upon an accused member the burden of proving his innocence merely because his spreads may have exceeded 5 percent.

Two separate groups attacked the board’s action as improper, arguing among other things that the interpretation was in fact a rule and as such was a nullity since it had not been submitted to the membership for approval. Each group filed a petition with the Commission requesting a public hearing on the matter. A hearing was held before the Commission on June 13, 1944. Permission to file briefs was granted and thereafter the Commission took the matter under consideration. [Footnote: On November 25, 1944, the Commission dismissed the petitions, holding that the NASD’s announcements were simply policies and not rules, and that the Commission could not prohibit or approve them on their merits, apart from individual cases wherein such policies were given specific application. Securities Exchange Act Release No. 3623]

The Sherman Gleason and Company Case

Two disciplinary actions by the Association against a member have come before the Commission for review on application of the member (in addition to a case pending at the close of the fiscal year). Both cases concern the same member and were joined for the purpose of hearing and disposition. The first of these complaints alleged that Sherman Gleason & Co., of Boston Massachusetts, had failed to maintain required books and records, had improperly commingled customers' securities and had charged customers unfair prices. The second was based on the firm's refusal to supply information on its business practices in response to a questionnaire circulated by the district business conduct committee.

In the first case, the district business conduct committee found violations of the rules of fair practice and imposed the penalty of severe censure and fine of $250. In the second case, the committees found a violation and expelled the firm from membership. Gleason sought review of both these cases before the NASD's board of governors. The board independently reviewed each case, found violations and affirmed the penalties. Gleason then petitioned the Commission for review. The Commission affirmed the penalty of severe censure and fine of $250 imposed in the first action but cancelled the penalty of expulsion imposed in the second. [Footnote: Securities Exchange Act Release No. 3550]

The "PSI Case"

At the end of the fiscal year, the so-called "PSI Case" was before the Commission for determination. On October 8, 1941, the Commission announced that it would call up for review, on its own motion, 6 representative cases of disciplinary actions by the NASD against some seventy members. [Footnote: Securities Exchange Act Release No. 3035] These actions involved findings by various district business conduct committees and the board of governors acting as an appellate body that the members had violated high standards of commercial honor and just and equitable principles of trade in transactions in the First Mortgage Bonds of the Public Service Co. of Indiana during an original distribution of $38,000,000 of such securities in a public offering made December 7, 1939. The decisions rested on a finding that the failure of a member to observe a contract voluntarily entered into for the purpose of maintaining a uniform offering price during the course of a distribution was a violation of Section 1 of Article III of the rules of fair practice which requires observance of high standards of commercial honor and just and equitable principles of trade.

The Department of Justice was admitted as a party in interest over objection by the association, its interest in the case arising out of the possibility of violations of the Sherman Act.

Extended hearings in the matter were held after which the Commission heard oral argument. The decision was pending at the close of the fiscal year.

ENFORCEMENT OF SECTION 10 (b)

Under Section 10 of the Securities Exchange Act, it is unlawful for any person to employ, in connection with the purchase or sale of any security, any manipulative or deceptive device in contravention of the Commission's rules and regulations. In May 1942, the Commission adopted Rule X-10B-5, generally prohibiting the employment of manipulative and deceptive devices by any person in the purchase or sale of securities.

From time to time since the adoption of that rule, the Commission has detected instances in which persons other than brokers and dealers have resorted to fraud in the purchase of securities from others. By virtue of Rule X-10B-5, such persons were guilty of violating the Securities Exchange Act. The leading case so far reported in detail in a Commission report, is "The Purchase and Retirement of Ward LaFrance Truck Corporation Stock." [Footnote: Securities Exchange Act Release No. 3445 June 12, 1943]

In that case, two officers who were in control of Ward LaFrance entered into negotiations with another corporation with a view to selling their interest and merging Ward LaFrance with the purchasing corporation. The two officers, after it appeared probable that the deal would be consummated, and well aware of the figures at which it probably would be made, authorized a broker to buy the Ward LaFrance shares in the over-the-counter market for Ward LaFrance's account. Shares were obtained from the company's stockholders at prices ranging from approximately $3 to $6 a share. None of the stockholders who sold their shares was advised that Ward LaFrance was the ultimate buyer. Nor were they told of the negotiations to sell the controlling shares at approximately $45 a share, or of the proposal to liquidate Ward LaFrance at a figure which would give shareholders $25 a share on liquidation. Also withheld from them was the fact that the company's earnings had improved since the last published statement from $2.75 to $15.75 a share.

There was a clear necessity for the issuer and those in control to make timely and adequate disclosure of these facts. The Commission stated that the purchase of securities under such circumstances unaccompanied by appropriate disclosure constituted a violation of Rule X-10B-5.

When the Commission brought these facts to the attention of the parties involved, arrangements were made to pay the stockholders who had sold their

shares the difference between $35.98 per share and the price they had received in selling their shares. Such payments amounted to approximately $165,000.

While this is the only case arising under Rule X-10B-5 in which the Commission has issued a public release, others have occurred and the number of alleged violations is increasing. Although the Commission took no action in, several such cases when rescission was extended shareholders by the violators of the rule, the need for more drastic action to prevent violations of this type is becoming increasingly apparent.

Part III

THE ADMINISTRATION OF THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The Public Utility Holding Company Act of 1935 deals with holding companies having subsidiaries which are electric utility companies, or which are engaged in the retail distribution of natural or manufactured gas. The Act was passed for the express purpose of eliminating certain evils and abuses which the Congress had found to exist in connection with the activities of such companies, and was intended for the protection of both investors and consumers. It provides for the registration of holding companies (Sec. 5); supervision of security transactions of holding companies and their subsidiaries (Secs. 6 and 7); supervision of acquisitions of securities and utility assets by holding companies and their subsidiaries (Secs. 9 and 10); the supervision of payment of dividends, solicitation of proxies, inter-company loans and other intra-system transactions (Sec. 12); the supervision of service, sales, and construction contracts (Sec. 13); and the supervision of accounting practices (See. 15). The key provisions of the Act, however, are contained in Section 11, which requires the limitation of holding company systems to an integrated system or systems and related other businesses and the corporate simplification and equitable distribution of voting power of companies in holding company systems.

NECESSITY FOR FEDERAL REGULATION OF INTERSTATE HOLDING COMPANY SYSTEMS

The Act was passed by Congress after a thorough study of electric and gas utility and holding companies conducted by the Federal Trade Commission from 1928 to 1934, pursuant to Senate Resolution 83, Seventieth Congress, first session. The resulting 101 volumes of reports made to the United States Senate have been characterized as "the most thorough investigation of an American industry

that has ever appeared.” [Footnote: Barnes, The Economics of Public Utility Regulation (1942), p. 71] The House Committee on Interstate and Foreign Commerce, pursuant to House Resolution 59, Seventy-second Congress, first session, and House Joint Resolution 572, Seventy-second Congress, second session, also conducted an extensive study of the practices of holding company systems. This study, conducted by Walter W. Splawn, consists of six volumes and was submitted to Congress shortly before passage of the Holding Company Act.

A brief description of the excessive concentration of control of the utility industry which led to many of the evils against which the Act is directed and the need for financial rehabilitation of many of the public utility holding company systems is given in. the following sections.

Concentration of Control of the Electric and Gas Utilities

The electric utility industry, unlike many other major industries is essentially local in its operations and markets. By existing means, power can be transmitted economically for only limited distances. In the manufactured gas industry economic transmission is much more limited. Consequently, there are no operating economies in the organization of these industries on a national scale. Regional Power groupings on an integrated basis correspond to the economic needs of such public utilities and appear to be the appropriate ownership pattern in the present state of the arts. Those are the findings of Congress in Sections 1, 10 (c), and 11 (b) of the Holding Company Act.

To the extent that concentration of control in the public utility industry reflected the merger of competing plants serving the same areas, the absorption of small plants in outlying towns and the coordination of urban and rural plants into interconnected regional systems, the public interest appears to have been definitely served. During the period 1920 - 30, however, holding companies, irrespective of any economic or functional relation to other properties in the system, acquired utility properties all over the country in order to build extensive utility empires. These empires grew enormously in the speculative period preceding 1930. For example, the consolidated assets of the Associated Gas and Electric system, now in bankruptcy, grew from approximately $6,000,000 in 1923 to $1,000,000,000 in 1929.

The realization, by banking, engineering and promotional interests of the variety and magnitude of the available gains and emoluments of control led to a race for the acquisition of utility properties, in the course of which prices were driven up to fantastic levels. [Footnote: “Fundamentally, the holding company problem always has been, and still is, as much of a problem regulating investment bankers as a problem of regulating the power industry.” Report of the National Power Policy

Committee to the House of Representatives, 74th Cong., 1st sess. (1935), H. Doc. 137 p. 56] Holding company expansion was stimulated in many instances on the one hand by investment bankers who were eager for commissions and profits in the sale of securities, and on the other by holding company promoters who desired to increase the sources from which they collected fees for management and engineering services. It has been estimated that, from 1924-30, utility holding companies floated some $5 billion of Securities, the great bulk of which went not to build or improve utility properties, but to purchase already outstanding voting securities of operating utility companies. [Footnote: S. Report No. 621, 74th Cong., 1st sess. (1935), p. 15] Part of the total represented the securities issued by super holding companies, such as the United Corp., which was organized in 1929 by J. P. Morgan & Co., Drexel & Co., and Bonbright & Co., Inc.

By 1932, according to the data, presented by the Federal Trade Commission, the holding companies had obtained control of the great bulk of the electric and gas utilities of the country. Of the electric power produced (privately owned plants) in the United States in 1932, the operating companies controlled by the 5 largest utility holding company systems generated 72.7 percent. Of the national production of manufactured and natural gas, the holding company systems accounted for 66.4 and 25.3 percent, respectively. Of the trunk line mileage of natural gas pipe line, 4 holding companies controlled 56.3 percent and 15 holding companies controlled 80.3 percent. [Footnote: Summary Report of the Federal Trade Commission to the Senate, No. 72-A, pp. 38-39,47. Figures adjusted to include the electric output produced by Pacific Gas and Electric Co., Detroit Edison Co., and Central Hudson Gas and Electric Co., being companies then controlled by the large systems through ownership of 17.9, 35.8, and 29.7 percent, respectively, of their voting stock.]

Among the subsidiaries in the holding company systems were companies engaged in one or more of a variety of enterprises - coal mining, production refining, and transportation of oil; wood, coal, and oil retailing; foundries; textiles; farming, irrigation, orchards; taxicabs; ice and cold storage; towing and lighterage; real estate, finance and credit, water, street railways, railroads, bus transportation, and telephone companies. Obviously the reasons for placing such heterogeneous collections of enterprises under a common control did not have to do with functional interdependence or with operating economies.

The scramble of rival holding company systems to acquire local operating utilities also impeded the development of integrated systems. In this connection, the National Power Policy Committee found:

The growth of the holding company systems has frequently been primarily dictated by promoters’ dreams of far-flung power and bankers’ schemes for

security profits, and has often been attained with the great waste and disregard of public benefit which might be expected from such motives. Whole strings of companies with no particular relation to, and often essentially unconnected with, units in an existing system have been absorbed from time to time. The prices paid for additional units not only have been based upon inflated values but frequently have been run up out of reason by the rivalry of contending systems. Because this growth has been actuated primarily by a desire for size and the power inherent in size, the controlling groups have in many instances done no more than pay lip service to the principle of building up a system as an integrated and economic whole, which might bring actual benefits to its component parts from related operations and unified management. Instead, they have too frequently given us massive, overcapitalized organizations of ever-increasing complexity and steadily diminishing coordination and efficiency.

These huge systems proved beyond the power of any single State to regulate. As the President said in his message to Congress of March 12, 1935 (quoted in S. Rept. No. 621, 74th Cong., 1st sees., at p. 2):

Regulation has small chance of ultimate success against the kind of concentrated wealth and economic power which holding companies have shown the ability to acquire in the utility field. No Government effort can be expected to carry out effective, continuous, and intricate regulation of the kind of private empires within the Nation which the holding company device has proved capable of creating.

The Need for Financial Rehabilitation of Holding Company Systems

The vast concentration of control of the public utility industry was accomplished by methods which led to the creation of unsound and top-heavy financial structures, many of which could not weather slight declines in earnings. The pyramided capital and corporate structures and the arbitrary “write-up” of the assets of operating and holding companies were two devices which enabled the promoters and bankers to acquire utility properties all over the country with a minimum of investment and these devices are likewise responsible for many of the present financial difficulties of holding company systems. These complex overcapitalized structures resulted in huge losses to American investors and the bankruptcy of many holding company systems.

Write-ups were sometimes based on appraisals made by closely affiliated interests, frequently on sketchy evidence. Very few of them were subject to any cheek by governmental authority. They were usually based on an estimate of what it would cost to reproduce the property. That application of the doctrine of Smyth v. Ames has cost American investors many millions of dollars. In the first place, Smyth v. Ames was not authority for the consideration of reproduction cost

in anything except rate cases, and in the second place, even in a rate case, it was but one of several elements to be weighed. Write-ups alone, or excessively pyramided structures alone, were highly dangerous financial practices; but their combination could have no other effect than catastrophe.

The typical holding company system consists of pyramids of companies, as well as of pyramids of securities within a company, [Footnote: An extreme example is afforded by the capitalization of Associated Gas and Electric Co., which issued 3 classes of common stock, 6 classes of preferred stock, 4 classes of preference stock; also 24 classes of debentures (some of them convertible at the option of the company into equity securities), 7 issues of secured notes, 4 issues of investment certificates, as well as various warrants and rights. These securities rest on securities of underlying companies.] all resting chiefly on the common stocks of operating companies. The pyramids are held together by the stock of the top holding company. The debt securities and preferred stock of the systems are held by the public. This technique afforded a maximum area of economic control with a minimum of investment. [Footnote: For example, the Commission recently found that two subholding companies, American Power and Light Co. and Electric Power and Light Corp., with consolidated assets of about $851,000,000 and $750,000,000 respectively, were controlled by Electric Bond and Share Co., whose interest represented only 3.42 and 8.72 percent of the total capitalization of the subsidiaries of the subholding companies, before adjustment for write-ups (Holding Company Act Release No. 3750, pp. 65-66). The Federal Trade Commission reported other striking instances e.g., the Standard Gas and Electric Co. had pyramided control until an investment of less than $1,000,000 exercised dominion over a system with a reputed investment of $370,000,000.]

The pyramiding device resulted in the highly speculative quality attached to the holding company securities through “leverage” known as “trading on the equity” or “the lifting power of other people’s money.” As a result of leverage small changes in the earnings of the underlying companies become magnified into large changes in the earnings applicable to holding company securities; during the 1929 boom, the profits thus appeared to be huge but when the boom collapsed, leverage worked in reverse and many holding companies and their subsidiaries were forced to default on their obligations and to cease dividend payments to stockholders. The complex capital structure also afforded many opportunities for the manipulation of accounts and finances, and for diversion of profits or losses through intercompany channels, to the detriment of investors and of the public. The corporate pyramids had the further effect of enabling holding companies to defeat or obstruct local regulation of operating companies.

The write-up permitted holding companies to acquire valuable properties on a “shoestring” investment by inflating the value of the assets acquired, selling

sufficient senior securities to the public to recoup the cash outlay, and retaining the controlling common stock for itself at little or no cost. As long as the public would buy the securities, there was every incentive to employ the scheme to acquire any property no matter where located and irrespective of the clear advantages of the property's integration with adjacent properties. [Footnote: The "write-ups" took place at the level of the operating, subholding, and top or apex companies. In the examination of the capital assets of 18 systems, the Federal Trade Commission ascertained write-ups of nearly $1.5 billion, of which about $854 million were found in the operating subsidiaries. The capital of the operating subholding and holding companies contained write-ups, on the average, of 22.1, 16.5. and 9.6 percent respectively.]

The fair-weather capital structures of the systems were ill-adapted to withstand any sudden decline in earnings. The data on bankruptcies and defaults indicate in part the scope and character of the task of reconstruction facing the Commission. From September 1, 1929, to April 15, 1936, 53 utility holding companies, with about $1.7 billion of securities outstanding, went into receivership or bankruptcy. Some of these were liquidated and present no further problem; others, reorganized in bankruptcy proceedings, subsequently began to default on their preferred stocks. An additional 23 holding companies, with about $535 million of outstanding securities, defaulted on interest and offered readjustment plans. The corporate income of many of the holding companies was insufficient to service both their debt securities and preferred stock, and arrearages on the latter were mounting. As of December 31, 1940, the registered holding companies had about $2,501,723,000 of preferred stock outstanding of which $1,442,18S,060 was in default, the total arrearages as of that date being approximately $476,000,000.

The financial practices of the holding companies had also resulted in serious injury to many of their operating subsidiaries. From September 1, 1929 to April 15, 1936, 36 utility subsidiaries, with outstanding securities of $445 million, went into bankruptcy or receivership. An additional 16 companies, with $152 million of securities outstanding, offered readjustment or extension plans after defaulting on interest. Many other operating companies escaped bankruptcy or receivership by deferring needed replacements, stinting on maintenance, and by stopping dividends on the publicly held preferred as well as the control stocks. Of preferred stock of operating subsidiaries aggregating about $1.6 billion at December 31, 1940, some $453 million were in default, such accumulated arrearages then amounting to about $165 million.

The facts and financial data pointed out above indicate that the Nation's vital interest in its electric and gas public utility companies had been seriously jeopardized by financial practices conducted in the interest of a small group of promoters and bankers, that public investors and consumers of such industries

had suffered heavily as a result of such practices, and that a constructive program of rehabilitating and simplifying the corporate structures of holding company systems was highly desirable in the national interest. Such a program was provided by Congress in the corporate simplification and integration provisions of Section 11 of the Holding Company Act.

INTEGRATION AND SIMPLIFICATION OF HOLDING COMPANY SYSTEMS

The provisions of Section 11 of the Holding Company Act are carefully designed to strengthen the capital structures of utility systems and to return control over the Nation's utilities to local management and State and local regulation. Section 11 (b) (1) of the Act requires the limitation of each holding company system to a single integrated public-utility system with provisions for the retention of additional utility systems and related incidental businesses under certain designated circumstances. It is, in effect, a specialized antitrust act designed to meet the problem of the serious and uneconomic concentration. of control of public utility companies. Section 11 (b) (2) provides for the simplification of the structures of holding company systems, including the elimination of unnecessary and "great-grandfather" holding companies and the reorganization of holding companies, which are unduly complicated and overcapitalized, and the redistribution of voting power among security holders of holding and operating companies. The basic provisions for carrying out Section 11 (b) are to be found in Section 11 (d), which permits recourse to the courts by the Commission, if necessary, to enforce the Commission's orders, and in Section 11 (e), which permits the filing of voluntary plans for compliance with the standards of Section 11 (b). To a very large extent, Section 11 results in the Holding Company Act being self-liquidating, for, as utility companies are freed from holding company control, the Commission generally loses jurisdiction over them under this Act.

The problem of conforming the electric and gas utility-holding companies to the requirements of Section 11 (b) is a task of great magnitude. Progress under Section 11 was slow in getting under way. Although the statute was enacted by Congress in August 1935 the Commission was directed to enforce the integration and simplification provisions only *** as soon as practicable after January 1, 1938." In the intervening period holding companies were given an opportunity to take voluntary steps to comply with Section 11. However, the companies did not avail themselves of that opportunity but chose instead to test the constitutionality of the Act. After the decision of the Supreme Court in March 1938 upholding the constitutionality of the registration provisions, the Commission gave all holding companies a further opportunity to submit to the Commission their plans for voluntary compliance. They responded to the Commission's invitation by submitting tentative plans which on examination were clearly impractical and not in conformity with the statute. In general their plans amounted to little more than attempts to justify the retention of existing scattered holdings.

It thus became clear to the Commission that compliance with the Act could be achieved only by the institution of affirmative proceedings, pursuant to the statutory direction in Section 11 (b). Accordingly in the spring of 1940, the Commission instituted integration proceedings with respect to nine major utility holding company systems and corporate simplification proceedings with respect to three major systems. The two classes of proceedings are interrelated, since action taken to comply with the geographical standards may also facilitate corporate simplification, and steps taken in the direction of corporate simplification may serve to eliminate substantial problems which would otherwise require determination in proceedings under Section 11 (b) (1).

Once proceedings under Section 11 are instituted by the Commission (or are initiated by the filing of a voluntary plan), full hearings are held in which all interested parties are given the opportunity to present evidence and voice their views before the Commission. On the basis of the record before it and the contentions made as to the applicability of the law to the facts, the Commission issues its findings and opinion and order. All such orders are subject to full judicial review in the Federal courts.

The Commission's decision to date under Section 11 (b) have clarified most of the import an interpretative problems which arose under that Section, in the Columbia Gas and Electric Corporation [Footnote: Holding Company Act Release No. 2477] and The United Gas Improvement Company [Footnote: Holding Company Act Release No. 2692] cases, the Commission held that gas and electric utility companies cannot be considered as together constituting a "single integrated public-utility system" within the meaning of the Act. Thus holding company must satisfy the requirements prescribed by Congress for the retention of additional systems if it desires to retain both an electric and gas utility system.

In a subsequent case, Engineers Public Service Company and its Subsidiary Companies, [Footnote: Holding Company Act Release No. 2897] the Commission's opinion settled the most important interpretative issue arising under Section 11 (b) (1). The company had contended that it was not precluded under Clause (b) of Section 11 (b) (1) from having one integrated system in Virginia and states adjoining Virginia, and another in Texas and States adjoining Texas. Interpreting Clause (B) in the light of its legislative history, and in the light of other provisions of the statute, the Commission concluded that additional systems are retainable under Clause (B) only if they are located in the state or states in which the principal system operates or in states adjoining thereto. The Commission's decision in this respect was upheld by the Court of Appeals for the District of Columbia. [Footnote: 138 F. (2d) 936] This case is now pending before the United States Supreme Court. [Footnote: In the North American case, the

Circuit Court of Appeals for the Second Circuit also upheld the Commission's interpretation of Clause (B) of Section 11 (b) (1) (133 F (2d) 148). This case is pending before the United States Supreme Court but the company requested and was granted certiorari only on the issues of constitutionality.]

The application of the standards of Section 11 (b) (1) to the retention by holding companies of non-utility businesses, has led to such conclusions as that coal mines which do not supply the utility may not be retained, nor may transportation systems unrelated to the operations of the utility system; whereas coal mines the output of which is consumed by the utility and even railroads used to carry such coal to the utility may be retained. Whenever the problem of retention of gas and electric appliance businesses has been presented to the Commission, the Commission has permitted retention. In many instances, the Commission has been unable to find that ice and water businesses have been shown to be reasonably incidental or economically necessary or appropriate to utility operations. In several cases, the Commission has permitted the retention of ice and water businesses where statutory requirements were satisfied. Each situation has to be considered on its own merits and in the light of all the relevant evidence .

In the enforcement of Section 11 (b) (2), the Commission orders have required numerous holding companies to dissolve, many others to recapitalize so as to achieve a simple structure, and certain operating companies where control was exercised by a class of stock which had an insufficient investment in the company in relation to the investment of all the security holders to change their capital structures so as to achieve an equitable distribution of voting rights.

The orders issued by the Commission under Section 11 have carefully guarded against any forced liquidations or dumping of securities on the market. Although it is the Commission's view that it has the power to specify methods of compliance, its practice in most cases is to issue a general order specifying the objective to be achieved, but without detailing the manner in which the company should comply. This is intended to encourage voluntary compliance, assist the company by indicating the goal to be reached, and give the company a reasonable opportunity to work out the specific methods of compliance. Recently, the Circuit Court of Appeals for the Third Circuit, in Commonwealth and Southern Corp. v. S.E.C., [Footnote: 134 F. (2d) 747] unanimously upheld this method of enforcing Section 11.

In the appendix to this report there is included a group of tables which indicate some of the progress that has been made in carrying out the objectives of Section 11 (b) of the Holding Company Act. The information given in parts 1,2, and 3 of table 17 relating to the electric, gas, and non-utility subsidiaries which

have been divested by registered companies from December 1, 1935, to June 30, 1944 is summarized below:

(chart omitted)

It will be noted that 260 electric, gas and non-utility subsidiary companies with total assets of approximately $3,765,000,000 have been divested in this period. This includes l05 electric utility companies with total assets of $2,957,000,000, 78 gas utility companies with total assets of $654,000,000, and 83 non-utility companies with total assets of $156,000,000. Most of the electric utility companies and substantially all of the gas and non-utility companies were divested for the purpose of, or with a view to, meeting the integration requirements of Section 11.

Of the total number of these divested companies, 232 companies, with total assets of $2,273,000,000, are no longer subject to the Holding Company Act and 34 Companies, with total assets of $1,494,000,000, are still subject to the Act by reason of their relationship to other registered holding companies.

In addition to the divestment of companies, as such, the tables show that 78 other subsidiary companies have sold parts of their electric, gas, and non-utility properties for a total consideration of $92,000,000. The greater part of these properties are no longer subject to the act.

Reference is made to appendix table 18 which lists the subsidiary utility and non-utility companies, the control of which must be divested by their respective parents under Section 11 (b) (1) orders outstanding as of June 30, 1944. By virtue of these orders, 17 holding companies must divest themselves of their control over 196 subsidiary companies having aggregate total assets of $3,887,000,000.

In a number of holding company systems, there are holding companies which are merely pyramiding devices and perform no useful function. Many of these have already been ordered dissolved after appropriate Section 11 (b) (2) proceedings. Table 19 in the appendix lists the holding companies which have been ordered to dissolve or liquidate under Section 11 (b) (2) orders outstanding as of June 30, 1944. The tabulation includes 14 holding companies and shows that 11 of these companies have 229 utility or non-utility subsidiaries with total assets of approximately $3,946,000,000.

The Carrying Out of Section 11 Orders

Section 11 (c) provides that all orders of the Commission under Section 11 (b) should be complied with within 1 year except that an additional year may be obtained upon a showing of due diligence. If the company does not voluntarily comply with the order, the Commission is empowered under Section 11 (d) to seek the aid of a United States district court to enforce the order. Under Section 11 (4) the court may take jurisdiction and possession of the company and its assets, may appoint a trustee, and may enforce a plan to meet the Section 11 (b) order, if the plan has been approved by the Commission.

It was Congress' intention, however, to encourage the various holding company systems to comply with the Act voluntarily. For this reason Section 11 (e) provides that a company may file a voluntary plan with the Commission, that the Commission shall approve the plan, after a public hearing in which investors are encouraged to voice their views, if the plan is found necessary to effectuate Section 11 (b) and fair and equitable to the affected persons, and that on the request of the company the Commission may seek enforcement of the plan in the courts. The courts are required to enforce Section 11 (e) plans if they are found appropriate to effectuate Section 11 (b), and fair and equitable. Thus, security holders have the protection of findings as to the fairness and equity of plans by both the Commission and a United States district court.

Many plans for complete or partial compliance with Section 11 have already been approved by the Commission and have been or are being consummated. Many more systems have filed plans which are currently being considered by the Commission, and a number of other holding companies are discussing with the Commission's staff drafts of plans which they have prepared. The filing, approval, and consummation of these plans represent major achievements in the financial and operating reorganization of the American Utility industry.

The Protection of the Rights of Security Holders in Section 11 (e) Plans

Voluntary compliance with Section 11 (b) does not mean, as the alarmists once contended dumping or forced sales of securities on the markets. There has not been a single instance of "dumping" of securities upon a market unable to pay a fair price for them in the entire history of enforcement of the Act. Indeed, in many instances the sales have resulted in substantial profits. In addition to sales, other methods of compliance such as exchanges of underlying portfolio securities for holding company securities, or exchange of securities of a soundly reorganized company for the old securities thereof, have been widely used by the holding companies.

Exchange plans have been successfully used by such holding companies as the United Gas Improvement Co., Standard Gas & Electric Co., National Power & Light Co., and the United Light & Power Co. In all of these cases holding

company preferred stockholders or bondholders were offered underlying portfolio securities in discharge of their claims. A variant was employed by the North American Co., which has distributed all of its holdings of The Detroit Edison Co. common stock and a large part of its holdings of Washington Railway & Electric Co. and Pacific Gas & Electric Co., which it was not permitted to retain under Section 11 (b) (1), by paying them out over a period of time as dividends to North Americans stockholders. Similarly, Lone Star Gas Corp. distributed all of its holdings in Northern Natural Gas Co. as a dividend to its stockholders, Cases where corporations were reorganized and the new securities of the simplified structure were (or are being) passed out to the old stockholders and bondholders were Jacksonville Gas Co., Puget Sound Power & Light Co., Southern Colorado Power Co., International Utilities Corp., and the Laclede Gas Light Co. The arguments of the opponents of the Act to the effect that Section 11 could not be enforced without the dumping of securities on the markets in enormous quantities, have not been borne out in practice.

Up to June 30, 1944, a total of 115 plans had been filed with the Commission under Section 11 (e). The Commission approved 48 of these plans, frequently after securing necessary modifications; 19 were withdrawn or dismissed, 3 were denied, and 45 were pending before the Commission in various stages of completion. In addition a great number of steps have been taken to meet the standards of section 11 without the filing of Section 11 (e) plans. Thus, for example, in certain cases there have been divestments by holding companies of underlying securities without the filing of Section 11 (e) plans to effectuate the divestment.

In some cases where Section 11 (e) plans have been approved by the Commission, the companies are unable to carry them out without obtaining a court order. The Act permits the Commission at the request of the companies to go to court for the purpose of obtaining enforcement of such plans. Court orders have been entered enforcing Section 11 (e) plans filed by Community Power & Light Co., Columbia Oil and Gasoline Corp., Puget Sound Power & Light Co., The United Light & Power Co., United Gas Corp., Southern Colorado Power Co., North American Gas & Electric Co., Central States Power & Light Corp.,. North Continent Utilities Corp., Consolidated Electric & Gas Co., Clarion River Power Co., American Gas & Power Co. International Utilities Corp., Great Lakes Utilities Co., and the Laclede Gas Light Co. [Footnote: For citations see appendix table 32, part 2]

As has been said, security holders are not required to accept Section p (e) plans unless they are found fair and equitable by both the Commission and a United States district court. In determining whether plans are fair and equitable the Commission has sought to enforce the intent of Congress that Section 11 should not have the effect of destroying values for any security holder, that it should not

cause any portion of the legitimate investment interest of any security holder to be given to another. Two principal types of cases in which this problem has been before the Commission are those involving the relative rights of preferred and common stockholders and those involving bond or debenture holders whose securities are redeemable at the option of the company.

In the first type of case, the Commission has held that where a company is being reorganized or liquidated under Section 11, fairness and equity require that the common stock be permitted to participate in the reorganization where it has a legitimate investment interest in the holding company, and but for the necessity of winding up the company under Section 11, it would be in a position to receive earnings in the future. If, therefore, on a "going concern" basis, the common stock has an equity, the Commission protects this valuable right fully and does not permit the Section 11 order to have the effect of maturing the liquidation claims of the preferred stock.

A majority of the Commission has consistently applied this principle. [Footnote: Commissioner Healy, while agreeing with the proposition that investment values should no be sacrificed and that valuations should be made on a going concern basis, has dissented from all these cases, claiming that the preferred stockholders were not receiving the equitable equivalent of what they were surrendering and that their rights were not fully recognized.] Companies which have been reorganized on this basis include Federal Water Service Corporation, [Footnote: Holding Company Act Release No. 2635] Puget Sound Power & Light Co., [Footnote: Holding Company Act Release No. 4255] and international Utilities Corp. [Footnote: Holding Company Act Release No. 4896] in the Community, Puget, and International cases the plans were also approved by United States district courts under Section 11 (e), while in the Federal case the company was able to put the plan into effect without court enforcement. The Commission has also applied this principle to the reorganization of Southern Colorado Power Co., an operating company, and to the winding up of The United Light & Power, a holding company. [Footnote: Holding Company Act Release No. 4215 Commissioner Healy's dissenting views are set forth in detail in his dissenting opinion in this case and in his dissenting opinion in the Federal Water Service Company case.] In both cases the Commission applied to United States district courts for enforcement, and the district courts affirmed this principle and ordered that the plans be put into effect. In the United Light case an appeal was taken from the district court's order to the circuit court of appeals, [Footnote: Ottis and Co. v. S.E.C., 142 F. (2d) 411] which upheld the Commission's decision, and the question is now pending before the Supreme Court. [Footnote: The Supreme Court has rendered its decision in Ottis V. S.E.C. approving the Commission's holding (three justices dissenting), 65 S. Ct. 483 (1945)] In the Southern Colorado case an appeal from the district court's order is pending in a circuit

court of appeals. [Footnote: On appeal the Tenth Circuit Court of Appeals upheld the Commission's approval of the plan.]

The principle that fair and equitable plans should not cause any class of securities to sacrifice valuable rights and confer a windfall on another class is also illustrated in the premium cases. In many cases the carrying out of Section 11 requires the retirement of bonds and debentures. For example, if a holding company is ordered to wind up it obviously cannot continue to have bonds outstanding, and the bonds must be paid to conform to the standards of Section 11 (b). Similarly, if a company has to be reorganized on such a basis that there is a substantial debt reduction or indeed the elimination of all of its debtedness, the standards of Section 11 (b) require retirement of the debt. In a number of cases where bonds or debentures were being retired in the course of such plans to meet the standards of Section 11 (b) the Commission has held that such retirements are not voluntary and that the bonds or debentures are not entitled to the call premium specified in the indenture as payable in the event of a voluntary redemption. The Commission's decisions in this respect have been enforced by United States District Courts in a number of cases [Footnote: In the Matter of Consolidated Electric and Gas Company, 55 F. Supp. 211 (D.C. Del., 1944); and have been upheld by two United States Circuit Courts of Appeals. [Footnote: New York Trust Co. v. Securities and Exchange Commission, 131 F. (2d) 274 (C.C.A. 2d, 1942), cert. den. 318 U.S. 786 rehearing denied 329 U.S. 781; and City National Trust Co. v. Securities and Exchange Commission, 134 F. (2d) 65 (C.C.A. 7th, 1943).]

The "Deep Rock" Principle

In the "Deep Rock" case, [Footnote: Taylor v. Standard Gas and Electric Company, 306 U.S. 308] the Supreme Court held that under the circumstances there present, a parent corporation could not participate on the same basis as the public security holders in a reorganization of a subsidiary, and that the parent's debt claims must be subordinated to the publicly held preferred stock of the subsidiary. One of the principles derived from the decision is that this restriction or subordination applies where a parent is guilty of mismanagement or unfair treatment of the subsidiary. As a principle of equity this is simple of statement, but in practice it has been found that each case where the issue arises presents a complicated set of facts requiring careful analysis. Since one of the cardinal abuses which led to the, passage of the Holding Company Act was overreaching by holding companies in their dealings with their subsidiaries, the Commission examines every situation with care to insure that the public security holders will be protected.

In many situations, plans filed by companies under Section 11 have given recognition to this principle. For example, Empire Gas & Fuel Co., which was

being re-capitalized under the Act, had outstanding a large amount of preferred stock in the hands of the public. It was indebted to its parent, Cities Service Co., in the amount of more than $100,000,000. Empire had been incorporated by Cities in 1912 and had been continuously dominated and controlled by it. No dividends had been paid on the preferred stock for more than 10 years although interest had been paid regularly on the debt owed to the parent. The history of the intercorporate relationships between Cities and Empire raised serious doubts as to the validity and proper rank of the huge debt claim of Cities. After consultation with the Commission's staff, Cities agreed to a plan whereby the public preferred stockholders of Empire received new debentures of Empire in an amount equal to the par value of the preferred stock plus accumulated unpaid dividends, and Cities" $100,000,000 of intercompany debt claims against Empire were made junior to those new debentures. [Footnote: Holding Company Act Release No. 3711.]

It is noteworthy that although the market price of the preferred stock of Empire was $57.50 per share the day before the proceedings were commenced, the preferred stockholder could have sold the new debenture be received for $157 immediately after the plan was put into effect.

Elimination of Inequitable Distribution of Voting Power

An important effect of Section 11 (b) on operating companies is the requirement that necessary steps shall be taken to insure that the corporate structure of an operating company does not involve an inequitable distribution of voting power among its security holders. One of the significant evils against which the Act was directed, was control over operating companies by holding companies which had a disproportionately small equity investment in the operating company. Frequently in holding company systems an undue portion of the capital of the operating utility companies was raised by selling bonds and preferred stock to the public and the holding company paid little or nothing for the common stock which had voting control.

In considering what steps should be required to cure situations of that kind, and in passing on voluntary plans designed to bring operating companies into conformity with Section 11 (b) (2), the Commission has been faced with the problem whether the inequitable distribution of voting power might not be cured simply by giving voting control to the preferred stockholders or bondholders of the operating company and leaving the security structure otherwise untouched. After careful consideration, the Commission determined that half measures of that type would not solve the problem, for such plans would not be feasible. Over-capitalized operating companies which are so top- heavy with senior securities that it is inequitable for the common stockholder to have control, have structures which impede the raising of new capital, and obstruct regulation.

Furthermore, it is financially unsound to have a company controlled by a senior security with a limited dividend claim, for then the more junior securities would be powerless to protect themselves. The Commission determined that when an inequitable distribution of voting power is attributable to an operating company's bad structure, to its excessive senior securities; the proper remedy may well be to change the corporate structure and reduce the high amount of senior securities.

An example of the Commission's action in this respect is found in the Jacksonville Gas case. [Footnote: Holding Company Act Release No. 3570.] Jacksonville Gas Co., an operating subsidiary of American Gas & Power Co., had bonds and debentures outstanding in amounts greatly exceeding Jacksonville Gas" properties. The maturity of the debt was nearing and the company filed a Section 11 (e) plan providing for the issuance of new bonds in greatly reduced amounts, and common stock; the bonds and stock were to be distributed to the company's creditors in a fair proportion and the old stock which was admittedly worthless was to be cancelled. There was no doubt on the facts that the deplorable corporate structure of Jacksonville Gas Co. caused an inequitable distribution of voting power among its security holders, for its creditors who had the sole interest in the company, had no voice whatsoever in its management. It was equally clear that merely giving votes to the bondholders and debenture holders would leave the company as sick as it ever was, and would not be a feasible solution of the company's problems. The Commission accordingly approved the plan and at the company's request applied to a United States district court for its approval and enforcement of the plan. The district court found the plan appropriate to effectuate Section 11 (b), and fair and equitable, and thus Jacksonville Gas Co. was soundly reorganized in a manner beneficial to all of its security holders, and to consumers and the public at large. Under the procedure available in Section 11, the court order approving the plan was entered within 4 and one half months from the time the Commission made application to the court to enforce the plan.

Other companies which have filed recapitalization plans designed to cure an inequitable distribution of voting power among their security holders are Southern Colorado Power Co., International Utilities Corp., Virginia Public Service Co., Puget Sound Power & Light Co., and the Laclede Gas Light Co. All of these companies except International Utilities Corp., are operating companies. These plans as amended were all approved by the Commission but the Virginia Public Service plan was not put into effect because the company instead was merged with a neighboring utility. In regard to the other plans, on application of the Commission, appropriate orders were entered by United States district courts approving and enforcing the plans. The Southern Colorado plan, however, is now on appeal in a circuit court of appeals.

In reorganization cases which involve the issuance of equity voting securities to senior security holders, the Commission has taken steps to insure that the election machinery at the initial election of directors gives the security holders an effective opportunity to exercise their newly acquired voting rights. Although this machinery is still being improved, it generally provides for two steps: First, nomination and second, election. To facilitate nominations and elections the company is required to make available lists of stockholders and their addresses and all of the holders of the new voting stock are invited to nominate candidates for directorships, with. a certain number of votes necessary for each nominee. The slate of candidates is twice as large as the board of directors will be, and consists of those who receive the largest number of nominating votes. After the close of nominations, an impartial proxy is circulated among the new stockholders at the expense of the company, and those receiving the largest number of votes (cumulative voting being generally required) are elected to the board. The Commission examines all proxy solicitation material, both in the selection of nominees and in the election of directors, to insure full and fair disclosure.

Beneficial Effects of Section 11 Upon Investors and Consumers

The above discussion outlines only briefly the progress in enforcing Section 11, the most controversial provisions of the Holding Company Act during the time the bill was being considered by Congress. The history of the administration of Section 11 shows that the fears of certain opponents of the legislation that there would be destruction of values and hardships to investors if Section 11 were adopted, were unfounded. The effect of Section 11 (b) (2) on operating companies has been to substitute sound structures which fairly allot voting rights for top-heavy structures where the senior security holders, who supplied almost all the capital, were disfranchised. Section 11 (b) (1) has the effect of releasing operating companies from absentee control and permitting the management of each operating unit to be truly responsive to the needs of the community it serves. The effect of Section I1 (b) on holding companies has resulted in many cases in the distribution of underlying portfolio securities to the holding company investors, Thus, their investors have acquired securities close to the “rails” instead of the highly speculative holding company securities. In both holding companies and operating companies, there are many instances where the effectuation of plans of corporate simplification to comply with Section 11 (b) has permitted the flow of dividends to investors who have not received any income for many years. In many other cases holding companies have retired their senior securities by cash payments. Pursuant to the requirements of Section 11 (b) (1) many holding companies have been reducing the scope of their operations thus reducing a concentration of economic power which, as Congress found, had reached dangerous proportions.

In all of these situations investors have been fully protected. Thus, before Southern Colorado Power Co., an operating subsidiary of Standard Gas & Electric Co., filed its recapitalization plan with the Commission, its preferred stock was selling at $32 per share; after the Commission approved the plan the stock was selling at $60 per share and by the time the district court's order was entered also approving the plan and directing its enforcement, the stock was selling at $70 a share. The United Gas Improvement Co., a registered holding company, divested itself of its holdings in Philadelphia Electric Co. and Public Service Corp. of New Jersey (which companies have combined assets of $1,200,000,000) by distributing these holdings plus cash to U. G. I.'s own preferred and common stockholders. Just before the plan was filed, the market price of U. G. I. common stock was about $4 per share although as in the case of most other holding company stocks the break-up value of the shares was substantially greater than that amount. Since the plan proposed to eliminate a large portion of this discount by transferring direct ownership of certain of these investments of U. G. L's common stockholders, the common rose to $6 per share immediately after the plan was filed and just before the distribution of the securities to stockholders the common stock sold at $9 7/8 per share. Many instances of similar benefit to investors as a result of the enforcement of Section 11 are available in the Commission's files.

Investment analysts such as Standard and Poor's have long pointed out that "there seems little justification for any fear that holding companies will be forced to dispose of properties at inadequate prices or to take any action that would adversely affect true values."

Standard and Poor's, Moody's Stock Survey and Barron's frequently publish studies showing that holding company securities sell at substantial discounts on their liquidating values. In its publication "The Outlook" for June 7, 1943, Standard and Poor's state:

Holding company stocks have benefited from integration or liquidation plans filed with the S.E.C. in recent months. *** Since utility holding company stocks normally sell at a discount from their liquidating value (just as do investment trust equities) the filing of liquidation plans has caused the price of securities involved to advance sharply to approximately those values.

This was the experience of the common stocks of Federal Water & Gas, National Power and Light, Niagara Hudson Power, and United Gas Improvement, all of which have lately filed integration plans, as well as the preferred stocks of Standard Gas and Electric and United Light & Power. Many of these issues more than doubled in price with the announcement that liquidation or integration of the holding company was planned. *** Additional utility holding companies will

probably file integration or liquidation plans, which should prove beneficial generally to the market price of their securities.

Similar expressions concerning the beneficial effects of Section 11 have been made by a number of holding company managements.

Status of Each of the Major Holding Company Systems Under Section 11

A brief summary of the status of each of the major holding companies under the more important aspects of Section 11 at the close of the past fiscal year is presented in the appendix at the end of this chapter.

REGULATION OF SECURITY ISSUES

The control over security issues given to the Commission under the Act in Sections 6 and 7 is an important part of the statutory aim to restore the utility industry to full financial health. [Footnote: The Senate Committee on Interstate Commerce, reviewing the proposed holding company legislation stated that the intent of sections 6 (a) and 7 was “to give the Commission continuous over the revamping of holding-company systems to meet the requirements of title I looking toward the establishment of financially sound and economically integrated units and the avoidance of injury to investors and consumers”. Sen. Rept. No. 621, 74th Cong., 1st sess. on S. 2796, May 13, 1935.] These sections are well designed for the achievement of these objectives. Section 7 prescribes qualitative standards in regard to proposed security issues and changes in priorities, preferences, voting power or other rights of outstanding securities. In brief, the Commission may not permit the issuance of a security if the terms and conditions thereof are detrimental to the public interest or the interest of investors and consumers; if the proposed financing is not necessary or appropriate to the efficient operation of the applicant’s business; if the proposed security is not reasonably adapted to the earning power or security structure of the declarant; if the fees, commissions, etc., paid in connection with the issue are not reasonable. The Commission may not permit changes in priorities, rights, etc., of outstanding securities if it finds that such changes are detrimental to the public interest or the interest of investors and consumers. Any order permitting a security issue may contain such terms and conditions as the Commission finds necessary to insure compliance with the above standards.

Subject to the Commission’s powers to impose “such terms and conditions as it deems appropriate in the public interest or for the protection of investors and consumers” Section 6 (b) directs the Commission to exempt from the requirements of Section 7 an issue and sale of securities which has been expressly authorized by a State commission of the State in which the issuer is

both organized and doing business and where the securities are solely for the purpose of financing the business of the issuer. These provisions limit the Commission's powers over security issues where a State commission has full authority over the subject matter and where the other conditions for exemption are met. In granting a Section 6 (b) exemption, however, the Commission is empowered to impose terms and conditions appropriate in the public interest even where State commission approval has been secured. As discussed in a later section of this report, the Commission usually consults with State commissions with regard to the imposition of terms and conditions in Section 6 (b) cases.

The determination of whether a particular security issue meets the standards of the Act demands accounting, engineering, and legal skills, together with an export knowledge of public utility financing. While insisting at all times upon adherence to the standards of the Act, the Commission does not approach security issues with a rigid set of requirements applicable to all situations. It considers one of its major functions to be that of helping companies to meet the requirements of the Act. For example, where the terms of a proposed security issue, as initially filed with the Commission, fail to meet one or more of the statutory standards, the Commission does not simply refuse to permit the declaration concerning the issue to become effective, but seeks to strengthen the terms of the issue to a point where investors and consumers receive the protection afforded by the safeguards of the Act. This work is done largely around the conference table and in informal meetings with the company's officials and its financial and legal advisers.

In a great number of cases, conferences precede the formal filing of the issue with the Commission and here the company and the Commission work out the terms of the issue to meet the requirements of the Act. For example, adequate maintenance and depreciation charges, restrictions on dividends, effective voting rights for preferred stock in the event of default in dividends, limitations on the future issuance of securities having a preference over the proposed issue, elimination of conflicts of interest of indenture trustees, correction of accounting practices, and similar matters, have been worked out informally, both before and after filing. In many instances, it has been possible to promote the rehabilitation of a weak company and to convert a speculative issue into a more conservative one.

Balanced Capital Structures

A major objective of the Commission's regulation of security issues has been to achieve a balanced capital structure with a substantial amount of common stock equity. A balanced capital structure provides a considerable measure of insurance against bankruptcy, enables the utility to raise new money most

economically, and avoids the possibility of deterioration in service to consumers if there is a decline in earnings. Since, by and large, the utility industry has been characterized by an excessive amount of debt and other senior securities, the Commission's regulatory efforts under Sections 6 (b) and 7 have been in considerable part devoted to reduction of these senior securities and the increase of the common stock equity. In some instances, conditions have been attached requiring that the interest savings from refunding or a certain amount of net earnings be reserved to redeem outstanding debt. In other instances, the Commission has required the inclusion of sinking fund provisions whereby the issuer agrees to devote annually a stated amount to retirement of bonds or to property additions. In still other instances, the objective of debt reduction has been achieved by financing through the issuance of securities with short-term serial maturities.

Equity Financing

As a corrective measure, the Commission insists that, wherever possible, more common stock equity be built up to improve the capital structure of those companies which have a high ratio of bonds to (a) "capitalization" and (b) net property, adjusted for write-ups. [Footnote: See appendix, El Paso Electric Company, Holding Company Act Release No. 2535.]

One method of increasing common stock equity has been to require the conversion of open accounts, bonds, or preferred stock held by the parent company into common stock of its subsidiary. [Footnote: See Public Service Co. of Colorado, 5 S.E.C. 788, Gulf Public Service Company, Holding Company Act Release No. 2253; East Tennessee Light and Power Co., Holding Company Act Release No. 2344. See also Georgia Power Company, Holding Company Act Release No. 2586] When the Appalachian Electric Power Co. [Footnote: Holding Company Act Release No. 2340.] refinanced its bonds and preferred stock, its parent, American Gas and Electric Co., made a $30,670,000 capital contribution to its subsidiary. This was accomplished by the surrender of an open-account advance and preferred stock with the provision that $22,500,000 of that amount be placed in an appropriate reserve to be available for possible adjustments to fixed capital accounts and depreciation reserve. The principles of the Deep Rock case [Footnote: Taylor v. Stanford Gas and Electric Company, 306 U.S. 307 (1939).] established by the Supreme Court of the United States have given considerable impetus to the conversion of senior security holdings into common stock.

A number of holding companies have increased their equity investments in their subsidiaries either by outright cash contributions or the purchase of additional common stock. An additional method of increasing the common stock equity is illustrated in the West Penn Power case. [Footnote: 7 S.E.C. 69 (1940)] That

company issued and sold common stock to the public to finance needed Property improvements rather than increase the proportion of senior securities in its structure as it proposed to do in its initial application to the Commission.

Elimination of Inflation in Property Accounts

In Passing upon security issues the Commission has consistently required that the securities proposed to be issued be based upon actual sums invested in utility property and not “watered” assets. The Securities and Exchange Commission like the State Commissions and the Federal Power Commission, has required the elimination of write-ups and other inflationary items from the plant accounts either by direct write-offs or by an amortization program. In this connection the operating utility subsidiaries of registered holding companies wrote down their property accounts by more than $500,000,000 in the seven years ended December 31, 1942. The process has continued since then at an accelerated rate as the companies” original cost studies have been completed. [Footnote: The system of accounts prescribed by the Federal Power Commission for electric utilities, effective January 1, 1937, originally required the submission of original cost studies within two years. Substantially the same system of accounts was adopted by the great majority of State Commissions at approximately the same time, upon recommendation of the National Association of Railroad and Utilities Commissioners. The uniform system of accounts for gas companies, likewise recommended by the association (N.A.R.U.C.) was adopted by most States.]

Depreciation Accruals and Depreciation Reserves

Correct accounting for “depreciation” is especially important in public utility enterprises because of their relatively large investment in depreciable fixed property. The understatement or overstatement of depreciation distorts net operating income and gives a misleading picture of the financial condition of the enterprise; investors are given an illusory and false impression with regard to earnings coverage, earned surplus and the depreciation reserve.

Prior to the adoption of revised systems of accounts for electric and gas utilities in 1937, which provide specifically for depreciation accounting, the retirement reserve method of accounting for property retirements was in general use in the electric and gas utility industry with the sanction of most of the regulatory agencies having jurisdiction. While a sound use of the retirement reserve method did not preclude adequate accruals and did not, of course, alter the fundamental nature of depreciation, many companies charged amounts sufficient to provide for only a little more than current property retirements and did not take into account the depreciation currently accruing on the property which continued in service. That practice was not only inherently deceptive but, because of the

growing need for capital, at resulted in the issuance and sale of a considerably larger volume of securities than otherwise would have been necessary. It is now generally recognized that adequate provision for depreciation is essential to the protection of the interest of investors.

To protect new and existing investors against the ill-effects of inadequate depreciation, the Commission has insisted upon certain protective measures. In the case of inadequate depreciation reserves coming before the Commission in connection with security issues, the Commission has attempted to make up for the mistakes of the past in a number of ways. In certain cases, the reported earned surplus has been made unavailable for any dividend charges or for any other charges, except certain limited and specified ones. In other cases, the Commission has required a direct transfer of earned surplus to the depreciation reserve. In the Georgia Power Company case [Footnote: Holding Company Act Release No. 2586.] the company, after round-table conferences with the Commission, agreed to increase its depreciation reserve by an amount in excess of $13,000,000. In the Appalachian Electric Power Company case, [Footnote: Holding Company Act Release No. 2430.] the company consented to a condition in the Commission's order requiring the creation of a reserve account of $22,500,000 to be available for possible adjustments to its fixed capital accounts and/or its depreciation reserve accounts.

To prevent future dissipation of the pledged properties and to preserve the operating efficiency of the utilities the indentures securing proposed new debt issues are required to contain certain protective provisions. In most financing cases the obligor has been required to set aside, annually, a fixed percentage, usually 15 percent of its gross operating revenues for maintenance, replacements, improvements, or other property additions, or for the reacquisition of bonds issued under the indenture. In some cases, the requirement as to depreciation has been measured in terms of fixed property. Such portion of the stipulated minimal amount as is not expended for these purposes is required to be deposited with the indenture trustee. Subsequently accumulated earned surplus is restricted to the extent that operating expense has not been charged with the stipulated amount of depreciation and maintenance. Frequently, earned surplus as of the date of the issue is "frozen" for dividend purposes. The Commission also requires that plant and property acquired with funds arising from depreciation accruals shall be "funded" - i.e., shall not be made the basis for the authentication of additional bonds, or for the release of cash deposited with the trustee, or for the purpose of sinking fund requirements.

The insistence of the Commission and ether regulatory authorities upon more adequate depreciation practices has materially strengthened the operating utilities. It will be observed from the following table that the accumulated depreciation reserves have been built up from an average of 10.05 percent of

property in 1938 to 17.53 percent in 1943, and that the annual depreciation accruals have risen from 1.72 percent of property in 1938 to 2.28 percent in 1943. [Footnote: The increase both in the annual depreciation accrual and in the depreciation reserve ratio since 1939 is partly attributable to the great rise in gross operating revenues during the war.]

(chart omitted)

It should be noted that the increased depreciation requirements, like many other restrictions imposed in connection with proposed security issues, do not require an actual outflow of cash. On the contrary, their effect is to increase the amount of cash retained in the business.

Bond Indentures

The principal financing medium of utilities has been the corporate bond secured by an indenture of mortgage upon the plant and property of the obligor. The ready market and low yield [Footnote: Allowing for supply and demand conditions in the capital markets.] of utility bends are doubtless to be attributed to the security conferred by a modern indenture and to the protective margin of earnings and assets over and above the claims of bondholders resulting from an increased common stock equity.

Until the enactment of the Public Utility Holding Company Act of 1935 and the Trust Indenture Act of 1939 the terms of indentures were largely determined by the holding companies and affiliated investment banking interests. The experience of the depression led to the enactment of the Trust Indenture Act, the primary purpose of which was to require the trustee to assume a mere active and responsible function in enforcing the terms of the indenture, and to prevent the designation of a trustee if a conflict of interest would result. In addition to applying the provisions of the Trust Indenture Act, it is the practice of the Commission, in connection with applications or declarations respecting proposed bond issues, to review the financial provisions from the viewpoint of the Holding Company Act.

Utility indentures are almost invariably “open-end.” The additional (equally ranking) bonds that may in the future be issued under the indenture, usually unlimited in absolute amount, are related to the additional property acquired by the obligor. Old indentures permitted the issuance of bonds in principal amount equal to 70 - 80 percent of the “fair value” of additional property; under current practice as reflected in Commission decisions the maximum allowed has been 60 percent of the cost or fair value, whichever is less, of net additions to fixed property. Net additions are required to be defined carefully in order to assure, among other things, that property which has been purchased by funds generated from depreciation accruals shall not form the basis of additional bonds. The

issuance of additional bonds is also conditioned upon a conservative interest coverage requirement. To prevent dilution or dissipation of the pledged property it is, of course, necessary to incorporate adequate provisions respecting maintenance and depreciation, the nature of which has been described above. Sinking fund provisions have been generally required, particularly where satisfactory ratios cannot be obtained at the time of the issuance of the securities for which the Commission's approval is sought.

Preferred Stock Protective Provisions

The abuses associated with the issuance of preferred stock by holding companies and operating companies are evident from the huge losses suffered by investors in these securities. These abuses have been so serious that they have led to a public policy, as expressed in Section 7 (c) of the Act, against the issuance of preferred stock except under limited circumstances. Where preferred stocks have been permitted to be issued by the Commission, it has insisted that the articles of incorporation contain various protective provisions.

These usually consist of the right to elect a majority of the board of directors in the event of default in the payment of four quarterly preferred stock dividends, and certain voting rights in connection with the following matters: the issuance of short-term debt in excess of prescribed amounts, mergers and consolidations, the authorization of any class of stock ranking prior to or on a parity with the outstanding preferred stock, the amendment of the charter to change the express terms of the preferred stock in any substantially prejudicial manner, the issuance of authorized but unissued preferred stock and increasing the amount of authorized but unissued preferred stock. In addition, the Commission has required that the charter limit the amount of initially authorized but unissued preferred stock and contain certain provisions with respect to the payment of common stock dividends which will reasonably safeguard the interests of the preferred stockholders.

Securities Issued under the Holding Company Act.

For the period November 1, 1935, to June 30, 1944, approximately $6,015,000,000 of securities were permitted to be issued by the Commission pursuant to the provisions of Sections 6 (b) and 7. The following table indicates the classes of securities issued and the purposes of the financing:

(chart omitted)

Of this large volume of security issues new or additional financing accounted for only some $268,470,000 or 4.5 percent. The bulk of new construction has been financed by the use of cash derived from depreciation accruals, amortization of

debt discount, amortization of account 100.5 (plant acquisitions), and other noncash charges to income, and retention of profits. There is little question but that the conservative financial practices required by regulatory authorities including this Commission, contributed substantially to the ability of the utilities to finance the now construction needed for the war program.

Refunding issues accounted for approximately 68 percent of the securities issued during this period. Lower money rates and an improved credit situation, due to more conservative financial policies, enabled most of the utilities to refund their bonds and to a considerable extent to refinance their preferred stocks on very favorable bases. The “cost to company” of money obtained on long-term utility bonds of the best investment quality has been as low as 2.58 percent and the like cost of preferred stock capital has been as low as 3 .85 percent. In some instances utilities which refunded at the beginning of the period of lower money costs have refunded a second time and achieved further savings in money costs.

Of the total amount of securities sold, operating utility companies have issued $5,143,119,542, and registered holding companies only $872,048,375. Of the $268,470,000 of new financing, the issues of holding companies accounted for only $1,555,134. The financial position of the holding companies has been such that relatively few have been able to effect refunding operations. Their bonds and preferred stocks frequently carry rates of 6 to 8 percent. The holding companies have not been a substantial source of capital for their operating utilities, and the credit enjoyed by the operating utilities of even moderate size has been substantially hotter than that of most holding companies.

This great mass of security issues was cleared through the Commission, on the basis of a great many individual applications and declarations, [Footnote: Up to June 30, 1944, the number of applications and declarations under sections 6 and 7 aggregated 1145. Of these 964 were approved (frequently after substantial amendments), 124 were withdrawn or dismissed, 43 are pending, and only 14 were denied.) each of which required a careful scrutiny of the position of the issuer, the terms of to issue, and the effect upon the enterprise and upon investors.

The table below shows the security issues during the fiscal year, ended June 30, 1944. The total issues of that year, $985,981,95l, were $373,402,588 or 61 percent larger than the total for the preceding fiscal year.

(chart omitted)

It will be observed from the table that refunding issues accounted for 66 percent of the total for the fiscal year 1944, securities issued in exchange for outstanding issues an additional 15.9 percent, and new financing only 0.4 percent. In respect

of the classes of securities issued, debt obligations constituted 66.8 percent of the total and common stocks 24.7 percent. Of the debt issues, $148,426,770, or 15 percent of all securities issued during the year, were serial and other short-term notes, issued (along with bonds) in refunding operations for the purpose of effecting a gradual reduction of the outstanding
debt.

COMPETITIVE BIDDING

On April 7, 1941, the Commission adopted Rule U-50, requiring competitive bidding in the sale of securities by registered public utility holding companies and their subsidiaries. The rule, applicable both to new security issues and to the sale by holding companies of portfolio securities, prescribes public invitation of sealed bids. Certain transactions are specifically exempt, including securities sold for less than $1 million securities issued pro rata to existing security holders pursuant to any preemptive right or privilege or in connection with any liquidation or reorganization; and loans of a maturity of 10 years or less, whore the lender is a financial institution not purchasing for resale and no finder's fee or other negotiation charge is to be paid to any third person. In addition, there is a general provision for exemption from competitive bidding by order of the Commission.

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

Some 2 and a half years before adopting its competitive bidding rule, the Commission attempted to meet the problem of maintaining arm's-length bargaining in the issuance and sale of public utility securities by means of a rule which prohibited, with exceptions, the payment of any underwriter's fee by registered holding companies or their subsidiaries to ally affiliate unless the affiliate had been awarded the securities as the most favorable bidder in open competition. After more than 2 years' experience with that rule, however, the Commission concluded that it was difficult to administer and was burdensome

and costly to issuers and underwriters. Accordingly, in February 1940, the Commission instructed its Public Utilities Division to make a full study of the problem. At the same time a letter was written to each holding-company system subject to the Act, as well as to State commission, investment bankers, and securities dealers throughout the country, inviting their suggestions as to the method by which the Commission might “best insure the reasonableness of fees and commissions and the fairness of the terms and conditions of any proposed issue and sale of utility securities,” Many replies were received and were analyzed by the Commission’s staff. The staff concluded that none of the suggestions received, other than competitive bidding, gave promise of meeting the problem effectively.

In December 1940 the Public Utilities Division rendered its report to the Commission formally recommending the adoption of a competitive bidding rule. [Footnote: Report of the Public Utilities Division on “The Problem of Maintaining Arm’s-Length Bargaining and Competitive Conditions in the Sale and Distribution of Securities of Registered Public Utility Holding Companies and Their Subsidiaries.” 1940] Copies of that report were distributed to registered holding companies, State and Federal regulatory bodies, and to a broad list of investment bankers and dealers, both directly and through the Investment Bankers Association and the National Association of Securities Dealers, Inc. In distributing the report, written comments were invited, following which numerous responses were received. The Commission then called a public conference to consider the recommended rule and public discussion continued for 4 and a half days. The conference was attended by approximately 200 persons from every part of the country, including two members of Congress, investment bankers, securities dealers, and representatives of other governmental agencies. Four members of the Commission were present at all times. All shades of opinion, pro and con, were expressed on the question, both in the written responses and at the conferences.

After weighing the evidence and considering all aspects of the problem, the Commission concluded that there was no way short of competitive bidding that would afford it satisfactory means of determining the fairness of prices, the reasonableness of spreads or assure disinterested advice in financial matters to the companies concerned, and effectively control their dealings with affiliates. [Footnote: Holding Company Act Release No. 2676. “Statement of Securities and Exchange Commission upon the Promulgation under the Public Utility Holding Company Act of 1935. of Rule U-50.”]

In the 3-year period ending June 30, 1944, 59 public utility issues in the aggregate amount of approximately $960,000,000 were sold competitively under the procedures specified in Rule U-50. Pertinent information concerning the results of competitive bidding under the rule is presented each year by the

Commission in a report entitled “Security Issues of Electric and Gas Utilities” [Footnote: The latest report under this title was published February 28, 1945, covering the period 1934-44.] It may be noted that except in one or two instances, insurance companies and other institutional investors have not submitted bids for issues sold pursuant to Rule U-50. It may also be observed that since the Commission’s competitive bidding rule became effective, there has been a, substantial decrease in the relative amount of public utility securities that have been privately placed.

Prior to the adoption of the competitive bidding rule, the Commission’s staff had made a study of underwriting spreads prevailing during the 5-year period ending January 1, 1940. It was found that slightly over one-half of the 159 utility mortgage bond issues covered by that study were sold by underwriters on the basis of a two-point spread and that the spread fell below that level in only four cases. The average spread for the 159 Issues sold under the traditional method of private negotiation was 2.49 points ($2.49 per $100).

From June 1, 1941 to June 30, 1944, 37 electric or gas utility mortgage bond issues were sold to underwriters under the competitive bidding rule, and the underwriting spreads for these issues are shown in the following table:

Underwriting spread: No. of issues

Under 1.00: 18
1.01 to 1.25: 10
1.26 to 1.50: 8
Over 1.50: 1

Total 37

It will be noted that in 18 of the 37 issues the underwriting spread was less than one point and in only one case was the spread more than a point and a half. The total principal amount of the 37 issues was $788,627,060 and the total underwriting spreads and commissions were $9,568,615, giving a weighted average spread of $1.21 per $1.00.

Based on the experience of 3 years, the competitive bidding rule has functioned with marked success, has materially aided the Commission in the determinations it must make in passing upon the issuance and sale of securities under the Holding Company Act and has benefited the issuers of such securities.

The insistence upon competition in the sale of public utility securities under the Holding Company Act follows the traditional American pattern of the Sherman Act, the Clayton Act, and the Federal Trade Commission Act, all of which aimed

to preserve competition and to keep that competition fair. The principles embodied in these laws, hacked by both major political parties, are among the foundation stones of our democratic system of capitalism.

PROGRESS IN SERVICE COMPANY REGULATION

One of the most serious of all the holding company abuses was the exploitation of their operating subsidiary companies through unwarranted service fees, commissions, and other charges. These charges, dictated by the holding company sitting on both sides of the table, in nowise represented bargains freely and openly arrived at by the subsidiary on the basis of the lowest cost in a competitive market. Prior to the passage of the Act, and particularly of Section 13 of the Act, the annual profits made from subsidiaries by holding companies ran into many millions of dollars annually. While some of the service fees were earned, there were many more cases where the charges were either exorbitant or completely spurious. Service charges were generally operating expenses ahead of interest on the books of the utility companies, and were deductible in computing the fair rate of return. In many instances they were capitalized and found their way into the rate base. They were in the nature of a special dividend to the holding company disguised on the books of operating company as an operating expense or as a capital charge.

The Electric Bond and Share Co., for example, in 1930, collected total service fees and charges from its operating public utility companies amounting to $ 14,057,111, or 26 percent of the holding company's total gross income of $54,387,000, and in 1931. collected service fees totaling $9,870,312, or 30 percent of its total gross income of $32,560,000. These service fees were charged to the local operating companies by the holding company management in New York for alleged services which the holding company management accorded to them, usually without request. The history of the Standard Gas and Electric System is also of interest in this connection. During the years 1910 to 1929, the service company in the system collected $36,900,000 from the operating companies. The net income for this 11 year period, after deducting expenses, was in excess of $17, 134,000. In 1927 alone this management company collected over $5,000,000.

Section 13 of the Public Utility Holding Company Act was designee to retain the benefits but to end the abuses of servicing relationships. It provides that holding companies can no longer perform services or construction work for, or sell goods to, any operating company for a charge. All such services, etc., may be rendered to operating companies only by a system service company which performs such services "* * * economically and efficiently for the benefit of such associated companies at cost, fairly and equitably allocated among such companies." Since

Section 13 outlawed profits, savings of millions of dollars annually resulted immediately to the operating subsidiaries, their investors and consumers.

The Commission has enforced the provisions of Section 13 by rules and regulations and by proceedings under the Act. In addition, it has adopted a Uniform System of Accounts for service companies as well as annual report forms which, for the first time, have opened the books of service companies for inspection and analysis. State commissions, as well as this Commission, are thus enabled to follow closely the expenses of these companies and their charges to associate operating companies.

The rules and regulations adopted by the Commission permitted the continuation of central service, sales, and construction contracts provided these were performed by a subsidiary of the holding company or a mutual service company, that is one which is owned by the companies being serviced. The standards of the Act required that these contracts be performed at cost, fairly and equitably allocated, that the transactions be necessary ones for the benefit of the companies receiving them, and that they be performed efficiently and economically. Procedurally it was required that the proposed methods of operation and conduct of business of the companies engaged in the performance of these contracts be submitted to the Commission's scrutiny for approval or disapproval as warranted.

When these companies submitted their proposed methods of doing business several difficult problems were confronted by the Commission in disposing of these cases. There had been no uniformity in practices among the various systems to serve as a basis of comparison. The functions to be performed by the service company were described in broad and general terms, making it almost impossible to identify the specific transactions to be performed for specific system companies. The costs of these organizations generally were billed to the system companies on a percentage of gross revenues or a percentage of construction costs.

With the experience gained in these early cases it became increasingly apparent that a substantial portion of the amounts charged to operating companies should be borne by the holding company. The Commission's problem then was one of determining what holding company costs actually were and requiring that these costs be paid by the holding companies and thus eliminated as an item of expense to the operating companies. This problem presented difficulties because of the commingling of holding company and operating company activities in the central organizations.

In a series of proceedings initiated by the Commission and in connection with the consideration of cases which had been pending for some time, the Commission

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

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

In the case of Ebasco Services, Inc., [Footnote: Holding Company Ac Release No. 2255.] the system service company of Electric Bond and Share Co., it appeared that six of Bond and Share’s directors and principal executive officers held identical positions in the service company and received portions of their compensation from both of these companies. The Commission held that the functions of the principal executives as officers of Ebasco were commingled with their functions as officers of Bond and Share and that it was an “almost impossible and wasteful task” to ascertain what segments of the services of each of the common officers were for Ebasco and hence properly included in the cost to the service company, and what part was for Bond and Share and therefore chargeable only to it.

After the Ebasco decision, numerous service companies voluntarily adjusted their practices to conform to the opinion of the Commission. [Footnote: Holding Company Act Release Nos. 2608 and 2696 relating to the United Light and Power Services Co. and Middle West Service Co., respectively.]

The Atlantic Utility Service Corporation case (formerly the Utility Management Corp.), a mutual service company in the Associated Gas & Electric Corp. system, presented many complexities due to the replacement of the Hopson management. The trustees, prior to the final disposition of this case, had made material changes resulting in substantial annual reductions in charges to the operating companies. For instance, when this company first filed for approval, it reported service fees of $4,868,191. Subsequent revisions of its operations had

reduced these fees to $1,940,805. However, the issue was still before the Commission as to whether the services performed by this company were not essentially holding company activities. As a result of the proceedings before this Commission and the review of these transactions as related to the New York companies by the Public Service Commission of New York, the latter Commission denied approval of the proposed contracts. This resulted in the complete elimination of this company as a service company. The technical staff formed Gilbert Associates, Inc., an independent company, and under the proposals submitted to this Commission proposed that all future business would be obtained on a competitive basis from the operating companies. All of the holding company functions, with their related costs, were transferred to the system holding companies, thus reducing materially future annual charges to the operating companies.

One of the most important of the service company cases was In the Matter of Columbia Engineering Corporation, Columbia Gas and Electric Corporation. [Footnote: Holding Company Act Release No. 4166.] In the Ebasco opinion the Commission had stated: that interlocking personnel could not be permitted and that those involved must resign either from the holding company or the service company. In the Columbia case, the issue was raised that it was the functions rather than the positions held or situs on any particular pay roll that would determine whether or not any particular individual was an officer or employee of the holding company. Following the briefs amid oral arguments in this matter, the companies submitted certain proposals for the purpose of complying with the statutory requirements. In the opinion and findings in this case, certain principles and standards as to holding company, service company, and operating company relationships were crystallized. The Commission held:

(1) No operating company should be charged or have allocated to it, directly or through the medium of a service company or by any other arrangement, including treasurer’s or agent’s account, split-check system, or other devices, any portion of the salaries or expenses of any person or persons who are holding company officers or employees or whose functions relate primarily to the functions of supervision of the holding company system and review of the activities of operating companies, their officials and staffs.

(2) A corollary to the above principle is that no holding company officer or person or persons whose functions relate primarily to the holding company functions of supervision of the holding company system and review of the activities of operating companies, their officials and staffs, should receive any compensation or reimbursement of expenses from any operating company directly or through a service company or any other arrangement including treasurer’s or agent’s account and split-check systems.

(3) Each service company should confine itself to functions which the operating subsidiaries cannot perform as efficiently and economically themselves These services should be limited to services of an “operating nature” as distinguished from managerial, executive, or policy-forming functions.

Following the termination of the Columbia Engineering Corporation case, the above principles were applied in several other situations including two cases discussed in the next section of this report. [Footnote: Holding Company Act Release Nos. 4432, 4395, 3135, 4749.]

COOPERATION BETWEEN STATE COMMISSIONS AND THE SECURITIES AND EXCHANGE COMMISSION

It is the established policy of the Securities and Exchange Commission to foster effective cooperation with the State Commissions in all matters where their respective jurisdictions interlock and in all additional matters where such cooperation is desirable and appropriate in the case under consideration. The purpose of the Holding Company Act is, in large part, to free operating companies from the absentee control of holding companies, thus permitting them to be regulated more effectively by the State. This fundamental purpose of the Holding Company Act -- the facilitating of State regulation -- underlies the Commission’s efforts to work cooperatively with the various State commissions in the administration of the Act.

The protection of State regulation is specifically provided for in several sections of the Act. For example, certain issues of securities by registered holding companies and their subsidiaries are exempted by Section 6 (b) from Section 6 (a) if they have been approved by the State commission, subject to such terms and conditions as the Securities and Exchange Commission may deem appropriate in the public interest or for the protection of investors or consumers. Certain security and utility asset acquisitions are likewise exempted under Section 9 (b) from the provisions of Section 9 where they have been approved by a State commission. Moreover, the commission may not authorize security issues [Section 7 (g)] or the acquisition of assets [Section 10 (f)] unless applicable State laws have been complied with. Section 8 prevents the ownership of both electric and gas utility properties in violation of State law, while Section 20 (b) requires that accounting standards established by the Commission shall not be inconsistent with the provisions of applicable State law.

A number of specific sections of the Act reflect the Congressional intent that the Commission’s work should be coordinated with the work of State commissions. Section 19 of the Act, for example, expressly provides that in any proceeding before the Commission, the Commission, in accordance with such rules of

practice as it may prescribe, shall admit as a party any interested State, State commission, municipality or any political subdivision of the State. Pursuant to this provision, the Commission uniformly notifies interested State commissions of proceedings before it which may affect the work of such commission. Many State commissions have taken advantage of this provision and have intervened in proceedings before the Commission and in these and other cases there has been an interchange of ideas and information between the Securities and Exchange Commission and the State commission concerned. In one instance, although there is no specific statutory authority for joint hearings by the Commission and a State commission, a joint hearing was, in fact, held by the Securities and Exchange Commission and the Public Utilities Commission of the District of Columbia.[Footnote: See *Potomac Electric Power Company*, Holding Company Act Release No. 2283.]

Section 18 of the Act places at the disposal of the State commissions the investigatory power of the Securities and Exchange Commission in regard to the business, financial condition, or practices of registered holding companies and their subsidiaries and Section 18 (a) authorizes the Commission to make available to State commissions the results of its own investigations made pursuant to the Act. Pursuant to this and other provisions of the Act, the Commission was requested on September 19, 1942, by the Public Utilities Commission of the District of Columbia to undertake an investigation of the various relationships between Washington Railway & Electric Co. and the North American Co., its parent. The investigation was completed in accordance with the request of the District of Columbia Commission.

The Securities and Exchange Commission through its jurisdiction over intersystem service charges, has been in a position to render significant assistance to State commissions in this field, and such assistance, in fact, has been rendered in several notable instances. Under Section 13 (d) of the Act, the Commission, upon the request of the State commission, is authorized, after notice and opportunity for hearing, to require by order " a reallocation or reapportionment of costs among member companies of a mutual service company if it finds the existing allocation inequitable and may require the elimination of a service or services to a member company which does not hear its fair proportion of costs or which, by reason of its size or other circumstances, does not require such service or services."

Illustrative of the workings of this provision of the statute was the proceeding which the Securities and Exchange Commission instituted at the request of the Vermont Public Service Commission in 1940 concerning servicing arrangements between the New England Power Service Co., a subsidiary of New England Power Association, and associate operating companies in Vermont. A hearing was held at Montpelier, Vt., at which representatives of the Vermont commission

participated as well as Commissioner Healy of this Commission. The results of the proceeding, described in Holding Company Act Release No. 3135, were the complete reorganization of the service company, including a reduction of its personnel from 1,048 employees to 626; in addition, the service company pay roll was cut approximately in half, and numerous other changes were made in its accounting and operating practices. Those results are indicative of the type of assistance which the Securities and Exchange Commission can render to State commissions with regard to the functioning of service organizations.

Again, in the *American Water Works and Electric Company, Incorporated, Service Company* case, [Footnote: Holding Company Act Release No. 4749.] a proceeding was instituted by the Commission at the request of the New Jersey Board of Public Utility Commissioners. The New Jersey commission was concerned with the service charges made to New Jersey subsidiaries of American Water Works. The Securities and Exchange Commission exercised its power under Sections 13 and 18 of the Holding Company Act to investigate the service arrangements within the American Water Works System, to determine what action was required by Section 13 and, at the same time, to obtain information which would be available for the use of the New Jersey commission. To that end, the Commission directed that the first hearings be held in the offices of the New Jersey commission in Newark. At the hearing, Commissioner Healy of the Securities and Exchange Commission sat jointly with members of the New. Jersey commission. Representatives of the Public Utilities Commission of Connecticut, which had jurisdiction over some of the American Water Works subsidiaries, also appeared at the hearing in New Jersey. During the pendency of the proceedings, conferences were had among the staffs of the commissions concerned and between representatives of the staffs and representatives of American Water Works. An agreement was reached as to changes in future servicing activities, and after the hearing in New Jersey, American Water Works filed an application for approval of the organization and conduct of business of a new subsidiary service company. Hearings on that application and on the proceedings instituted by the Commission were held in Philadelphia beginning in April 1943. Representatives of New Jersey arid Connecticut commissions became parties in these proceedings, and representatives of the Public Utility Commission of Pennsylvania also participated.

There have been many other instances of close cooperation between the Securities and Exchange Commission and State commissions. In the Laclede Gas Light Co. reorganization proceedings, for example, a plan was filed with the Securities and Exchange Commission and the Missouri Public Service Commission for the reorganization of the Laclede Gas Light Co. and the sale to Union Electric Co. of Missouri of the electric properties operated by Laclede Power & Light Co. These transactions could not be consummated without the approval of the Missouri Public Service Commission and the Securities and

Exchange Commission. The case was characterized by the very closest cooperation between the two commissions and between the staff of this Commission and representatives of the Public Utilities Department of the city of St. Louis.

In the Portland Electric Power Co. reorganization proceedings, the Securities and Exchange Commission had to pass upon a plan of reorganization of the company pursuant to the Bankruptcy Act, as required by Section 11 (f) of the Public Utility Holding Company Act. The public utilities commissioner of Oregon and the Washington Department of Public Service had jurisdiction over transactions which constituted important parts of the plan. Hearings before the Securities and Exchange Commission were started in Washington, D. C. Both the Oregon and Washington commissioners intervened in the proceedings, and the Oregon commissioner participated in the examination of company witnesses. In February 1943, at the request of the Washington and Oregon commissions, the hearing was reconvened in Portland, Oreg. Both State commissions were represented by counsel and introduced evidence in the proceeding. In addition, many conferences were held between the Securities and Exchange Commission staff and the staffs of the State commissions involved. The active cooperation among the commissions was particularly helpful in the entire proceedings. The above examples illustrate the pattern of cooperation between the Securities and Exchange Commission and State commissions. This Commission has found such cooperation most helpful in its own work and believes it has been helpful also to the State commissions.

LITIGATION UNDER THE HOLDING COMPANY ACT

The Commission's record of litigation under the Public Utility Holding Company Act of 1935 dates back to September 1935, 2 _ months before the effective date of the Act. Between that time and December 1935, 58 proceedings were brought by or on behalf of holding companies to enjoin enforcement of the Act and for declaratory judgments holding all of its provisions unconstitutional. None of these proceedings resulted in a decision on constitutionality by the Supreme Court. However, in the test case instituted by the Commission on November 26, 1935, to enjoin Electric Bond and Share Co and the intermediate holding companies in its system from violating the registration provisions of the Act, the Supreme Court, on March 28, 1938, held that only the registration provisions of the Act could be challenged by an unregistered holding company; that the registration provisions are applicable solely to registered holding companies and their subsidiaries; and that the registration provisions are constitutional. [Footnote: *Electric Bond and Share Co.* v. *S.E.C.*, 18 F. Supp. 131 (S.D.N.Y., 1937); 92 F (2d) 580 (C.C.A. 2, 1937); 303 U.S. 419 (1938).] This decision effectively terminated the flood of litigation over the constitutionality of the Act and resulted in registration by all companies affected by the Act, excepting those companies

that claimed exemption from its provisions. [Footnote: A sweeping decision of the District Court of Maryland holding the act unconstitutional in its entirety was limited by the fourth circuit to the specific facts of the American States Public Service Co. reorganization proceeding. *Burco, Inc.* v. *Whitworth*, 81 F. (2d) 721. The Government, as amicus curiae, urged the Supreme Court to certiorari in that case on the ground that the case was collusive and not a proper vehicle for determining constitutional questions which could be better considered in the Electric Bond and Share case. The Supreme Court denied certiorari.]

(b) Exemptions

The first problem to arise under the Act involved applications for exemption from the registration and regulatory provisions of the Act. The first case to deal with this problem and, indeed, the first instance in which a circuit court of appeals was petitioned to review an order of the Commission under the Holding Company Act, was *Lawless* v. *Securities and Exchange Commission*. [Footnote: Lawless v. Securities and Exchange Commission, 105 F. (2d) 574 (C.C.A. 1, 1939).] There a holding company, which had been granted a temporary exemption from the requirements of the Act, applied to the Commission while its application for permanent exemption was pending, for a report on a plan of recapitalization and an order exempting the Company from the provisions of the Act applicable to the proposed plan. The Commission issued the report and granted the order, Commissioner Haley dissenting. On review the order was reversed on the ground that unregistered companies are not entitled to the benefits conferred by the Act, and accordingly, the Commission was without power or authority to issue the order in question.

By June 30, 1944, 565 applications for exemption had been filed with the Commission, 164 had been approved, 317 had been withdrawn or dismissed, and 52 had been denied by order of the Commission. In almost all of these cases the right to exemption has depended upon whether the applicant is a holding company, subsidiary, or affiliate with respect to another company. This question under the statute is answered in terms of the existence or absence of control or controlling influence of one company over the other. The Commission's orders denying exemption applications of Hartford Gas Co., Public Service Corp. of New Jersey, Detroit Edison Co., Pacific Gas & Electric Co., [Footnote: *Hartford Gas Co.* v. *S.E.C.*, 129 F. (2d) 794 (C.C.A. 2, 1942), 2 S.E.C. Jud. Dec. – (C.C.A. 2, No. 250, 1942); *Public Service Corporation of New Jersey* v. *S.E.C.*, 2 S.E.C. Jud. Dec. – (C.C.A. 3, No. 7879 (1941), 129 F. (2d) 899 (C.C.A. 3, 1942); 317 U.S. 691; 63 S. Ct. 266 (1942); *Detroit Edison Company* v. *S.E.C.*, 119 F. (2d) 730 (C.C.A. 6, 1941; 314 U.S. 618; *Pacific Gas & Electric Co.* v. *S.E.C.*, 127 F. (2d) 378 (C.C.A. 9, 1942), 139 F. (2d) 298 (C.C.A. 9, 1943). The Supreme Court has affirmed the decision of the circuit court of appeals in the latter case.] and Koppers United Co., [Footnote: *American Gas & Electric Co.* v. *S.E.C.*, 134 F.

(2d) 633 (App. D>C. 1943); 319 U.S. 763 (1943); *Koppers United Co*. v. *S.E.C*., 138 F. (2d) 577 (App. D.C. 1943)] have been subjected to judicial review and in these cases the Commission's orders were affirmed by the Circuit Courts of Appeals for the Second, Third, Sixth and Ninth Circuits, and the Court of Appeals for the District of Columbia, respectively.

(e) Corporate Integration and Simplification

The most significant litigation under the Holding Company Act since the *Bond and Share* case was the group of review proceedings involving the constitutionality of the corporate integration and simplification provisions of the Act (Secs. 11 (b) (1) and (2)). In three of these cases, filed by the North American Co., United Gas Improvement Co., and Engineers Public Service Co., [Footnote: *North American Co*. v. *S.E.C*. 133 F. (2d) 148 (C.C.A. 2, 1943); 318 U.S. 750; 63 S. Ct. 764; *United Gas Improvement Co.* v. *S.E.C*., 138 F. (2d) 1010 (C.C.A. 3, 1943); *Engineers Public Service Co*. V. *S.E.C*., 138 F. (2d) 936 (App. D.C. 1943).] the second and third Circuits and the Court of Appeals for the District of Columbia in unanimous decisions upheld the constitutionality of Section 11 (b) (1), [Footnote: In the *North American* case the Supreme Court has granted a petition for write of certiorari but has been unable to hear arguments in the case because of the lack of a quorum of justices qualified to hear it. In the *Engineers Public Service Company* case, a petition for writ of certiorari has been granted by the Supreme Court.] while the constitutionality of Section 11 (b) (2) was similarly sustained by the first and third circuits and the Court of Appeals for the District of Columbia [Footnote: The *American Power & Light Company, Electric Power & Light Corporation* case is now pending before the Supreme Court on petition for a writ of certiorari.] in review proceedings instituted by American Power & Light Co., and Electric Power & Light Corp. (one case) , Commonwealth & Southern Corporation, and Central & Southwest Utilities Co. [Footnote: *American Power & Light Co. and Electric Power & Light Corporation* v. *S.E.C*., 141 F. (2d) 606 (C.C.A. 1, 1944); *Commonwealth & Southern Corp.* v. *S.E.C*., 134 F. (2d) 747 (C.C.A. 3, 1943), 2 S.E.C. Jud. Dec. – (C.C.A. 3, No. 8052, 1943); *Central & South West Utilities Co*. v. *S.E.C*., 136 F. (2d) 273 (App. D.C. 1943), 2 S.E.C. Jud. Dec. – (App. D.C. No. 8333, 1943).] In addition to upholding the constitutionality of Sections 11 (b) (1) and 11 (b) (2), these decisions have affirmed, in virtually all respects, the Commission's views as to matters of statutory interpretations.

To assist holding companies and operating subsidiaries in achieving voluntary compliance with the corporate simplification and integration provisions of the Act, the Commission has, at the request of companies concerned, instituted 15 proceedings in Federal district courts under Section 11 (e) of the Act to enforce and carry out voluntary plans of reorganization previously approved by the Commission as fair and equitable and necessary to effect the corporate

simplification and integration provisions of the Act. In these cases involving *Community Power and Light Company* (D. N. Y.), *Great Lakes Utilities Company* (D. Pa.) *Jacksonville Gas Company* (D. Fla.), *United Light and Power Co.* (D. Del.), *Puget Sound Power & Light Co.* (D. Mass.), *Southern Colorado Power Co.* (D. Colo.), *North Continent Utilities Corp.* (D. Del.), *Columbia Oil & Gasoline Corp.* (D. Del.), *North American Gas and Electric Company* (D. Del.), *Central States Power & Light Corp.* (D. Del.), *Consolidated Electric and Gas Co.* (D. Del.), *Clarion River Power Co.* (D. Pa.), *American Gas and Power Co.* (D. Del.), *The Laclede Gas Light Co.* (D. Mo.), and *International Utilities Corporation* (D. N. Y.), the courts have not only assisted in effectuating the congressional policies expressed in the Act but, in so doing, have accomplished a uniformity of reorganization procedures. [Footnote: *In re Community Power and Light Company*, 33. F. Supp. 901 (S.D. N.Y., 1940): *In re Great Lakes Utilities Company*, 2 S.E.C. Jud. Dec. – (E.D. Pa. No. M 989, 1942); *In re Jacksonville Gas Co.,* 46 F. Supp. 852 (D.C. Fla., 1942), 2 S.E.C. Jud. Dec. – (S.D. Fla. No. 483-J, 1942); *In re United Light and Power Co.*, 51 F. Supp. 217 (D.C. Del., 1943); *In re Puget Sound Power & Light Co.*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re Southern Colorado Power Company*, 2 S.E.C. Jud. Dec. – (D. Colo. No. 670, 1944). Affirmed on appeal by the Tenth Circuit Court of Appeals. *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del., 1944); *In re Columbia Oil and Gasoline Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 290, 1942). 50 F. Supp. 965 (D. Del., 1943), 134 F. (2d) 265 (C.A.C. 3, 1943); *In re North American Gas and Electric Company*, 2 S.E.C. Jud. Dec. – (D. Del., No. 352, 1944); *In re Central States Power & Light Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 354, 1944); *In re Consolidated Electric & Gas Co.*, 57 F. Supp. 211 (D. Del., 1944); *In re Clarion River Power Co.*, 2 S.E.C. Jud. Dec. – (W.J.) Pa. No. 2903, 1944); *In re American Gas and Power Co.*, 55 F. Supp. 756 (D. Del., 1944); *In re The Laclede Gas Light Co.*, 57 F. Supp. 997 (D.C.E.D., Mo., 1944) – now on appeal; *In re International Utilities Corporation*, (D.C.S.D.N.Y. Civ. 25-260 (1944)).] Beginning with the *Community Power and Light Company* case decided in 1940, the Commission's orders approving Section 11 (e) plans have been upheld by the courts with respect to both holding companies and operating subsidiaries. In these proceedings the settled practice of the courts has been to consider the plan solely upon the evidence presented before the Commission, and to consider new evidence only for the purpose of determining whether it could and should have been considered by the Commission. In addition, the Commission, in a number of cases, has passed upon, pursuant to Section 11 (f) of the Act, plans of reorganization of holding companies and subsidiaries in proceedings under Chapter X and former Section 77B of the Bankruptcy Act.

A corollary to the reorganization of holding companies and their subsidiaries under the Holding Company Act is the Commission's determination to prevent holding companies from escaping the requirements of the Act by liquidating under State procedures. This policy of requiring that the reorganization of holding

company systems shall be in accordance with plans which are fair and equitable and comply with the purposes of the Act is illustrated by the Commission's injunction suit against the North American Co. and its subsidiary, North American Light & Power Co., to prevent Light & Power from dissolving or liquidating under State law. The case was ultimately dismissed by stipulation and the liquidation of Light & Power is proceeding under the Act.

A comparable problem has arisen in several cases wherein stockholders of registered holding companies in process of reorganization or liquidation under the Holding Company Act have filed derivative actions in State and Federal courts, asserting claims either on behalf of the company in reorganization or in the interest of one or more of its subsidiaries. These suits have generally been based upon charges of corporate waste, alleged improper acts of the company through its directors and officers, and other causes of action generally falling in the category of breaches of fiduciary duty. The Commission has taken the position that where a fair, equitable, and feasible plan of reorganization cannot be effectuated without considering and giving effect to such causes of action, they should properly be asserted as claims in the Commission's reorganization proceeding. To protect its jurisdiction, the Commission has intervened or appeared as amicus curiae in certain of these civil cases to request that they be dismissed or stayed pending determination of the issues in the Commission's proceeding. The courts have recognized the importance of having this type of litigation adjudicated in the context of a complete reorganization proceeding and have in the exercise of judicial discretion, stayed the cases before them. Typical of these cases are *Dederick* v. *The North American Company* (D. N. Y.) and *Illinois Iowa Power Company* v. *North American Light & Power Co.* (D. Del.). [Footnote: *Dederick* v. *North American Light and Power Co.* 48 F. Supp. 410 (S.D.N.Y., 1943); *Illinois Iowa Power Co.* v. *North American Light and Power Co.*, 49 F. Supp. 277 (D. Del., 1943).]

In cases arising out of the Commission's Section 11 (e) proceedings a number of novel and highly significant issues have been raised and settled in accordance with the views of the Commission. For example, thoroughgoing reorganizations of operating subsidiaries have been sustained upon the premise of correcting an inequitable distribution of voting power in the subsidiary, pursuant to the last sentence of Section 11 (b) (2). *Jacksonville Gas Company* (D. Fla.), *Puget Sound Power & Light Co.* (D. Mass.), *Southern Colorado Power Co.* (D. Colo.) [Footnote: *In re Jacksonville Gas Co.*, 46 F. Supp. 852 (D.C. Fla., 1942), 2 S.E.C. Jud. Dec. – (S.D. Fla. No. 483-J, 1942); *In re Puget Sound Power and Light Company*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re Southern Colorado Power Company*, 2 S.E.C. Jud. Dec. – (D. Colo. No. 670, 1944).]

Now pending before the Supreme Court is the important question of the meaning and application of the "fair and equitable" standard prescribed in Section 11 (e),

in determining the proper allocation of securities in a reorganization or liquidation under the Act, between the preferred and common stockholders of the company. The case in which that problem is posed is *Otis & Co.* v. *Securities and Exchange Commission*, which involves the Commission's holding, discussed in the section on integration and simplification of holding company systems, that the allocation should be based upon the entire bundle of rights of both classes of stock with primary reference to their relative expectations of participation in income under the existing structure, rather than exclusively upon the basis of the charter liquidation preference of the preferred stock.

Another similar case involving a plan for the reorganization of Southern Colorado Power Co. is now pending on appeal before the Circuit Court of Appeals for the Tenth Circuit under the title of *Disman* v. *Securities and Exchange Commission*. [Footnote: Since this writing, the Supreme Court has rendered a decision in *Otis & Co.* v. *S.E.C.* approving the Commission's holding (3 Justices dissenting). 65 S. Ct. 483 (1945).]

Federal district courts which have considered plans of reorganization following this same allocation principle have without exception approved and enforced the plans before them. *In re Puget Sound Power and Light Co*. (D. Mass.), *In re North Continent Utilities Co.* (D. Del.), *In re Central States Power & Light Corp*. (D. Del.), *In re Consolidated Electric & Gas Co.* (D. Del.), *In re The Laclede Gas Light Co*. (D. Mo.), and *In re International Utilities Corp.* (D. N. Y.). [Footnote: *In re Puget Sound Power and Light Company*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del., 1944); *In re Central States Power & Light Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 354, 1944); *In re Consolidated Electric & Gas Co*., 55 F. Supp. 211 (D. Del., 1944); *In re The Laclede Gas Light Co*., 57 F. Supp. 997 (D.C.E.D. Mo., 1944); *In re International Utilities Corporation* (D.C.S.D.N.Y. Civ. 25-260 (1944)).]

A cognate problem which has resulted in two review proceedings (*New York Trust Co.* v. *Securities and Exchange Commission*, *City National Bank & Trust Co.* v. *Securities and Exchange Commission*) [Footnote: *New York Trust Co.* v. *S.E.C.*, 131 F. (2d) 274 (C.C.A. 2, 1942); *City National Bank & Trust Co. of Chicago* v. *S.E.C.*, 134 F. (2d) 65 (C.C.A. 7, 1943).] and in several district court decisions in voluntary plan enforcement proceedings (*In re North Continent Utilities Corp., In re Consolidated Electric & Gas Company*),[Footnote: *In re North Continent Utilities Corp*., 54 F. Supp. 527 (D. Del., 1944); *In re Consolidated Electric & Gas Co*., 55 F. Supp. 211 (D. Del., 1944) concerns the contractual right of debenture holders to receive a premium upon premature retirement of the debentures in the liquidation of their company, where liquidation takes place pursuant to a Section 11 (e) plan designed to comply with the mandate of Section 11 (b) (2). As noted in the section on integration and simplification of holding company systems, the second and seventh circuits and the District Court

of Delaware in these cases upheld orders of the Commission's determination that it would be unfair and inequitable to the other security holders of the companies to give the debenture holders a premium or other compensation for premature termination of their rights in the context of a reorganization or liquidation required by the Act.

Another reorganization problem under the Holding Company Act not yet finally settled by the courts, is whether a plan of reorganization prepared and negotiated by a management group is fair and equitable and not detrimental to the interests of investors and the public, where the plan permits the management to profit either in terms of control or pecuniary gain from stock of the corporation which the management has purchased during the course of the reorganization proceeding. In *Chenery* v. *Securities and Exchange Commission*, [Footnote: Chenery Corporation v. S.E.C., 128 F. (2d) 303 (App. D.C., 1942), 318 U.S. 80 (1943).] the Commission held, with respect to a voluntary plan proposed by Federal Water Service Corporation, that equity decisions as to the fiduciary obligations of corporate managers forbade managerial profit from such transactions. The Appellate Court for the District of Columbia held that the Commission exceeded its statutory authority in so deciding. On further appeal the Commission's order was set aside and remanded to the Commission by the Supreme Court (three Justices dissenting), on the ground that the equity precedents upon which the Commission had relied were not applicable to the case. The Supreme Court held that the Holding Company Act empowered the Commission to correct reorganization abuses arising in proceedings under the Act and that the Commission was authorized to consider the problem posed in this case in the light of the statutory purposes and its experience with reorganization practices in proceedings under the Act. The case is now pending before the Commission upon the remand. [Footnote: On February 8, 1945, the Commission issued its findings and opinion reaffirming its previous determination. Holding Company Act Release No. 5584.]

A corollary to this problem of fiduciary responsibilities under the act was presented in *Morgan, Stanley & Co. Inc.* v. *Securities and Exchange Commission*, [Footnote: *Morgan, Stanley Co*. v. *S.E.C.*, 126 F. (2d) 325 (C.C.A. 2, 1942).] where the second circuit affirmed an order of the Commission prohibiting Dayton Light & Power Co. from paying underwriter's fees to Morgan, Stanley, on the ground that Morgan, Stanley and the company stood in such relation to each other that there was likely to have been an absence of arm's-length bargaining in the transaction.

(d) Judicial Review Procedure

Judicial opinions in cases under the Holding Company Act have resulted in settling important general questions bearing upon the conduct of the

Commission's proceedings and the rights of "aggrieved" persons to obtain judicial review of Commission orders. One such question related to the proper method of disposing of two or more petitions filed in different circuit courts to review the same or parts of the same order issued by the Commission. Relying upon the statutory provision that the Court in which the Commission shall file its transcript of record shall have exclusive jurisdiction to affirm, modify, or set aside the Commission's order in whole or in part, the Commission has contended that when two or more petitions for review are filed in different courts the Commission must determine which review proceeding will best serve the public interest and file its transcript in that court, thereby giving it exclusive jurisdiction over the Commission's order. The procedure has been judicially established that petitions filed in courts other than that in which the Commission files the transcript of the record are to be dismissed unless the petitioners desire to intervene in the proceeding before the court which has been given exclusive jurisdiction over the Commission's order. To protect the rights of such petitioners, there has been developed the judicial procedure of transferring and transmitting to the court of exclusive jurisdiction the petitions for review filed in the other courts.

More recently the analogous question has arisen as to the disposition of petitions for review filed by stockholders of companies directly or indirectly affected by the Commission's orders under the Holding Company Act. The Commission has been upheld by reviewing courts in its contention that before a stockholder can claim to be "aggrieved" by the Commission's order his petition must show that he has complied with the general rules applicable to stockholders' derivative actions, i.e., that he has made a demand upon his corporation to file a petition for review and that the corporation has refused to do so for improper reasons. [Footnote: *Okin* v. *S.E.C.*, 143 F. (2d) 943 (C.C.A. 2, 1944) and *American Power & Light Company* v. *S.E.C.*, No. 470 (C.C.A. 1, 1944)

(e) Political Contributions

The provision of the Holding Company Act which makes it unlawful for any holding company or subsidiary to give political contributions was held constitutional by the eighth circuit in *Egan and Union Electric Company of Missouri* v. *U.S.* [Footnote: *Egan* v. *U.S.* and *Union Electric Co. of Missouri* v. *U.S.*, 137 F. (2d) 369 (C.C.A. 8, 1943), 64 S. Ct. 195 (1943).] In that case, which was the outgrowth of an extensive investigation conducted by the Commission, the circuit court affirmed the conviction of the company on charges of making political contributions in violation of the provisions of the Holding Company Act, and that of its former president, for conspiracy to violate the same section. The evidence showed that the defendants had established a "slush fund" accumulated by kickbacks and legal lees, payments to contractors and insurance agents, and the padding of expense accounts. Three other officials of the

company had previously been convicted of perjury in their testimony before officers of the Commission during the course of the investigation.

APPENDIX TO PART III

Status of Each of the Major Holding Companies Under Section II

A brief summary of the status of each of the major holding companies under the more important aspects of section 11 at the close of the past fiscal year follows:

1. Electric Bond and Share Co.

Electric Bond and Share is the largest system registered under the Holding Company Act. The parent, Electric Bond and Share Co. (Bond and Share), controls five major subholding companies: American and Foreign Power Co., Inc. (American Foreign), American Gas and Electric Co. (American Gas), American Power & Light Co. (American) Electric Power & Light Corp. (Electric), and National Power & Light Co. (National).

On May 9, 1940, the Commission instituted Section 11 (b) (2) proceedings directed to Bond and Share and certain of its subsidiaries. [Footnote: Holding Company Act Release No. 2051.] On August 23, 1941, the Commission found that National served no useful function, that it served as the central tier in a pyramid which enabled Bond & Share to control the National system with practically no investment and that it violated Section 11 (b) (2) because it constituted an undue and unnecessary complexity in the Bond and Share system. As a result National was ordered to dissolve. [Footnote: Holding Company Act Release No. 2962.] Considerable progress has been made in getting National's affairs in shape for liquidation. All of its bonds were retired through the use of cash on hand and its preferred stock was eliminated through a voluntary exchange of common stock of Houston Lighting & Power Co. and by sale of the remainder of the Houston stock and the use of the proceeds together with treasury cash to retire the remaining National preferred stock at $100 per share plus accumulated dividends. The last of the preferred stock was retired in January 1944 pursuant to an authorization of the Commission dated January 4, 1944. [Footnote: Holding Company Act Release No. 4811.] The principal assets remaining for disposition are the common stocks of three operating companies. Birmingham Electric Co., Carolina Power & Light Co., and Pennsylvania Power & Light Co.

On August 5, 1942, [Footnote: Holding Company Act Release No. 3832.] the Commission acting under Section 11 (c) granted National an extension of 1 year from August 22, 1942, for compliance with the order of dissolution but conditioned its action upon National's filing plans for resolution of the voting

power and accounting problems of its subsidiaries. Such plans have been filed by National. After several amendments the plan filed by Carolina Power & Light Co. was approved by the Commission on December 11, 1943. [Footnote: Holding Company Act Release No. 4746.] Similarly the plan for Birmingham Electric Co. as amended was approved on March 21, 1944. [Footnote: Holding Company Act Release No. 4955.] In both of these cases the operating Companies, through capital contributions by National and accounting and voting power adjustments were able to conform their accounts and structures to the standards of the Act so as to be ready for disposition. Final action has not been taken with respect to Pennsylvania Power & Light Co. largely by reason of uncertainty as to the classification of the accounts of that company An order to show cause with respect to that company, directed toward a disposition of its accounting problems, was instituted by the Federal Power Commission on December 17, 1943. At the close of the past fiscal year, this proceeding was pending.

On August 22, 1942, American and Electric were ordered dissolved on grounds similar to those set forth above with respect to National. [Footnote: Holding Company Act Release No. 3750.] These two companies appealed to the United States Circuit Court of Appeals for the First Circuit which on March 17, 1944, affirmed the order of the Commission [Footnote: *American Power & Light Co.* v. *S.E.C.*, *Electric Power & Light Co.* v. *S.E.C.*, 141 F. (2d) 606.] and on April 18, 1944, denied an application of the companies for a rehearing. Thereupon the companies petitioned the Supreme Court for a writ of certiorari on which the Court has not yet acted.

The Commission instituted proceedings under Section 11 (b) (2) and various other sections of the Act directed to American and its subsidiary, Florida Power & Light Co. (Florida), on July 10, 1941. Issues were raised as to the distribution of voting power among the security holders of Florida, the existence of large amounts of write-ups in its accounts, and the validity and rank of the $22,000,000 of its debentures held by American. On September 17, 1941, respondents filed a refinancing plan, in part to meet the allegations in the Commission’s order for hearing. The matters were consolidated and hearings were held. Prior to the final determination of the case by the Commission, however, American and Florida submitted amendments to their previous proposal. The proposal as so amended , which provided for substantial adjustments to the accounts of Florida, the surrender by American to Florida as a capital contribution of $17,000,000 of the debentures held by it and certain other securities, and the retirement of all publicly held securities at their contract prices from treasury cash and the proceeds of issuance of new securities, was approved by the Commission on December 28, 1943. [Footnote: Holding Company Act Release No. 4791.]

On November 15, 1943, American filed an application and declaration with respect to the conversion of its outstanding stock, consisting of $5 and $6 preferred stock and common stock into a new common stock. The company stated in its filing that while it was contesting the constitutionality of Section 11 (b) (2) and the Commission's order of dissolution directed to it thereunder it believed that the proposed transaction would be appropriate to the carrying out of such order, if upheld. The Commission consolidated the proceedings with respect to the filing with the proceedings under Section 11 (b) (2) directed to American and set forth as among the issues, whether the allocations of the equity of American among the respective classes of security holders as filed or as hereinafter modified could appropriately form the basis of a plan for the dissolution of American in accordance with the previous order of the Commission to that end. [Footnote: Holding Company Act Release No. 4695.] Hearings have been held in this consolidated proceeding and the matter is pending.

United Gas Corporation, a subsidiary of Electric, filed an application on May 5, 1941, with respect to a proposed refinancing, and in connection therewith the repayment of $52,025,000 in debt claims held by Bond and Share. On May 31, 1941, the Commission ordered hearings on this application and instituted proceedings pursuant to Section 11 (b) (2) and other sections of the Act. [Footnote: Holding Company Act Release No. 2790.] The Section 11 (b) (2) proceedings raised issues as to the necessity for a reorganization of United Gas, and as to the validity and rank of the debt claims held by Bond and Share. A consolidated hearing was ordered with respect to the application and the Section 11 (b) (2) proceedings and extensive hearings were held. After the close of the record on the major issues in the consolidated proceedings a Section 11 (e) plan was filed on March 6, 1944, which provided for a comprehensive reorganization of United Gas and a compromise settlement of the debt claims of Bond and Share together with its stock interests in United Gas for $44,000,000 in cash. After hearings on this plan the Commission issued its findings and opinion, and order approving the plan as necessary to effectuate the provisions of Section 11 (b) (2) and as fair and equitable. [Footnote: Holding Company Act Release No. 5271.] In accordance with the request of the companies the Commission has applied to the United States District Court for the District of Delaware for enforcement of the plan. [Footnote: The plan has been approved by the court.]

On March 8, 1943, Utah Power & Light Co., a subsidiary of Electric, filed a refinancing plan and the Commission instituted 11 (b) (2) proceedings which it consolidated with the proceedings on the plan. [Footnote: Holding Company Act Release No. 4157.] On November 20, 1943, the Commission approved the refinancing and ordered a recapitalization of Utah involving the conversion of its preferred and common stocks into a single class of common stock and directed that adjustment be made in the accounts of Utah and its subsidiary companies. [Footnote: Holding Company Act Release No. 4716.]

On September 1, 1943, the Commission approved the sale by Electric of its entire common stock interest in the Idaho Power Co. to underwriters for resale to the public. [Footnote: Holding Company Act Release No. 4527.] Electric received $10,361,250 for the stock. The Commission has subsequently approved the use of portions of these proceeds for the investment of Electric in the common stocks of two of its remaining subsidiaries Mississippi Power & Light Co., [Footnote: Holding Company Act Release No. 5237.] and Arkansas Power & Light Co. [Footnote: Holding Company Act Release No. 5294.] The increase of Electric's investment in these subsidiaries through the use of this cash together with the portion of their senior securities held by Electric enabled them to make necessary accounting adjustments and substantially improve their structures

On May 18, 1943, the Commission issued its notice of and order reconvening the hearings with respect to the Section 11 (b) (2) proceedings directed to Bond and Share and its subsidiaries, raising as an issue the question as to whether or not Bond and Share is an undue and unnecessary complexity with respect to American Gas and Electric Co., and its subsidiaries and American Foreign and its subsidiaries respectively, and also raising an issue with respect to the necessity for a reorganization of American Foreign under Section 11 (b) (2) of the Act. [Footnote: Holding Company Act Release No. 4305.] The notice and order directed that the issue with respect to Bond and Share's relation to American Gas be first considered. Hearings have been held but the matter has not been completed by reason of the request of Bond and Share that it be permitted to formulate and present a plan for its disposition of its stock interest in American Gas. After the close of the fiscal year, American Foreign filed a plan of reorganization on which hearings are being held. [Footnote: Holding Company Act Release No. 5388.]

2. The North American Co.

Proceedings pursuant to Section 11 (b) (I) were instituted March 8,1940, with regard to the North American Co. (North American) and its subsidiaries [Footnote: Holding Company Act Release No. 1960.] and on December 2, 1941, pursuant to Section 11 (b) (2) with regard to North American Light & Power Co. [Footnote: Holding Company Act Release No. 3168.] (Light & Power), a subsidiary of North American. Under date of December 30, 1941, the Commission ordered the dissolution of Light & Power. [Footnote: Holding Company Act Release No. 3233.]

The Commission's opinion and order in the 11 (b) (1) proceedings was rendered April 14, 1942, [Footnote: Holding Company Act Release No. 3405.] and dealt with the status of each registered holding company in the system, including subsidiary holding companies of Light & Power but not including Light & Power

since its liquidation had been previously ordered. The Commission's order directed that North American confine its operations to a single integrated electric system based upon Union Electric Co. of Missouri, and allowed North American 15 days in which to state an alternative choice. No such choice was made but North American filed a petition requesting modification of the order, which petition was denied June 25, 1942. [Footnote: Holding Company Act Release No. 3630.] North American appealed to the United States Circuit Court of Appeals for the Second Circuit, which affirmed the Commission's order on January 12, 1943. [Footnote: 133 F. (2d) 148.] The Supreme Court granted a writ of certiorari on March 1, 1943, [Footnote: On August 22, 1941, the Commission instituted proceedings with respect to Illinois-Iowa Power Co, (now Illinois Power Co.) pursuant to section 11 (b) (2) of the act, determination of which has been retarded by the claims of Illinois Power against its parents.] to review the decision of the Second Circuit, but on April 15, 1943, indefinitely deferred hearing the case because of the lack of a qualified quorum. Until the Supreme Court has disposed of this case, the difficulties, practical and otherwise, with respect to enforcement of that part of the order awaiting review are obvious.

Subsequently, on August 4, 1943, North American submitted a plan, under Section 11 (e) of the Act, proposing several regional holding companies and the final dissolution of North American. Hearings have been held on this plan, but the Commission has reserved decision because of the pendency of related questions which have not been resolved.

North American has disposed of substantially all of its holdings in Detroit Edison Co. common stock and has reduced its holdings in Washington Railway and Electric Co. and Pacific Gas and Electric Co. by the payment of shares of these companies as regular dividends to the common stockholders of North American, enabling North American to use the cash so conserved to reduce its outstanding debt from $70,000,000 to approximately $30,000,000. As a result, North American has been able to refund its entire debt with a 2 percent bank loan. maturing serially over a 5-year period.

The determination of a fair and equitable plan of liquidation for Light & Power has been delayed pending the disposition of certain claims asserted against it by Illinois Power Co., an indirect subsidiary. [Footnote: 134 F. (2d) 65.] In the interim, Light & Power has taken steps toward liquidation through the retirement of $3,376,500 publicly held debentures (without the payment of redemption premiums), such action having been appealed by the trustees under the indentures securing such debentures to the United States Circuit Court of Appeals for the Seventh Circuit, which upheld the order of the Commission; [Footnote: 134 F. (2d) 65.] and further, by the deposition of its investment in certain subsidiary companies, including Western Illinois Ice Co., Blue River

Power Co., Power & Light Securities Co., and McPherson Oil & Gas Development Co.

3. The United Gas Improvement Co.

The commission instituted proceedings with regard to the United Gas Improvement Co. (U. G. I.) and its subsidiaries, pursuant to Section 11 (b) (1), on March 4, 1940. Pursuant to a request by U. G. I., the Commission issued, on January 18, 1941, a statement of tentative conclusions as to the application of the Provisions of Section 11 (b) (1) to the holding company system of U. G. I., in which the Commission stated tentatively that the system's single integrated public utility system was composed of the electric properties of its subsidiaries in the Pennsylvania-Delaware-Maryland area. [Footnote: Holding Company Act Release No. 2500.] Divestiture orders were issued on July 30, 1941 and May 7, 1942, based upon this interpretation. [Footnote: Holding Company Act Release Nos. 2913 and 3511.] U. G. I. appealed these orders to the United States Circuit Court of Appeals for the Third Circuit. The court sustained the orders in a unanimous decision on November 17, 1943. [Footnote: 138 F. (2d) 1010.]

After argument before the court but before its decision, U. C. I. and its subsidiary, Philadelphia Electric Co., filed applications under Section 11 (e) for the purpose of enabling the U. G. I. holding company system to effect partial compliance with Section 11 (b). The plan provided for the distribution to U. G. I. 's preferred and common stockholders of $30,600,000 in cash and substantially all its stockholdings in Philadelphia Electric and Public Service Corp. of New Jersey, two subsidiaries with combined assets of $1,200,000,000. The plan was filed in December 1942, was approved by the Commission March 18, 1943, [Footnote: Holding Company Act Release No. 4173.] by the common stockholders April 19, 1943, and was declared effective as of June 18, 1943. By effecting the retirement in this manner of its preferred stock, U. G. I. made possible the further distribution of investments or cash to its common stockholders.

Subsequent to the distribution of its interest in Philadelphia Electric Co. and Public Service Corp. of New Jersey, the United Gas Improvement Co. effectuated a series of transactions which enabled it to distribute to its stockholders in May of 1944 its holdings of the securities of Delaware Power & Light Co. and subsidiaries which had consolidated assets of $52,334,642 [Footnote: Holding Company Act Release No. 4505.]

4. The Commonwealth & Southern Corp.

Section 11 (b) (1) proceedings were started with respect to The Commonwealth & Southern Corp. and its subsidiaries on March 6, 1940. This proceeding was later consolidated with Section 11 (b) (2) proceedings instituted on April 8, 1941.

On April 9, 1942, [Footnote: Holding Company Act Release No. 3432.] the Commission, under Section 11 (b) (2), ordered Commonwealth to reduce its outstanding preferred and common stock to a single class of common stock. Commonwealth appealed the order to the Circuit Court of Appeals for the Third Circuit which, on March 31, 1943, upheld the Commission's order in all respects. [Footnote: 134 F. (2d) 747] Commonwealth filed a recapitalization plan on April 20, 1943, designed to comply with the order. The plan as originally filed provides for reclassifying the existing preferred and common stocks into a single class of new common stock and for the distribution to its stockholders (or earlier sale) of the common stock of one of its northern subsidiaries. The plan contemplates that the remaining subsidiaries would continue to be owned by Commonwealth, pending the outcome of the Section 11 (b) (1) proceedings.

On February 26, 1944, Commonwealth filed an amended plan which, in substance, changed two basic features of the original plan, namely the 80-20 percent plan of allocation was changed to an 85-15 percent allocation for the preferred and common stockholders respectively and the proposed distribution of the common stock of Consumers Power Co. was changed to the proposed distribution of the common stocks of all of the northern subsidiaries to the preferred and common stockholders.

Hearings on the amended plan were concluded on March 27, 1944, and the staff filed its proposed findings on May 29, 1944, approving the basic features of the amended plan but recommending that certain amendments be made. Briefs have been filed and oral argument held on the issues involved and the case is presently under advisement by the Commission.

Like many other holding companies Commonwealth has refinanced most of its utility subsidiaries and in the process has materially improved their financial condition.

5. Cities Service Co.

On July 3, 1941, the Commission instituted a Section 11 (b) (1) proceeding with respect to Cities Service Co. (Cities), the top company in this system, and all its subsidiaries. Hearings were completed and the Commission issued its opinion and order on May 5, 1944. [[Footnote: Holding Company Act Release No. 5028.] The order directed Cities to comply with Section 11 (b) (1) by reducing the operations of its system, to certain gas distribution properties located in the Mid-Continent section and certain gas production and transmission properties found retainable therewith. [Footnote: Cities Service itself has not appealed this order.] The order provided, however, that the retention in the Cities' system of all of its nonutility holdings was not foreclosed if Cities should choose to comply with Section 11 (b) (1) by disposing of its holdings in all utility holding companies.

Subsequent to the issuance of that order, Cities filed a petition requesting that the order of May 5, 1944, be supplemented or modified so as to provide in substance that in lieu of compliance with the provisions of this order Cities may comply with requirements of Section 11 (b) (1) by disposing of its interests in utilities without prejudice to the right of Cities to apply for an exemption from the previsions of the Act under Section 3, and be exempt as a registered holding company, after it has disposed of its interest in utilities to the extent where it becomes entitled to such exemption and discharge. At the end of the fiscal year no action had been taken on this petition.

The order of May 5, 1944, was also directed to Arkansas Natural Gas Corp., a subsidiary holding company of Cities, and required that company to confine its operations to the production, transmission and distribution of natural gas conducted by Arkansas Louisiana Gas Co., its only utility subsidiary, and required it to dispose of its interests in its nonutility subsidiaries including its interests in Arkansas Fuel Oil Co. Arkansas Natural Gas Corp. has filed a petition to review the order of the Commission in the Circuit Court for the Fifth Circuit, which petition was pending at the end of the fiscal year,

On March 4, 1940, the Commission instituted a proceeding under Section 11 (b) (1) with reference to the holding company system of Cities Service Power & Light Co. (Power & Light), principal holding company of Power & Light. The Commission's decision in that case was issued on August 17, 1943, [Footnote: Holding Company Act Release No. 4489.] and required Power & Light to confine its operations to the electric utility business conducted by certain subsidiaries in the State of Ohio. The order also required Federal Light & Traction Co. to confine its operations to certain electric utility businesses conducted by subsidiaries in the States of New Mexico and Colorado.

In compliance with the requirements of that order, Power & Light has disposed of its interests in several subsidiaries, the Principal one being Public Service Co. of Colorado and its subsidiaries, [Footnote: Holding Company Act Release No. 4699. Commissioner Healy dissented.] and Federal Light & Traction Co. has disposed of its interests in Olympic Public Service Co. and Rawlins Electric Co. [Footnote: Holding Company Act Release No. 4820.]

By order dated August 29, 1942, a proceeding was instituted under Section 11 (b) (2) respecting Power & Light and certain of its subsidiaries. In December 1943 Power & Light filed a Section 11 (e) plan designed to effect partial compliance with Section 11 (b) (2). On March 14, 1944, the Commission approved the plan which included a proposal to retire the publicly held senior securities of Power & Light through the use of treasury cash (obtained principally through sales of subsidiaries) and a $20,000,000 short term bank loan. [Footnote: Holding Company Act Release No. 4944.] Reference has already

been made above concerning the reorganization of Empire Gas and Fuel Co. under Section 11.

6. Associated Gas & Electric Co.

The Commission, on September 4, 1941, instituted a Section 11 (b) (1) proceeding with regard to the trustees of Associated Gas and Electric Corp. (Agecorp) who controlled directly or indirectly, 175 subsidiaries of which 68 were public utilities as defined by the Act. To meet the issues raised by the Commission the trustees proposed to create out of the system 4 groups of properties to be disposed of as units in the liquidation of Agecorp. One of these 4 groups of properties is located in Florida and Georgia, while the other 3 are in New York, Pennsylvania, and New Jersey.

On August 13, 1942, the Commission issued an order requiring the trustees to divest themselves of all interest in a long list of utility and nonutility companies reserving for future consideration questions relating to the composition of the groups of properties as single integrated systems, additional systems, and permissible nonutility businesses. [Footnote: Holding Company Act Release No. 3729.] The trustees filed a petition for leave to file an amended supplemental answer relative to the retainability of certain additional properties and companies in each of the four groups. On February 17, 1944, the Commission permitted respondents to file the amended supplemental answer and adduce additional evidence in regard to the issues thus raised.

On February 3, 1941, the Commission initiated Section 11 (b) (2) proceedings with respect to General Gas and Electric Corp (Gengas), a registered holding company subsidiary of Agecorp. [Footnote: Holding Company Act Release No. 2543.] Subsequently, Section 11 (e) plans for the reorganization of Gengas were filed by Gengas [Footnote: Holding Company Act Release No. 2598, March 7, 1941.] and by Agecorp, [Footnote: Holding Company Act Release No. 4382, June 24, 1943.] the hearings on which were consolidated with the Section 11 (b) (2) proceedings. After the close of the fiscal year a revised plan was filed jointly by Agecorp and Gengas. [Footnote: Holding Company Act Release No. 5228.] This plan provided for the distribution by Gengas of certain assets among its public security holders, after which there would remain no claims against Gengas except those held by the trustees of Agecorp, who proposed to turn in all their securities of, and claims against, Gengas and receive in exchange an entire issue of new common stock. Hearings on the joint plan have been completed and the matter is under advisement.

Section 11 (b) (2) proceedings were directed to Virginia Public Service Co., a subsidiary of General Gas and Electric Corp. (Gengas), on August 12, 1941, raising, among others, the issue as to whether the voting power was fairly and

equitably distributed among its security holders. In answer to these proceedings, Virginia filed a Section 11 (e) plan which, after modification, was approved by the Commission on November 2, 1943. [Footnote: For the history of these proceedings, see Holding Company Act Release Nos. 4823, 3562, 4618, 4654.] Subsequently, however, on April 29, 1944, the Commission issued an order granting applications and whereby, among other things, Virginia was merged with Virginia Electric and Power Co., a subsidiary of Engineers Public Service Co., a nonaffiliated registered holding company. [Footnote: Holding Company Act Release No. 5021.]

On February 10, 1943, the Commission instituted Section 11 (b) (2) proceedings with regard to Georgia Power & Light Co., another subsidiary of Gengas. On April 24, 1944, Georgia, together with its parent, Gengas, and an associate company, Florida Power Corp., filed a joint application-declaration wherein, among other things, Georgia was to be recapitalized. It is proposed that Florida donate $1,400,000 in cash to Georgia. These funds are to be used in part to reduce the mortgage debt of Georgia and provide for a cash settlement in the amount of $150 a share in full satisfaction of the interests of the public holders of the preferred stocks of Georgia. The matter was pending at the close of the fiscal year.

On September 29, 1943, the Commission instituted 11 (b) (2) proceedings with regard to Tide Water Power Co., another subsidiary of Gengas, raising, among others, the issue as to whether the voting power of Tide Water was fairly and equitably distributed among its security holders. [Footnote: Holding Company Act Release No. 4594.] An answer and a supplemental answer were filed, and hearings were held. Subsequent to the end of the fiscal year, the Commission issued its findings and opinion and order directing Tide Water to file a plan, providing, among other things, for a recapitalization of the company by substituting for the present classes of stock a single class of common stock. [Footnote: Holding Company Act Release No. 5238.] On August 11, 1944, Tide Water filed a plan providing, among other things, for its recapitalization to comply with the Commission's one-stock order. After hearing, the plan was approved subject to reservation of jurisdiction as to the percentage of the new common stock issued to be received by Gengas. [Footnote: Holding Company Act Release No. 5512.]

On June 14, 1943, a thoroughgoing reorganization plan was filed jointly by the Trustee of Associated Gas and Electric Co. and the trustees of Associated Gas and Electric Corp. [Footnote: Holding Company Act Release No. 4399.] The plan, filed pursuant to Section 11 (f) of the Act, was designed to extricate these companies from bankruptcy proceedings which have been pending since January 10, 1940, in the United States District Court for the Southern District of New York under Chapter X of the Bankruptcy Act and to compromise and settle

the respective rights of the security holders of the two companies to the assets nominally held by Agecorp alone. Extensive hearings were held and oral argument heard. On April 14, 1944, the Commission entered an order approving the plan. [Footnote: Holding Company Act Release No. 4985.] After the close of the fiscal year, the plan was also approved, pursuant to Chapter X of the Bankruptcy Act, by the United States District Court for the Southern District of New York, An appeal was taken to the Circuit Court of Appeals for the Second Circuit and was argued on December 8, 1944.

On September 30, 1941, the Commission instituted Proceedings under Section 11 (b) (2) with respect to New England Gas and Electric Association (Negea), a registered holding company, Subsequent to the close of the hearings but prior to a final order of the Commission, the Trustees of Ageco and Agecorp and a subsidiary company in the Associated systems inspirited suits in both a State court and a Federal court, in Massachusetts against Negea. The suit in the State court involved consideration of the status of indebtedness, in the amount of 5 $14,583,290 which had been cancelled in 1930 through the issuance by Negea of equity securities. The suit in the Federal court involved an accounting for alleged profits received by Negea in, and resulting from, the transfer of certain stock and indebtedness of Electric Associates, Inc. from Agecorp to Negea in 1932.

It appeared to the Commission that the subject matter of the suits against Negea were relevant to any determination of a proper allocation of securities under any plan of recapitalization of Negea. Hence, on February 17, 1943, the Commission instituted further proceedings under various sections of the Act, including Section 11, for the purpose of determining (1) whether, and to what extent, the trustees of Ageco and Agecorp and its subsidiary had valid claims against Negea, and (2) in the event that any claims were deemed to be valid, the rank of such claims in relation to the claims of publicly held securities of Negea. [Footnote: Holding Company Act Release No. 4124.]

The issues in this matter were subsequently broadened to include consideration of whether and to what extent the trustees of Ageco and Agecorp, and their subsidiaries have claims against Negea for unjust enrichment as the result of any transfers or diversions to Negea of assets of the Associated system. Hearings in the matter have been completed and argument was heard. At the close of the fiscal year the Commission's findings and opinion and order were in preparation

7. Standard Power and Light Corp. - Standard Gas and Electric Co.

On March 6, 1940, the Commission instituted proceedings pursuant to Section 11 (b) (1) with regard to Standard Power and Light Corp. (Standard Power) and Standard Gas and Electric Co. (Standard Gas) and their subsidiaries, and on

June 5, 1940, pursuant to Section 11 (b) (2) with respect to Standard Power. At subsequent hearings counsel for Standard Power acknowledged that the Company performed no useful functions and on June 19, 1942, the Commission ordered it to liquidate and its existence terminated. [Footnote: Holding Company Act Release No. 3607.] After the close of the fiscal year, the Commission approved a dissolution plan for Standard Power filed jointly by Standard Power and Standard Gas. [Footnote: Holding Company Act Release No. 5625.]

Standard Gas, under date of March 24, 1943, filed a plan pursuant to Section 11 (e) for the purpose of enabling it to comply with the provisions of Section 11 (b) and on the same date the Commission instituted proceedings pursuant to Section 11 (b) (2), 15 (f), and 20 (a) and directed consolidation of the two hearings. Hearings were completed, briefs submitted, oral argument heard, and under date of May 31, 1942, the Commission issued findings and opinion, [Footnote: Holding Company Act Release No. 5070.] stating that it could not make the findings necessary for approval of the plan, for the reasons stated therein. It withheld entering its order for 90 days to give Standard Gas an opportunity to file an amendment in accordance with views expressed in the findings and opinion. Subsequent to the end of the fiscal year, Standard Gas submitted an amended plan providing for the distribution of its holdings in all its subsidiary companies except Philadelphia Company (selected as its principal system), Louisville Gas and Electric Co. (Delaware), Louisville Gas and Electric Co. (Kentucky), Wisconsin Public Service Corp., Public Utility Engineering and Service Corp, and a foreign subsidiary. An amendment to the amended plan provides for the distribution of the securities of Wisconsin Public Service Corp. (Holding Company Act Release No. 5279.) This plan was approved by the Commission in its Findings and Opinion dated November 18, 1944. [Footnote: Holding Company Act Release No. 5430.]

On June 5, 1942, Northern States Power Co. (Delaware) filed its plan of liquidation pursuant to Section 11 (e) and on the same date the Commission instituted proceedings pursuant to Section 11 (b) (2) and other sections of the Act with respect to that Company and each of its subsidiary companies. Hearings were held, subsequent to which the Company submitted an amended plan, upon which extensive hearings were also held, briefs submitted, and argument heard. The decision of the Commission is pending.

On June 30, 1942, Southern Colorado Power Co., a subsidiary of Standard Gas, filed a plan pursuant to Section 11 (e) for recapitalization and, on July 2, 1942, the Commission instituted proceedings under Section 11 (b) (2) and ordered consolidated hearings thereon. On August 3, 1943, the Commission approved the plan subject to certain modifications, which were satisfied by amendments filed October 21, 1943. The amended plan was approved by the Commission on November 24, 1943, [Footnote: Holding Company Act Release No. 4501.] and by

the United States District Court in Colorado on December 31, 1943. [Footnote: Enforced without opinion.] Appeal was taken therefrom to the United States Circuit Court of Appeals for the Tenth Circuit, which has rendered its decision upholding the Commission's approval of the plan.

8. Columbia Gas & Electric Corp.

Proceedings initiated by the Commission on August 25, 1941, with regard to Columbia Gas & Electric Corp. (Columbia) and several of its subsidiaries including Columbia Oil & Gasoline Corp., pursuant to Sections 11 (b) (1) and 11 (b) (2), were consolidated with a Section 11 (e) plan by order dated July 14, 1942. The plan involved, among other things, the sale by Columbia Oil & Gasoline Corp (Columbia Oil), a subsidiary of Columbia, of its interest in Panhandle Eastern Pipe Line Co. (Panhandle), the transfer of its five oil and gasoline subsidiaries to Columbia Gas, and the liquidation of Columbia Oil. The Commission in an order [Footnote: Holding Company Act Release No. 3829.] and opinion [Footnote: Holding Company Act Release No. 3885.] dated October 2, 1942, approved the plan. On March 23, 1943, the United States Circuit Court of Appeals, Third Circuit, affirmed the Commission's order [Footnote: 134 F. (2d) 822.] and 6 days later the United States District Court for the District of Delaware entered its order approving the plan. [Footnote: 50 F. Supp. 965.] Columbia's relationships with certain of its subsidiaries had involved it in a long series of legal difficulties. Among other results, consummation of Columbia's plan had the effect of divorcing Panhandle from the Columbia system, a step which the Commission had found to be necessary to effectuate the provisions of Section 11 (b) (1), extricated some of the companies and other interested parties from problems which they faced under the antitrust laws, and terminated a complex tangle of private litigation.

Further proceedings were instituted by the Commission on May 2, 1944, with regard to Columbia and its remaining subsidiaries pursuant to Sections 11 (b) (1) and 11. (b) (2). Initial hearings were held before the Commission on June 15, 1944, at which time various suggestions as to methods of compliance by Columbia with Section 11 (b) were made by the parties. Subsequent to this hearing, and after conferences among members of the staff of the Public Utilities Division and certain of the parties to the proceedings, Columbia requested the Commission to issue its tentative conclusions as to the status of Columbia in relation to the requirements of Section 11 (b) (1). The Commission acquiesced in this request, and on August 10, 1944, issued its tentative conclusions. [Footnote: Holding Company Act Release No. 5213.] Subsequent to the close of the fiscal year, the Commission issued its findings, opinion, and order in this matter, [Footnote: Holding Company Act Release No. 5455.] in which it found that Columbia Gas could retain the distribution operations of the Charleston, Pittsburgh, and Columbus groups of properties as well as the production and

transmission properties owned and operated by the companies within each such group. The Commission further held that certain other properties, including the properties owned by the Cincinnati Gas & Electric Co. and the Dayton Power & Light Co, were not retainable and should be divested. Jurisdiction was reserved as to the retainability of certain other designated properties.

9. Niagara Hudson Power Corp.

The Commission instituted Section 11 (b) (2) proceedings in August 1942 with respect to Niagara Hudson Power Corp., Buffalo, Niagara and Eastern Power Corp., and their subsidiary companies.

During the course of the hearings, the Commission held a public conference to explore the means whereby dividend payments on the preferred stocks of the two holding companies in the system, which were discontinued in the fall of 1942, could be resumed. The management formulated an over-all plan of reorganization, filed in June 1943 under Section 11 (e) of the Act, providing for the consolidation of the principal public utility companies in the system and Buffalo, Niagara and Eastern Power Corp. into one operating company, and the dissolution of Niagara Hudson Power Corp. The plan further provided for the payment in cash of all accrued and unpaid dividends.

On January 21, 1944, the New York Public Service Commission denied the petition of the companies involved to consolidate as contemplated by the plan. The Securities and Exchange Commission on June 19, 1944 denied the application of Buffalo, Niagara and Eastern Power Corp., a subsidiary of Niagara Hudson, for exemption as a holding company from the provisions of the Act insofar as applicable to the provisions of Section 11 (b) (2) , and further ordered that Buffalo, Niagara & Eastern change its capitalization by substituting for its outstanding $ 1.60 cumulative preferred stock, class A stock and common stock one class of stock, namely, common stock. [Footnote: Holding Company Act Release No. 5115.] The order further required that appropriate voting rights be extended to the $5 preferred stock of Buffalo, Niagara & Eastern.

10. International Hydroelectric System

Proceedings under Section 11 (b) (2) of the Act involving International Hydroelectric System (IHES) were instituted on June 17,1940. IHES is a Massachusetts trust which owns directly the equity in New England Power Association, also a registered holding company, the equities in Gatineau Power Co., a Canadian public utility company, and in two wholesale electric utilities operating in the United States.

On January 17, 1941, the Commission ordered that all of the common stock and all of the class B stock of IHES held by certain trustees for the benefit of International Paper Co., and International Paper & Power Co. be surrendered to IHES for cancellation, the Commission having found such stocks to be of no value. [Footnote: 8 S.E.C. 485.] On June 18, 1941, this order was complied with by the trustees and the class B and common stocks were thereafter cancelled.

On July 21, 1942, IHES itself was ordered to liquidate and dissolve, the Commission finding that IHES performed no useful function and constituted an unnecessary complexity in. the system. [Footnote: Holding Company Act Release No. 3679.]

On March 17, 1943, the Commission, pursuant to Section 11. (b) (2), ordered that Massachusetts Utilities Associates Common Voting Trust be liquidated and dissolved and that Rhode Island Public Service Co., Massachusetts Utilities Associates, Massachusetts Power & Light Associates and North Boston Lighting Properties be eliminated as subholding companies in the New England Power Association and IHES system. [Footnote: Holding Company Act Release No. 4168.]

Paul H. Todd, a stockholder and director of IHES, filed petitions on September 19, 1942, and December 20, 1942, in the United States Circuit Court of Appeals for the Sixth Circuit, for the review of the Commission's order of July 21, 1942, directing the liquidation and dissolution of IHES and asking the court to remand the proceedings to the Commission for further investigation of certain alleged rights of action of IHES against International Paper Co. The Commission contended that dissolution was the appropriate action in the light of the applicable statutory standards and that the alleged claims against Paper Co. would be fully explored, but that such exploration was not a necessary prerequisite to the issuance of the dissolution order. IHES intervened in the review proceeding and supported the validity of the Commission's order. The court denied the application to adduce additional evidence and dismissed the petition for review, thereby sustaining the Commission's order. [Footnote: 137 F. 475 (C.C.A. 6, 1943).

In July 1943 IHES notified the Commission that because of the asserted claims against International Paper Co., former parent of IHES, and the imminence of the maturity of its bonds, it would be impossible for it to comply with the Commission's order of July 21, 1942, without the aid of court enforcement thus virtually inviting the Commission to apply to the court. On August 12, 1943, the Commission instituted a proceeding pursuant to Section 11 (d) of the Act in the United States District Court for the District of Massachusetts to enforce compliance with its liquidation order, and on October 11, the court took jurisdiction over IHES and its assets and appointed a special counsel to

investigate the claims asserted against International Paper Co. This investigation is still in progress. On March 6, 1944, New England Power Association and its subsidiary holding companies filed an application for approval of a plan of simplification of the New England Power Association holding company system for the purpose of complying with the simplification provisions of Section 11 (b) (2) of the Act and with the Commission's order of March 17, 1943. This plan provided for the elimination of the Massachusetts Utilities Associates Common Voting Trust and for the substitution of a single holding company in lieu of New England Power Association, Rhode Island Public Service Co., Massachusetts Utilities Associates, Massachusetts Power & Light Associates, and North Boston Lighting Properties. Hearings on the plan were completed shortly after the termination of the fiscal year.

11. The Middle West Corp.

The Commission instituted Section 11 (b) (1) proceedings with regard to The Middle West Corp. (Middle West) and its subsidiaries on March 1, 1940. On January 24, 1944, the Commission ordered Middle West to sever its relations with its subsidiary companies, except Central Illinois Public Service Co., and its subsidiaries, Kentucky Utilities Co., South Fulton Power & Light Co., Old Dominion Power Co., and Dixie Power & Light Co. [Footnote: Holding Company Act Release No. 4846.] On May 9, 1944, a rehearing was granted to permit the introduction of further evidence with respect to the question of what constitutes the integrated system of Central & South West Utilities Co. (Central) and with respect to the retainability of the other businesses of the following subholding companies, American Public Service Co. (American), Arkansas-Missouri Power Corp., and Central. Hearings with respect to the issues of the rehearing have been completed and arguments have been presented. Sales by Middle West of its subsidiaries, Kansas Electric Power Co. [Footnote: Holding Company Act Release No. 4532.] and Missouri Gas & Electric Service Co., [Footnote: Holding Company Act Release No. 4782.] were approved by the Commission on August 31, 1943, and December 27, 1943, respectively. Sale of the gas properties of Southwestern Gas & Electric Co. was approved September 25, 1943. [Footnote: Holding Company Act Release No. 4782.]

In February 1940, Central and American, two subsidiaries of Middle West, filed a joint application proposing a consolidation of the two companies. On December 5, 1940, the Commission instituted proceedings under Section 11 (b) (2) and ordered that the hearings of the two cases be consolidated. The consolidation issue in the case centered around the question of whether the new corporation should issue any preferred stock. The proponents of the plan submitted by the companies contended that preferred stock was necessary in the new company in order to preserve the priorities of the holders of the prior lien and preferred stocks of Central and the preferred stock of American. The Commission on June 4,

1942, ruled that the new corporation could have only common stock. [Footnote: Holding Company Act Release No. 4585.] The respondents filed a petition for review in the United States Court of Appeals for the District of Columbia, which upheld the Commission in its opinion of June 7, 1943. [Footnote: 136 Fed. (2d) 273.] On August 2, 1943, Central and American filed an amended plan of merger to be effectuated through the issuance of a single class of capital stock. Hearings on this matter have been held.

The Commission on June 9, 1941, instituted proceedings pursuant to Section 11 (b) (2) which raised issues as to the equitable distribution of voting power among security holders of the North West Utilities Co. (North West) system, and also as to the continued existence of North West. The proceeding was consolidated on June 11 , 1941, with a plan of recapitalization of North West which had been submitted by North West and Middle West. The Commission on September 10, 1043, held that the proposed plan of recapitalization fell short of effectuating the provisions of Section 11 (b) and ordered that North West be liquidated. [Footnote: Holding Company Act Release No. 4552.]

12. The United Light and Power Co.

Three major Section 11 proceedings involving The United Light and Power Co. (United Light) were consolidated in 1941, namely: a Section 11 (b) (1) proceeding instituted on March 8, 1940, proceedings with respect to a recapitalization plan filed by United Light, and Section 11 (b) (2) proceedings started December 6, 1940. United Light is the top holding company astride two subsidiary tiers of holding companies in an excessively pyramided holding company system. United Light performs no necessary or useful function. No dividends have been paid since the first quarter of 1932 on its outstanding $60,000,000 preferred stock issue. Under the standards of Section 11, its liquidation was necessary and was ordered by the Commission. [Footnote: Holding Company Act Release No. 2636.] The company subsequently filed a number of applications covering action necessary to accomplish liquidation, now in its final stage. One of the most important steps involved the distribution by United Light of its principal asset, all of the common stock of a subsidiary holding company, The United Light and Railways Co. (Railways), to the preferred and common stockholders of United Light on a fair and equitable basis. The original plan filed by the company provided that 91.2 percent of the common stock of Railways should be distributed to the preferred stockholders of United Light and 8.8 percent to the common stockholders. In an opinion rendered April 5, 1943, the Commission disapproved this distribution, but approved the plan when it was amended to allow the preferred stockholders approximately 95 percent of Railways' common. [Footnote: Holding Company Act Release No. 4215.] Commissioner Healy dissented on the ground that the preferred stockholders were entitled to receive all the assets. The order of the Commission approving

the plan of distribution was confirmed by Judge Leahy of the United States District Court of Delaware on June 30, 1943, and was affirmed by the United States Circuit Court of Appeals, Third Circuit, on April 10, 1944. [Footnote: In re Securities and Exchange Commission (Otis & Co., intervener) 142 F. (2d) 411 (1944).] A petition for certiorari in the United States Supreme Court was granted on June 12, 1944. [Footnote: The Supreme Court has rendered its decision affirming the Commission's approval of the plan (three Justices dissenting) 65 S Ct. 483 (1945).]

The United Light and Power system has taken several major steps in compliance with the Section 11 (b) (1) order which the Commission issued with respect to this system on August 5, 1941. [Footnote: Holding Company Act Release No. 2923 (9 S.E.C. 833.).] United Light and Railways Co., on September 12, 1941, sold its stock interest in Northern Natural Gas Co. to underwriters for resale. Proceeds from the sale, $10,533,000 were applied on the purchase from United Light of common stock of Iowa-Illinois Gas & Electric Co. in order to facilitate the dissolution of United Light. A number of other divestments of properties by subholding companies in this system, including the sale on October 24, 1942 by American Light & Traction Co. of its holdings in San Antonio Public Service Co., are summarized in appendix table 17.

13. American Water Works and Electric Co., Inc.

This was the first registered holding company to file a corporate simplification plan pursuant to Section 11 (e). The plan contemplated the elimination of several "second degree" holding company relationships, the continuance of which is forbidden under the terms of Section 11 (b) (2) of the Act. Its consummation was contingent upon the accomplishment of certain refinancing. No change in the actual physical utility properties of the system was involved. The Commission approved the plan on December 31, 1937, reserving for future consideration the question of adjustments of write-ups of system properties and investments. [Footnote: 2 S.E.C. 972.] The refinancing was postponed because of changed market conditions, and the major simplification provisions of the plan have not been put into effect.

14. Engineers Public Service Co.

Section 11 (b) (1) proceedings were instituted with regard to Engineers Public Service Co. (Engineers) and its subsidiaries on February 28, 1940. On July 23, 1941, the Commission ordered Engineers to dispose of its interest in Puget Sound Power & Light Co. and the Key West Electric Co., and on the same date initiated Section 11 (b) (2) proceedings against the Western Public Service Co. (a Maryland corporation), a subsidiary of Engineers. [Footnote: Holding Company Act Release Nos. 2897 and 2898.] On. December 29, 1941, the Commission

approved the sale of Western's Nebraska and South Dakota Properties. Western then redeemed its publicly held securities and liquidated. Its remaining properties were acquired by Western Public Service Co., a Delaware corporation (Western, Del.), a newly formed subsidiary of Engineers, which also acquired the securities of Western's subsidiaries, Northern Kansas Power Co., and Missouri Service Co. Engineers accepted an order to divest itself of the properties owned by Western, Del., and by Northern Kansas Power Co. and Missouri Service Co. On September 16, 1942, the Commission ordered the divestment of the remaining properties in the Engineers system except the electric utility properties of Virginia Electric and Power Co., allowing Engineers, however, 15 days within which to petition for leave to retain instead the electric utility properties of gulf States Utilities Co. Engineers appealed to the United States Court of Appeals for the District of Columbia.

On November 22, 1943, the Court of Appeals for the District of Columbia rendered an opinion upholding the Commission's order in most respects but setting it aside upon the ground that the Commission had misinterpreted the so-called "incidental business clause" of Section 11 (b) (1). The Court intimated also that Engineers must be given a further right to designate the principal integrated utility system which it desired to retain. Both Engineers and the Commission filed petitions for writs of certiorari in the Supreme Court of the United States. On June 5, 1944 the petitions were granted and the matter is now pending in the Supreme Court.

Meanwhile, Engineers has divested itself of its interest in Puget sound Power & Light Co., Key West Electric Co., El Past Natural Gas Co., El Paso and Juarez Traction Co., Baton Rouge Bus Co., Inc., and the transportation businesses conducted by El Paso Electric Co., (Texas), and Virginia Electric and Power Co. On April 29, 1944, the Commission entered an order permitting Virginia electric and Power Co., a former subsidiary of Associated Gas and Electric Corporation and of General Gas and Electric Corp.

15. The United Corp.

On July 28, 1941, the Commission instituted proceedings under Sections 11 (b) (1) and 11 (b) (2) with respect to the United Corporation, and consolidated such proceedings for hearing with United's Section 11 (e) plan filed in March 1941. In its plan, United proposed to reduce its holdings in each of its statutory subsidiaries to less than 10 percent of the outstanding voting securities when such reduction would be advantageous in the opinion of its management. Pending such reduction, United proposed to refrain from voting the securities without prior approval of the Commission. The predominant portion of United's portfolio comprises the common stocks of four holding company subsidiaries: The United Gas Improvement Co., Public Service Corp. of New Jersey, Niagara

Hudson Power Corp., Public Service Corp. of New Jersey, Niagara Hudson Power Corp., and Columbia Gas & Electric Corp. On August 14, 1943, after extensive hearings, the Commission disapproved United's plan, and, pursuant to Section 11 (b) (2), ordered that United change its existing capitalization to one class of stock and cease to be a holding company.

On June 27, 1944, the United Corp. filed a plan pursuant to Section 11 (e) which provided for the exchange of substantially all of holdings of the common stocks of Philadelphia Electric Co. and Delaware Power & Light Co., plus cash for approximately one-half of its outstanding preferred stock. [Footnote: Holding Company Act Release No. 4870.] The plan was subsequently amended to provide for the exchange of only the Philadelphia Electric common stock and an increased amount of cash. The plan, as amended, was approved by the Commission on November 24, 1944 [Footnote: Holding Company Act Release No. 5440.] and has since been consummated.

16. Midland United Co. and Midland Utilities Co.

On February 19, 1943, a reorganization plan, as amended for Midland United Co. and its subsidiary company, Midland Utilities Co., was filed, pursuant to the requirements of Section 11 (f) of the Act, by the trustee of Midland United Co. Hearings on that plan were held from time to time. On September 20, 1943, a separate plan for the reorganization of Midland Utilities Co. alone was filed by the trustees of Midland Utilities Co. Thereafter, on November 9, 1943, a plan of reorganization for both Midland United Co. and Midland Utilities Co. was filed jointly by the trustee of Midland United Co. and the trustees of Midland Utilities Co. Hearings were held, briefs were filed by a number of interested persons, and oral argument heard on May 15 and May 16, 1944. On September 27, 1944, the Commission entered its Preliminary findings and opinion approving this joint plan subject to certain conditions (Holding Company Act Release No. 5317). The trustees of the two estates having filed an amended plan satisfying the conditions, an order approving the amended plan was entered on October 5, 1944, and the definitive findings and opinion was filed on October 24, 1944 (Holding Company Act Release Nos. 5335 and 5317A) The reorganization court also found the amended joint plan fair and equitable and feasible, and on December 11, 1944, filed its order approving the plan. On December 22, 1944, an appeal was taken to the Circuit Court of Appeals for the Third Circuit.

17. Standard Oil Co. (New Jersey)

Subsequent to the denial by the Commission of an application by Standard Oil Co. (New Jersey) for an exemption from the provisions of the Act pursuant to Section 3 (a) (3), on the ground that it was "only incidentally a holding company" with respect to four gas utility subsidiaries, [Footnote: Holding Company Act

Release No. 3312.] Standard Oil conceded that, under the requirements of Section 11 (b) (1), it could not retain its interest in both the petroleum and natural gas utility business. The company thereupon elected to divest itself of control of its gas utility subsidiaries. As a preliminary step thereto, Standard Oil caused Consolidated Natural Gas Co. to be organized and to register under the provisions of the Act. Thereafter, on August 12, 1943, Standard Oil also filed notification of registration as a holding company.

On October 11, 1943, the Commission issued its order approving a joint 11 (e) plan filed by Standard Oil and Consolidated providing for the transfer to Consolidated of all the outstanding stock of Standard Oil's four gas utility subsidiaries, Hope Natural Gas Co., East Ohio Gas Co., Peoples Natural Gas Co., River Gas Co., and the stock of New York State Natural Gas Corp., a nonutility pipeline subsidiary in exchange for all of the capital stock of Consolidated. The latter stock was then distributed to the common stockholders of Standard Oil as a dividend, and subsequent to such distribution Standard Oil was declared not to be a holding company under the Act.

18. New England Public Service Co.

On May 2, 1941, the Commission issued an order pursuant to Section 11 (b) (2) directing New England Public Service Co. to recapitalize on a one-stock basis or to liquidate. On December 6, 1941, the company filed a plan for compliance with this order, involving, among other things, the elimination of two public utility operating companies and the distribution of all its holdings in the remaining public utility subsidiaries to its security holders. During a previous fiscal year, one public utility operating company (Cumberland County Power & Light Co.) had been eliminated by merging it into Central Maine Power Co. During the past fiscal year, a Section 11 (e) plan was filed for the purpose of eliminating Twin State Gas & Electric Co. by calling its preferred stock and conveying its New Hampshire properties to Public Service Co. of New Hampshire and its Vermont properties to Central Vermont Public Service Corp. This plan was approved by the Commission in its order of November 25, 1943. [Footnote: Holding Company Act Release No. 4711.]

19. Federal Water and Gas Corp.

On December 31, 1942, proceedings were instituted by the Commission against Federal Water & Gas Corp. (Federal) and its subsidiaries under Sections 11 (b) (1) and 11 (b) (2). On the same date, Federal and certain of its subsidiaries filed a plan under Section 11 (e) for the purpose of complying with Section 11 (b), which plan, in general, provides for the disposition by Federal of all its interests in subsidiary companies and its subsequent elimination either by dissolution or by merger with an appropriate company, the recapitalization of certain subsidiaries,

and the elimination of certain other unnecessary subsidiaries. On February 10, 1943, the Commission approved Federal's plan and directed in general that steps be taken to carry out the provisions of the plan. [Footnote: Holding Company Act Release No. 5052.] Among other things, the Commission's order directed Peoples Water and Gas Co., Scranton-Spring Brook Water Service Co., and New York Water Service Corp. be recapitalized. In addition, Federal, Pennsylvania Water Service Co., and Scranton-Spring Brook Water Service Co. were directed to cause the elimination of Pennsylvania Water Service Co. and the 63 inactive subsidiaries of Scranton-Spring Brook Water Service Co. Since the entry of the afore-mentioned order Federal has sold its interests in one subsidiary, has caused another subsidiary to dispose of part of its properties, and has caused Scranton-Spring Brook Water Service to eliminate 62 of that company's 63 inactive subsidiaries. In addition, New York Water Service Corp. and Scranton-Spring Brook Water Service Co. have filed recapitalization plans under Section 11 (e) of the Act which are presently pending before the Commission.

20. Ogden Corp.

Ogden Corp. (Ogden) is the successor corporation to Utilities Power & Light Corp., which went into bankruptcy in 1937. The plan of reorganization of the latter company, approved by this Commission in 1939 [Footnote: 5 S.E.C. 483.] and approved and confirmed by the United States District Court for the Northern District of Illinois in 1940, provided among other things, that Ogden, the successor, would take the necessary steps to divest itself of all interests in utility companies.

Proceedings initiated by the Commission on March 22, 1943, with regard to Ogden and certain of its subsidiaries pursuant to Section 11 (b) (1) and 11 (b) (2), were consolidated with a Section 11 (e) plan of Ogden. On May 20, 1943, the Commission entered an order approving certain provisions of the plan, and directing that certain steps, provided for in the plan, be taken in order to achieve compliance with Sections 11 (b) (1) and 11 (b) (2). [Footnote: Holding Company Act Release No. 4307.] Ogden was ordered, among other things, to divest itself of all its interests in holding and public utility companies and to cause its elimination as a public utility holding company; provided that, in the cases of Central States Power & Light Corp. (Central States), Interstate Power Co. (Interstate) Laclede Gas Light Co. (Laclede Gas), and Missouri Electric Power Co. (Missouri Electric) such divestment not to be effected through the sale of securities prior to the recapitalization of such companies. Central States, Interstate and Laclede Gas were ordered to recapitalize, but, in the case of Central States it was directed that such recapitalization need not be effected if the company is liquidated and dissolved.

Substantial progress has since been made by the Ogden system with the view of complying with the directions of our order as well as the provisions of its plan. Ogden divested itself of all its interests in its directly owned subsidiaries, Derby Gas & Electric Corp. [Footnote: Holding Company Act Release No. 4768.] and Missouri Natural Gas Co. [Footnote: Holding Company Act Release No. 4847.] Central States, an indirect subsidiary of Ogden, consummated the sale of all of its assets and orders were obtained from the United States District Court for the District of Delaware approving and enforcing plans previously approved by the Commission [Footnote: Holding Company Act Release Nos. 4735 and 5481] providing for the retirement of its first mortgage bonds out of the proceeds of such sales and for the maturity extension of Central States 5 percent debentures The assets of the company now consist only of cash, which will be distributed to the remaining security holders of Central States after the Commission and the Federal enforcement court determine the rights of the various classes of security holders, including the issue of whether the securities of Central Slates held by Ogden should not be subordinated, in whole or in part, to the claims of the public security holders. Interstate has caused the liquidation of its subsidiary, Eastern Iowa Electric Co., and has divested itself of its interest in its wholly owned subsidiary Interstate Power Co. of North Dakota, [Footnote: Holding Company Act Release No. 4440.] and its Bemidji-Crookston properties. [Footnote: Holding Company Act Release No. 5351.]

In an opinion dated May 24, 1944, [Footnote: Holding Company Act Release No. 5062.] and in an opinion and order dated May 27, 1944, [Footnote: Holding Company Act Release No. 5071.] the Commission approved a comprehensive plan of reorganization of Laclede Gas, involving, among other things, substantial reduction in the debt of Laclede Gas, the elimination of preferred stock arrears, the conversion of its outstanding preferred and common stocks into a single class of stock, and the divestment by Ogden of its interest in Laclede upon consummation of the reorganization. The Commission also approved that portion of the plan which provided for the discharge and satisfaction of the company’s bonds by payment in cash of their full principal amount but without the premium payable in the event of voluntary redemptions, the Commission finding that the retirement of the bonds was not “ voluntary” but was due to the compulsion of Section 11 of the Act. The order of the Commission approving the plan was confirmed in an opinion handed down on August 25, 1944, by Judge Hulen of the United States District Court for the Eastern Division of the Eastern District of Missouri. Since certain of the holders of such bonds had indicated their intention to appeal from the Commission and the court’s decision in regard to the nonpayment of the redemption premiums, Laclede Gas, in order to consummate the plan while such appeals were pending, amended the plan to provide for the deposit in escrow of sufficient funds to pay such premiums in the event that it should be ultimately determined that the premiums were due and payable. By order dated December 2, 1944, the Commission approved the plan as so

amended [Footnote: Holding Company Act Release No. 5429.] and on December 4, 1944, the Federal court entered its findings and order approving the plan as so amended.

21. Lone Star Gas Corp.

On March 4, 1942, the Commission instituted proceedings under Section 11 (b) (1) with regard to the Lone Star Gas holding company system and consolidated such proceedings with a plan filed by Lone Star under Section 11 (e) providing for a comprehensive system reorganization. By order dated October 22, 1942, the Commission approved such plan and directed Lone Star to divest itself of its interests in Council Bluffs Gas Co., Northern Natural Gas Co., and the Galveston and El Paso Gas properties of Texas Cities Gas Co. Prior to the past fiscal year Lone Star effectuated the major portion of its reorganization program including the mentioned divestments and during the year consummated the remainder of its plan. [Footnote: Holding Company Act Release Nos. 4783 and 4812]

As a result of the effectuation of its Section 11 (e) plan, Lone Star's operations are now confined to an integrated natural gas system, including production, transmission, and distribution facilities. Its corporate structure has been greatly simplified; the Delaware holding company (Lone Star Gas Corp.), has been eliminated, and, in place of five operating subsidiaries, the system now consists of a single transmission and distribution company (Lone Star Gas Co., a Texas corporation) which has only one subsidiary (Lone Star Producing Co., also a Texas corporation) operating all the production facilities of the system. Lone Star's capitalization now consists only of bank loans and a single class of common stock. In addition, pursuant to its plan, Lone Star eliminated approximately $20,000,000 of questionable items from its combined property accounts. The company was the first major holding company system to comply completely with Section 11 (b) and is now no longer subject to the Act as a holding company.

Part IV

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

Chapter X of the Bankruptcy Act, as amended in 1935, affords appropriate machinery for the reorganization of corporations (other than railroads) in the Federal courts under the Bankruptcy Act. The Commission's duties under Chapter X are, first, at the request or with the approval of the court, to act as a participant in proceedings thereunder in order to provide, for the court and

investors, independent, expert assistance on matters arising in such proceedings, and second, to prepare, for the benefit of the courts and investors, formal advisory reports on plans of reorganization submitted to it by the court in such proceedings. The Commission has no right of appeal in any such proceeding, although it may participate in appeals taken by others.

COMMISSION FUNCTIONS UNDER CHAPTER X

The Securities Exchange Act directed the Commission to make a study and investigation of the activities of reorganization committees in connection with the reorganization of persons and properties and to report the results of its study and its recommendations to Congress. The eight parts of the report prepared by the Commission under that directive are: Strategy and Techniques of Protective and Reorganization Committees, Committees and Conflicts of Interest, Committees for the Holders of Real Estate Bonds, Committees for the Holders of Municipal and Quasi-Municipal Obligations, Protective Committees and Agencies for Holders of Defaulted Governmental Bonds, Trustees under Indentures, Management Plans Without Aid of Committees, and A Summary of the Law Pertaining to Equity and Bankruptcy Reorganizations and of the Commission's Conclusions and Recommendations.

The report brought to light a multitude of abuses, of which many people had been more or less aware in a general way, that were injurious to investors and incompatible with the public interest. Emphasis was placed upon the fact that reorganization and protective committees, which were supposed to mobilize security holders for group action for their own best interests, were frequently formed, controlled and used by insiders to protect or further their own interests instead. These disclosures gave impetus to a reform of the National Bankruptcy Law in 1938 and to the enactment of the Trust Indenture Act of 1939. Representatives of the Commission assisted in drafting this legislation and testified before Congressional Committees in support of it.

Corporations in financial distress are placed under the custody of Federal courts in order that creditors may be held off and the Corporation enabled to continue in operation until a plan of financial readjustment can be effected, or until it is determined that no plan is possible. In many cases, a reorganization that assures the continuation in business of the corporation may be more desirable for creditors in realizing on their claims than immediate liquidation.

Section 77B, passed in 1935 as an amendment to the Bankruptcy Act, had signally improved previously existing reorganization machinery but had not remedied certain fundamental defects. It contained no effective provision for a disinterested analysis of the causes of corporate failure or for an estimate of the honesty and competence of management. The section stipulated that a

reorganization plan should not be approved unless found to be fair, equitable and feasible but provided no effective procedure for making the information necessary to such a finding available to either the judge or the security holders.

On June 22, 1938, President Roosevelt approved the comprehensive revision of the Bankruptcy Act, referred to above, which is known as the Chandler Act after its sponsor, former Congressman Walter C. Chandler of Tennessee. Chapter X of this Act succeeds Section 77B and effects a number of improvements in the reorganization of corporations (other than railroads). Chapter X requires, in each case involving a corporation of substantial size, that a disinterested trustee be appointed to be primarily responsible for the operation of the business, to probe and evaluate the causes of the debtor's failure, to appraise the ability and fidelity of its management and to be responsible for the formulation and filing of a plan of reorganization which will meet the test of informed judicial scrutiny. If approved by the judge, the plan is submitted to the security holders for approval or rejection.

Chapter X places two responsibilities upon the Commission by providing (1) that, if requested by the judge or on its own initiative if the judge approves, the Commission shall be a participant in proceedings thereunder in order to provide independent, expert assistance and (2) that the judge shall, if the indebtedness of the debtor exceeds $3,000,000 and may, if the indebtedness does not exceed that amount, submit to the Commission for advisory reports all plans of reorganization which the judge deems worthy of consideration in practice, the services rendered by the Commission under these two provisions of the Act are complimentary.

The role of the Commission under Chapter X differs from that under the other acts pursuant to which it operates in that the Commission does not initiate the proceedings, hold its own hearings or adopt rules and regulations but acts, as the representative of investors and as an aid to the court, in a purely advisory capacity. It has no authority either to veto or to require the adoption of a reorganization plan. It has no authority to render decisions on any of the other issues in a proceeding. The facilities of its technical staff and its impartial recommendations are simply placed at the services of the judge affording him the views of experts in a highly complex area of corporate law and finance.

To aid in attaining these objectives the Commission has stationed qualified staffs of lawyers, accountants and analysts in its regional offices, where they can keep in close touch with all hearings and issues in the proceedings and with the parties, and be readily available to the courts, thus facilitating the work of the courts and the Commission.

Upon filing its notice of appearance, the Commission is deemed to be a party in interest and has a right to be heard on all matters arising in the proceeding, but it does not have the right of appeal. The Commission, however, appropriately appears before the appellate courts when appeals are taken by others. Thus, the Commission has participated as a party or as amicus curiae in many appeals raising significant legal questions in Chapter X proceedings.

Through its nation-wide activity in bankruptcy reorganizations the Commission has been in an advantageous position to encourage uniformity in the interpretation of Chapter X and in the procedure thereunder. Thus, the Commission has often been called upon by parties, referees and special masters for advice and suggestions. In this, the Commission has been able to extend substantial assistance derived from the experience accumulated through participation in many cases. This work of the Commission has been of special value because the solutions of many procedural and interpretative questions may not be available in the official or unofficial reports.

THE COMMISSION AS A PARTY TO THE PROCEEDINGS

The Commission, in order to ascertain the cases in which its participation would be desirable and practicable, endeavors to keep informed as to the nature of all pending cases. The clerks of the various Federal district courts transmit to the Commission copies of all petitions for reorganization filed under Chapter X as well as copies of other important documents filed in the proceedings. These papers are available to the public.

As a general matter the Commission has deemed it appropriate to seek to participate only in proceedings in which a public investor interest is involved. As a rough, administrative guide, proceedings are considered to have a public interest for this purpose if they involve securities in the hands of the public in the amount of $250,000 or more. However, the Commission has become a party to smaller cases where there were special features which indicated the desirability of participation by the Commission. On occasion also the Commission has entered smaller cases upon the request of the judge.

Prior to June 30, 1944, the Commission had become a party to reorganization proceedings involving the reorganization of 293 companies (243 principal debtor corporations and 50 subsidiary debtors) with assets of $2,625,791,000 and indebtedness of $1,639,163,000. In 112 of the cases the Commission filed its notice of appearance at the request of the judge and in the remaining 131 cases appearance was entered upon approval by the judge of the Commission’s motion to participate. As of June 30, 1944, 137 cases had been closed leaving 106 active cases.

During the past fiscal year the Commission actively participated in 129 reorganization proceedings under Chapter X of the Bankruptcy Act, as amended, involving the reorganization of 157 companies (129 principal debtor companies and 25 subsidiary debtors). The aggregate stated assets of the 157 companies totaled $1,838,829,000 and their aggregate indebtedness was $1,178,507,000. The Commission filed notice of appearance in 19 new proceedings under Chapter X during the year, in 9 of which the notice was filed at the request of the judge and in the remaining 10 proceedings the Commission's notice of appearance was entered upon approval by the judge of the Commission's motion to participate. These 19 proceedings involved 28 companies (19 principal debtors and 9 subsidiary debtors) with aggregate stated assets of $130,995,000 and indebtedness aggregating $73,698,000. Proceedings involving 23 principal debtor companies and 3 subsidiary debtor companies were closed during the year.

As of June 30, 1944, the Commission was actively participating in 106 reorganization proceedings involving 131 companies (106 Principal debtors and 25 subsidiary debtors) with stated assets aggregating $1,729,317,000 and stated indebtedness totaling $1,098,914,000.

Upon becoming a party to a reorganization, the Commission immediately begins to obtain and analyze all available information concerning the debtor and its affairs. It assembles essential information with regard to the physical and financial condition of the company, its past operating performance, the reasons for its financial difficulties, the quality of its management, and the approximate value of its properties This information is obtained from several sources: The trustees and the various interested parties, the books and records of the company witnesses examined in court, and the independent research of the analytical staff of the Commission into general economic factors affecting the particular industry and the competitive conditions faced by the company.

As a party to the proceeding the Commission is represented at all important hearings and on appropriate occasions files legal and analytical memoranda in support of its views with respect to the various problems arising in the proceeding. Of equal, if not greater, importance however, is the regular participation by the Commission's attorneys and analysts in informal conferences and discussions with the parties in an endeavor to work out solutions to problems in advance of formal hearing and argument. In this way the Commission has often been able to bring facts, arguments or alternative suggestions to the attention of the parties, which they had not previously considered, and parties have often been prompted thereafter to modify their proposed action. In general, the Commission has found these informal roundtable discussions an effective means for cooperation and of great value in expediting the proceeding.

There is a multitude of diverse questions with which the Commission is concerned as a party to a Chapter X proceeding. A few of the more important matters which have arisen are discussed in the following paragraphs.

Problems in Administration of Estate

An important part of the activities of the Commission relates to the independent trustee. The independent trustee has the duty of examining into the history of the debtor, ascertaining its financial and managerial problems and future prospects, and formulating the plan of reorganization, In addition, such trustees bear the primary responsibility for the operation of the business during the reorganization period. It is therefore obvious that the success of the reorganization depends largely upon the thoroughness and skill with which he performs his duties.

Without in any way usurping the functions or controlling the activities of the trustee the Commission is able to be of considerable assistance to him. In addition, the Commission's presence has emphasized for trustees and their counsel the importance of their functions and the necessity that their duties be performed with thoroughness, independence, and efficiency.

As an essential element in the proper conduct of reorganizations, the statute prescribes certain standards of disinterestedness which must be met by trustees appointed under Chapter X. In the light of these standards the Commission carefully examines the qualifications of trustees. In several cases sufficient evidence of conflicting interests was developed to warrant an appearance by the Commission before the judge for the purpose of urging the removal of trustees. In most of these cases the trustees either resigned or were removed by the Court after hearing.

Under the statute the Court can, in unusual cases, designate as an additional trustee an officer, director, or employee of the debtor, but only for the purpose of assisting in the operation of the business. The Commission has urged that this should be done only in the exceptional case and has, in several instances, taken the position that the appointment of an additional trustee was unnecessary. The Commission has also undertaken to prevent the encroachment by the additional trustee upon the functions of the disinterested trustee. For example, the Commission successfully objected to the participation by the additional trustee, in one case, in the preparation of the Trustee's report under Section 167 and, in another case, in the preparation of a plan. Likewise, the Commission's objection to an order which would have deprived the independent trustee of the power to participate in the operation of the business was upheld. Although the additional trustee may be a member of the old management, the Commission has urged that such appointees be free from interests adverse to the estate. This position was sustained by the Circuit Court of Appeals for the Second Circuit in an appeal

in which the Commission participated in proceedings for the reorganization of *Realty Associates Securities Corporation*. [Footnote: *Meredith et al.* v. *Thralls et al.,* 144 F. (2d) 473 (C.C.A. 2d, July 13, 1944); *certiorari denied*, October 23, 1944.]

The Commission has at all times urged bill compliance with Section 167 (5) of the Act which requires the trustee to report to the security holders as to his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof. It is felt that such reports are necessary not only to enable the security holders to make suggestions for a plan but also to give them the necessary information for determining the desirability of accepting proposed plans. The Commission's staff has often consulted with trustees upon problems arising in connection with the preparation of such reports and has been able to provide trustees with information useful in carrying out their duties. For example, as the result of its experience in reorganizations the Commission has been in a position to offer advice to trustees and to courts on such matters as the scope of the investigation to be made by the independent trustees or by accountants hired by them.

The importance of a thorough investigation by the trustee is manifest and the Commission has called the attention of the trustee, or the court, if necessary, to any omissions in this respect. For example, in the proceedings for the reorganization of *Central States Electric Corp.* the Commission urged that a more detailed investigation of possible causes of action against the former management be made. On appeal the Circuit Court of Appeals for the Fourth Circuit sustained this position. [Footnote: *Committee for Holders of Central States Electric Corporation 7% Cumulative Preferred Stock* v. *Kent et al*., 143 F. (2d) 684 (C.C.A. 4th, June 12, 1944).] The Circuit Court also held that the possibility that statutes of limitations might be pleaded as a defense to suits brought by the trustees was not sufficient ground for denying the requested investigation since an examination might disclose facts which would prevent the running of the statutes, suit might be brought in a Federal court of equity where it is extremely doubtful that the state statutes would be followed, and, in any event, the statutes might not be pleaded as a defense. The Court agreed with the Commission that the investigation ought not to be denied because opposed by a committee of debenture holders in view of the rights of preferred stockholders; they too had contributed capital to the corporation which was seeking reorganization and had a vital interest in any recovery that might be had in behalf of the corporation from those who had mismanaged its affairs.

In another case involving the provisions of Section 167, the Circuit Court of Appeals for the Seventh Circuit adopted the views urged by the Commission and recognized the responsibilities of a reorganization trustee to make a thorough examination of the financial worth of an individual who was a personal guarantor

of the debtor's bonds and who apparently was also indebted directly to the debtor. [Footnote: *In the Matter of South State Street Building Corporation*, 105 F. (2d) 680 (C.C.A. 7th, July 13, 1939).] The Court upheld the subpoena of books and records relevant to this issue.

In several instances the Commission has independently undertaken to investigate into and examine available information or evidence relating to possible causes of action for mismanagement fraud or other misconduct by insiders or others and its views have been presented to the trustees or to the court. As a consequence the public investors in many cases have benefited through the disallowance or reduction of claims or the recovery of substantial sums through suit or compromise.

Problems Regarding Protective Committees and Indenture Trustees

The Commission has consistently been alert to secure compliance with the provisions of the statute which require disclosure by committees and indenture trustees of relevant information concerning their appointment, affiliations and security transactions. Early in its participation in Chapter X proceedings the Commission advanced the position in the courts that formal intervention in Chapter X proceedings should not be granted to committees and indenture trustees since the new statute as distinguished from Section 77B affords committees and indenture trustees an unqualified right to be heard. In most of the cases dealing with this question this view was adopted. The Commission's position has been sustained in *Dana v. Securities and Exchange Commission* [Footnote: 125 F. (2d) 542 (C.C.A. 2d, Jan. 22, 1942).] and *In the Matter of The Philadelphia & Reading Coal & Iron Company*. [Footnote: 105 F. (2d) 354 (C.C.A. 3d, June 30, 1939.]

In connection with the activities of protective committees the Commission was particularly concerned with the problem of the solicitation of assents of security holders to plans of reorganization prior to approval of such plans by the courts. The provisions of Chapter X were designed to assure to creditors and stockholders the information essential to the exercise of an informed judgment concerning a plan before their vote thereon is exercised and also to remove from the courts the pressure which in the past customarily attended "support" of plans that were often neither fair nor feasible. Accordingly, the Commission in a number of cases objected to solicitations prior to the Court's consideration and approval of a plan. Likewise, the Commission has taken the position that a security holder retains the right to accept or reject a plan of reorganization in accordance with the procedure provided by the statute despite the fact that the security holder has deposited his security with a protective committee under a deposit agreement giving the committee the right to accept a plan of reorganization on behalf of the security holder.

Procedural Matters, Notices to and Communications With Security Holders

The Commission has often encountered procedural problems in Chapter X proceedings and has taken the position that security holders be given the full benefit of the procedural safeguards of the Act. For example, the Commission has had frequent occasion to call attention to noncompliance with provisions regarding notice to the parties entitled thereto. Most of the time, a conference with the parties was sufficient to dispose of the question. In other cases, it was necessary to present a formal motion to the Court.

The Commission has also been interested in procedural matters when it felt that the reorganization process would be expedited as the result of its suggestions. Thus, the Commission was instrumental in securing the transfer of the proceedings for the *Associated Gas and Electric Co.* and the *Associated Gas and Electric Corp.* from the district where the petition was filed to a district in which the proceedings might be handled with greater efficiency and economy because the main offices and sources of information were present in the latter district.

Under Section 164 of Chapter X the trustee is required to prepare and file a list of creditors and stockholders of the debtor, so far as known. The Court may, upon cause shown, direct the impounding of these lists but is required, in such event, to permit their inspection or use by the trustee or any bona fide security holder upon such terms as the Court may prescribe. The Commission has taken the position that in the ordinary case the list of security holders should be made available without restriction in the interest of free communication among security holders and that impounding should only be ordered in the exceptional case. This view was recently sustained by the Circuit Court of Appeals for the Second Circuit. [Footnote: *Delatour et al*. v. *Meredith et al*., 144 F. (2d) 594 (C.C.A. 2d, July 21, 1944).] The question of impounding lists of security holders was also presented in the Associated Gas and Electric Company case. In that case, where there were over 200,000 security holders, known to be largely inexperienced investors who had been induced to buy and exchange securities through high-pressure sales methods, the problem was to keep the lists of security holders accessible for proper ends while at the same time preventing use of these lists for objectionable purposes.

The Commission took an active part in working out a solution which while providing for impounding of the lists, made them available for inspection by proper persons and provided for the sending of communications to the security holders through the trustees upon payment of costs. In these cases the Commission has been alert to the possibility that security holders may be imposed upon by persons seeking to represent their interests. Thus, in the case

of *The Penfield Distilling Company* where a "committee" solicited authorizations and obtained funds from stockholders by means of fraudulent representations, the Commission petitioned for an injunction and accounting and the district court granted the petition. Upon appeal the Circuit Court of Appeals for the Sixth Circuit affirmed without opinion. [Footnote: *In the Matter of Penfield Distilling Company*, decided June 27, 1940; petition for rehearing denied, November 8, 1940.]

Activities With Respect to Allowances

The Commission has taken an active part in the matter of allowances to the various parties for services rendered and expenses inclined in the proceeding. In making allowances the Courts seek to protect the estate from exorbitant charges, while at the same time providing equitable treatment to the applicants for allowances. The Commission has been able to provide considerable assistance to the courts in this matter.

The Commission itself receives no allowances from estates in reorganization and is able to present a wholly disinterested and impartial view. The Commission has consistently tried to secure a limitation of the total compensation to an amount which the estate can feasibly pay. In each case the Commission also makes a careful study of the applications of the various parties to the end that unnecessary duplication of services shall not be recompensed and that compensation shall be allocated on the basis of the work done by each claimant and his relative contribution to the administration of the estate and the formulation of a plan. With these objectives in mind the Commission may undertake to make specific recommendations to the courts where the Commission has been a party throughout the proceeding and is thoroughly familiar with the activities of the various parties and all significant developments in the proceedings; in other cases where it has entered the proceeding at an advanced stage the Commission may undertake to advise the court generally as to the reasonableness of the requested amounts.

The Commission participated in many appeals concerning allowances where important questions were involved. Illustrative of this phase of the Commission's work are cases involving Section 249 of Chapter X. In *Otis & Company* v. *Insurance Building Corporation*, [Footnote: 110 F. (2d) 333 (C.C.A. 1st, Mar. 15, 1940.] the Court held, sustaining the position advocated by the Commission, that Section 249 bars any compensation to a person acting in a representative capacity in the proceeding who had purchased or sold securities of the debtor during the proceeding, regardless of his good faith or profit or loss, and that purchases or sales cannot be consented to or approved by the judge so as to remove the bar. In *In re Mountain States Power Co.*, [Footnote: 118 F. (2d) 405 (C.C.A. 3d, Mar. 5, 1941.] the court held that Section 249 merely codified existing

law and that the principle enunciated therein was applicable to a Section 77B proceeding. This was the position taken by the Commission. *In re Reynolds Investing Company* [Footnote: 130 F. (2d) 60 (C.C.A. 3d, Aug. 3, 1942).] involved the question whether a person who had violated Section 249 was barred from allowance of compensation for services rendered subsequently in a representative capacity which was assumed after the transactions in the debtor's securities had terminated. The Court held, as argued by the Commission, that Section 249 was a bar to an allowance for any services rendered by the applicant. In *In re Cosgrove-Meehan Coal Corporation et al.,* [Footnote: 136 F. (2d) 3 (C.C.A. 3d, May 24,1943) as amended on denial of rehearing June 17, 1943; certiorari denied, October 25, 1943.] the court upheld the contention of the Commission that Section 249 applies to a person who traded in the debtor's securities prior to the reorganization proceeding while he was a member of a bondholders' committee.

INSTITUTION OF CHAPTER X PROCEEDINGS

The Commission has striven for a liberal interpretation of the provisions of the Bankruptcy Act so that the benefits of Chapter X may be made fully available to security holders in accordance with the spirit and intent of the statute. For example, in *Brooklyn Trust Company v. R. A. Security Holdings, Inc.,* [Footnote: 134 F. (2d) 164 (C.C.A. 2d, Mar. 4, 1943.] the Commission urged that Congress intended to give persons holding claims against the property of the debtor, as distinguished from claims against the debtor itself, the right to file an involuntary petition under Chapter X. The District Court sustained this position and the Circuit Court of Appeals for the Second Circuit affirmed.

The possibility that the investor safeguards of Chapter X might be nullified by an improper resort by a corporation to proceedings under Chapter XI arose soon after Chapter X became effective. It was the Commission's opinion that only the provisions of Chapter X were properly available for the reorganization of corporations with securities in the hands of the public and that Chapter XI was the proper medium for securing arrangements or compositions of unsecured indebtedness by individuals or corporations with no public investor interest. The Commission intervened in a proceeding for an arrangement under Chapter XI filed by the United States Realty & Improvement Co., which had outstanding in the hands of the public 900,000 shares of stock and two series of debentures aggregating over $2,300,000. The debtor was also liable as guarantor upon $3,710,500 of mortgage certificates. The Commission moved to vacate the order approving the debtor's petition and to dismiss the proceeding. Upon appeal, [Footnote: Securities and Exchange Commission v. United States Realty and Improvement Company, 310 U. S. 434 (May 27, 1940).] the United States Supreme Court sustained the position of the Commission, holding that since the

provisions of Chapter XI were not adequate to secure to public investors the safeguards necessary for the consummation of a fair, equitable, and feasible plan of reorganization and since the provisions of the Bankruptcy Act contemplated that the reorganization of such debtors should take place under Chapter X, the District Court, as a court of equity, should have dismissed the petition, thus relegating the debtor, if it were so inclined, to the initiation of a proceeding under Chapter X. The Supreme Court also held that the order permitting the Commission to intervene in a Chapter XI proceeding for the purpose of moving its dismissal was properly entered.

In the case of *In re Marine Harbor Properties, Inc.,* involving the question of good faith in the filing of a petition, the Supreme Court upheld the Commission's contention that the debtor's participation in State court proceedings did not bar later resort to a proceeding under Chapter X, but affirmed the decision of the Circuit court reversing the approval of the debtor's petition upon the ground that the debtor had not sustained the burden of establishing its need for relief under, Chapter X (Sec. 130) and the existence of good faith in filing the petition (Sec. 146). [Footnote: Marine Harbor Properties, Inc. v. Manufacturers Trust Company, 317 U.S. 78 (Nov. 9, 1942).] *Sims v. Fidelity Assurance Association* [Footnote: 318 U.S. 608 (Apr. 5, 1943).] also involved the question as to whether the debtor's petition had been filed in good faith. The Commission urged approval of the debtor's petition but the decision of the district court sustaining this position was reversed by the circuit court. Certiorari was granted by the Supreme Court, which concluded that the petition had not been filed in good faith because the interests of creditors would be best subserved in the receivership proceeding pending in West Virginia and other States and because it was unreasonable to expect that a plan of reorganization could be effected.

In another case the Commission filed a brief as *amicus curiae* in which it urged that the district court was in error when it required a debtor to file a plan of reorganization and prove its ability to consummate this plan as a prerequisite to approval of the petition. The circuit court ruled that the district court had applied an erroneous test of good faith and reversed the order dismissing the petition. [Footnote: *In re Julius Roehrs Company*, 115 F. (2d) 723 (C.C.A. 3d, Nov. 14, 1940).]

PLANS OF REORGANIZATION UNDER CHAPTER X

The ultimate objective of a reorganization is the formulation and consummation of a fair and feasible plan of reorganization. Accordingly, the most important function of the Commission under Chapter X is to aid the courts in achieving this objective.

Fairness

In appraising the fairness of reorganization plans, the Commission has at all times taken the position that full recognition must be accorded claims in order of their legal and contractual priority, either in cash, or new securities or both, and that junior claimants may participate only to the extent that the debtor's properties have value after the satisfaction of prior claims or to the extent that they make a fresh contribution necessary to the reorganization of the debtor, Hence, a valuation of the debtor is necessary to provide the basis for judging the fairness as well as the feasibility of proposed plans of reorganization. In its advisory reports, in hearings before the courts, and in conferences with parties to proceedings, the Commission has consistently stated that the proper method of valuation for reorganization purposes is primarily an appropriate capitalization of reasonably prospective earnings.

These principles as to the recognition of priorities and as to valuation are now firmly established as a result of the Supreme Court decisions in Case v. Los Angeles Lumber Products Co., Ltd. [Footnote: 308 U.S. 106(1939).] and Consolidated Rock Products Co. v. DuBois [Footnote: 212 U.S. 510 (1941).] in which the Court sustained the positions urged in briefs filed on behalf of the Commission as *amicus curiae*.

In connection with the fairness of plans, the Commission has been concerned among other matters with situations where mismanagement or other misconduct on the part of a parent company or controlling person requires that its claims be subordinated to the claims of the public investors. Similarly, the Commission has been interested in situations where a person owing fiduciary obligations has purchased claims against the debtor or has engaged in conduct adverse to the interests of the estate and where these activities require that the fiduciary be limited to the cost of his claims, thereby preventing him from profiting by his conduct. Because of the importance and significance of these questions the Commission has made a careful study of the facts in situations where they arise and on various occasions has urged that the principles of subordination or limitation to cost be applied in favor of the public investors.

Feasibility

Although the representatives of security holders frequently regard the fairness of the plan as their principal concern, the provisions of the statute and the protection of investors' interests require also that the plan be feasible. To be feasible, a reorganization must be economically sound and workable. It must not hamper future operations or lead to another reorganization. The extent to which current reorganizations are attributable to lack of feasibility in previous reorganizations is indicated by the fact that numerous Chapter X proceedings

involved companies which had already undergone reorganization in equity receivership proceedings or under Section 77B of the Bankruptcy Act. In order to avoid a similar record as to Chapter X cases some years hence, with its attendant expense and injury to investors the Commission urges that adequate consideration be given to feasibility. In this connection, the Commission is particularly concerned with the adequacy of working capital, the relationship of funded debt and capital structure to property values, the adequacy of corporate earning power in relation to interest and dividend requirements, and the effect of the new capitalization upon the company's prospective credit.

In recent years the Commission has encountered difficulties because the parties are disposed to base values and capital structures upon inflated war earnings, either because they overlook the extent to which earnings are inflated or hope such earnings will continue long enough to permit debt to be sealed down to manageable proportions. Another obstacle to the formulation of feasible plans in the current period of high tax rates, is the reluctance of investors to scale down debt and thereby lose the deduction for interest payments.

Consummation of Plan

The Commission also gives its attention to the drafting and preparation of corporate charters, bylaws, trust indentures, and other instruments which are to govern the internal structure of the reorganized debtor. The Commission has striven to obtain the inclusion of various provisions in these instruments which will assure to the investors a maximum of protection, adequate information with regard to the enterprise, and a fair voice in the management. The Commission has generally opposed the control device of a voting trust except when its use has been justified by the special circumstances of the case and, when adopted, the Commission has sought to have the voting-trust agreement contain appropriate provisions in the interests of the investors.

ADVISORY REPORTS

Although the preparation of an advisory report is not the major part of the activity of the Commission in any particular case, such reports, because of their wide distribution, bulk large in the minds of the public: Generally speaking, an advisory report is prepared only in connection with a proceeding involving significant problems and a relatively large company in which the investing public has a substantial interest. Approximately 20 formal advisory reports and several supplemental reports have been filed.

Even though the Commission does not file a formal advisory report, it does, in all cases in which it is a participant, advise the court of its opinion with respect to any plan of reorganization under consideration by the court.

After the trustee has filed a plan, the customary procedure calls for a hearing at which this and any other plans that may have been filed are considered. At this stage of the proceeding, the attorneys representing the Commission are concerned primarily with getting into the record sufficient data (1) to enable the judge to decide whether any proposed plan is worthy of consideration and (2) to supply the factual basis for the report of the Commission. If the judge finds one or more of the plans worthy of consideration, it or they may be referred to the Commission for report.

An advisory report provides the court with an expert independent appraisal of the plan indicating in detail the extent to which, in the opinion of the Commission, it meets, or fails to meet, the standards of fairness and feasibility. After the report is filed and copies are made available to the parties who have appeared at the proceedings, the judge considers the approval, modification, or disapproval of the plan. If the judge approves the plan, it goes to the security holders for acceptance or rejection accompanied by a copy of the judge's opinion, and a copy of the report of the Commission, or a summary thereof prepared by the Commission. The report of the Commission, therefore, while not binding, aids both the judge and the security holders in determining whether or not to approve a plan.

Part V

ADMINISTRATION OF THE TRUST INDENTURE ACT OF 1939

The Trust Indenture Act of 1939 requires that bonds, notes, debentures, and similar securities publicly offered for sale, sold, or delivered after sale through the mails or in interstate commerce, except as specifically exempted by the Act, be issued under an indenture which meets the requirements of the Act and has been duly qualified with the Commission. The standards of the Act outlaw many provisions previously incorporated in indentures to exculpate the trustee. The Act is designed to insure that he will act on behalf of the bond or debenture owners and to insure his complete independence of the issuer and the underwriters. The provisions of the Securities Act of 1933 and the Trust Indenture Act of 1939 are so integrated that registration pursuant to the Securities Act of 1933 of such securities to be issued under a trust indenture shall not be permitted to become effective unless the indenture conforms to the specific statutory requirements expressed in the Trust Indenture Act of 1939. The indenture is automatically "qualified" when registration becomes effective as to the securities themselves.

ENACTMENT AND SCOPE OF THE ACT

The Trust Indenture Act of 1939, approved August 3, 1939, is the second of the two statutes which resulted from the Commission's study and investigation of protective and reorganization committees. It was designed to correct certain defects which had existed in trust indentures and to provide means whereby the rights and interests of security holders can be more effectively safeguarded. In order to accomplish this objective, the Act provides that issues of bonds, notes, debentures and similar debt securities exceeding $1,000,000 in principal amount, except certain classes which are specifically exempted, may not be offered for sale to the public unless they are issued under a trust indenture which conforms to specific statutory standards. The Commission has no powers with respect to the enforcement of the provisions of the indenture. Its only functions under the Act are to see that the trustee is eligible and qualified as provided in the Act and that the provisions of each indenture filed for qualification conform to the prescribed statutory standards. The Act is based on the theory that, if the terms of the trust indenture provide adequate protection for investors, it is appropriate to leave the enforcement of such terms to the bondholders without the continuing supervision of a governmental agency.

In order to assist applicants and their attorneys in meeting the requirements of the Act, the Commission has made its staff available to discuss with them in advance of the formal filing any questions which may arise and has also encouraged the practice of submitting copies of proposed indentures for informal preliminary examination. The Commission's staff also cooperated with a group of trust officers and attorneys familiar with trust indenture problems and practices in the preparation of a so-called model indenture to conform to the statutory provisions, which was printed and is in more or less general use. The Commission has also adopted a rule permitting a trust company to determine in advance of the filing of an indenture whether or not the Commission would find such trustee disqualified because of a control relationship with a particular underwriter. In brief, the rules and practices of the Commission make it possible for applicants to get indentures qualified with a minimum of time and effort.

An indenture, to be qualified under the Act, must incorporate certain specific provisions, including those governing the eligibility and qualification of the trustee, and must provide for periodic reports by both the obligor and the trustee to the security holders with respect to compliance by the obligor with conditions and covenants contained in the indenture and the trustee's continued eligibility. The Commission is required to issue an order refusing to permit qualification of an indenture if the indenture does not conform to the statutory requirements or if the trustee has any conflicting interest as defined in the statute.

The indenture, in. order to facilitate the cooperation of security holders in the protection of their interests, must provide that the trustee will maintain a reasonably current list of their names and addresses and either make the list available to such of their number as desire to communicate with the others or mail communications to those whose names appear on the list, when they are submitted by security holders with a remittance to cover the cost. If the trustee is of the opinion that the mailing of the material to the bondholders would be detrimental to their interests or in violation of applicable law, it may file with the Commission a copy of the material with a written statement specifying the basis for its opinion. After opportunity for hearing upon the objections specified in the trustee's statement, the Commission is authorized to enter an order either sustaining or refusing to sustain the objections made by the trustee.

One of the principal objectives of the Act is to insure that the holders of indenture securities will have the services of an effective and independent trustee. Standards relating to the eligibility and qualification of trustees are established in the Act. Provision must be made for a corporate trustee with a minimum capital and surplus of not less than $150,000 and with certain specified powers and duties to insure the more adequate protection of investors.

If a trustee has or acquires an interest in conflict with that of the security holders under the indenture it must either eliminate the conflict of interest or give up the trusteeship. The conditions under which a trustee shall be considered to have such a conflicting interest are set forth in detail in the Act. In general, the trustee must not be affiliated with either the obligor or an underwriter of the securities. Obviously, the trustee should not be permitted to be too closely affiliated with the obligor because the creditor interests represented by the trustee will clearly be adverse to the interests of the obligor and its stockholders in case there is a default or the threat of one. To a lesser extent there may be a conflict of interest between the two all during the life of the indenture securities with regard to such matters as substitution of collateral, disclosure of financial condition, declaration and payment of dividends, and wasting or diversion of assets.

Experience has proved that there is also grave danger in permitting the trustee to be affiliated with an underwriter of the indenture securities. This is true particularly in default situations where underwriters may consider it to their interest to conceal the default long enough to secure control of reorganization committees. The Trust Indenture Act is designed to eliminate the use of friendly or complacent trustees who fail to warn security holders and take no steps contrary to the wishes of the obligor or underwriter.

In case of default by the obligor (as this term is defined in the indenture), the duties and responsibilities assumed by the trustee are increased. A qualified

indenture may provide that, prior to default, the trustee shall not be liable except for the performance of duties specifically set out in the indenture but in case of default it must require the trustee to exercise such of the rights and powers vested in it by the indenture and to use the same degree of care and skill in their exercise as a prudent man would exercise or use under the circumstances in the conduct of his own affairs. These provisions are designed to bring all indenture trustees up to the high level of diligence and fidelity which has traditionally been associated with the more conscientious trustees.

STATISTICS OF INDENTURES QUALIFIED

Indentures covering more than $4,750,000,000 principal amount of securities have been either formally qualified under the Trust Indenture Act or conformed to the requirements of the Act pursuant to the provisions of the Public Utility Holding Company Act. This is equivalent to almost 70 percent of the corporate long-term debt floated since the Act became effective or approximately 80 percent of such debt exclusive of railroad issues which are exempt from the Act. In the short space of 4 1/2 years approximately one-sixth of the corporate long-term debt, exclusive of rails, has become subject to the requirements of the Act. This percentage will, of course, increase as older issues go out of existence through maturity, refunding, or reorganization.

[table omitted]

ADDITIONAL INFORMATION RELATING TO TRUST INDENTURES

During the past fiscal year the following additional material relating to trust indentures was filed and examined for compliance with the appropriate standards and requirements: 5 indentures exempt from the Trust Indenture Act of 1939 but subject to the Public Utility Holding Company Act of 1935; 84 trustee statements of eligibility and qualification under the Trust Indenture Act of 1939 (68 on form T-1 for corporations, and 16 on form T-2 for individuals); 82 amendments to trustee statements of eligibility and qualification (26 amendments to forum T-3, 48 amendments to form T-1, and 8 amendments to form T-2); 52 supplements S-T, covering special items of information concerning indenture securities registered under the Securities Act of 1933; 23 applications for findings by the Commission pursuant to Section 310 (b) (1) (ii); 9 applications on form T-4, for exemption pursuant to Section 304 (c); 217 annual reports of indenture trustees pursuant to Section 313.

During the period February 4, 1940, through June 30, 1944, an aggregate of 405 trustee statements (341 for corporations and 64 for individuals) and 232 Supplements S-T had been filed.

Under the Trust Indenture Act of 1939 there has been no litigation and there have been only two refusal order proceedings initiated since its enactment. In the first case, April 1940, the indenture was amended prior to the entry of an order and in the second case, July 1940, the refusal order was rescinded after the filing of an amendment and the trust indenture was thereafter qualified.

Part VI

STUDY OF INVESTMENT TRUSTS AND ADMINISTRATION OF THE INVESTMENT COMPANY ACT OF 1940

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

ENACTMENT OF INVESTMENT COMPANY ACT

An important segment of the Commission’s work since 1935 has been its study and investigation of investment trusts and investment companies and its administration of the Investment Company Act of 1940. [Footnote: A list of the reports on the Commission’s investigation is given in Part XI under publications.] Most of the basic data of the study was obtained from answers to questionnaires and from field studies and public examinations of many companies. From the

data thus obtained, an over-all report on investment trusts and investment companies and six supplemental reports were prepared and transmitted to the Congress together with the Commission's conclusions and recommendations.

The Act, which was approved on August 22, 1940, and became generally effective on November 1, 1940, was evolved from a bill which was based upon the conclusions and recommendations of the Commission. The legislation, as adopted was desired by the investment trust industry itself. The terms and provisions of the compromise bill were worked out in conference between representatives of the industry and the Commission with the approval of the congressional committees concerned. The industry recognized the existence of abuses and it joined in urging the passage of the Act. It passed both Houses without a vote against it.

BACKGROUND OF THE ACT

Investment trusts and investment companies are essentially institutions which provide a medium for public investment in common stocks and other securities. They have emerged as important financial institutions only within the last 20 years. By 1929 they were being created at the rate of almost one a day and the American public had invested altogether almost $7,000,000,000 in investment companies of all types. After the market crash of 1929, the substantial losses suffered by closed-end management investment companies acted as an impediment to the further distribution of their securities, and the rise of other types of companies was accelerated. The open-end management companies and the unit investment trusts rapidly increased the sales of their securities after 1930. Although face-amount certificate companies have been in existence since 1894, the greater portion of their certificates have been sold since 1929. Finally, since 1930, periodic payment plans have attracted the savings of a large number of individuals in the lower income strata of the country's population. The present assets of all investment companies have a value in excess of approximately $2,000,000,000. The securities of such companies are owned by approximately 2,000,000 investors throughout this country, probably exceeding the number of investors in all other industries except utility holding company systems.

Investment trusts and investment companies are vitally associated with the national economy. They conduct their business by the use of the mails and the channels of interstate and foreign commerce. In numerous cases they conduct a substantial portion of their business in States other than those in which they are incorporated or otherwise created. Their security holders are situated in every State and in several foreign countries. A large portion of all corporate securities sold in this country are those of investment trusts and investment companies. Investment companies are also substantial purchasers of securities listed on

national securities exchanges, and their trading may have an important effect on the price movements of securities.

The enterprises subject to the control and influence of investment companies include banks, insurance and mortgage-financing companies, aviation and steamship companies, oil-producing and refining companies, chemical companies, motion-picture producing and exhibiting companies, steel and rubber companies, food and food-products companies, manufacturing companies of all types, department stores and other merchandising companies engaged in sales of their wares by mail order and the channels of interstate commerce.

A most significant function of investment companies in relation to the immediate needs of the national economy is their potential usefulness in the supply of new capital to industry, particularly to small and promotional ventures. In this connection, the Investment Company Act contains provisions [Sec. 12 (e)] authorizing investment companies to organize and contribute funds to companies to be engaged in the business of " underwriting, furnishing capital to industry, financing promotional enterprises, purchasing securities of issuers for which no ready market is in existence, and reorganizing companies or similar activities." The investment companies have not made use of this provision, although several of the companies and the Commission have expressed great interest in the promising possibilities of such a development.

Problems in Connection With the Investment Company Industry

Basically the problems of the industry flow from the very nature of the assets of investment companies. The assets of such companies invariably consist of cash and securities, assets which are usually completely liquid and readily negotiable. Because of these characteristics, control of such funds offers manifold opportunities for exploitation by an unscrupulous management..

Since no specified amount of capital was required to organize investment trusts and companies, they were created and their securities were sold to the public in many instances by irresponsible individuals. Brokers, security dealers, investment bankers, and commercial banks were in a position to dominate the board of directors and control the management of investment companies and thus, when they were unscrupulous, to advance the pecuniary interest of their other businesses at the expense of the investment companies they had organized and the security holders.

The Securities Act of 1933 and. the Securities Exchange Act of 1934 have been ineffective to correct abuses and deficiencies in investment companies first, because the record is clear that publicity alone, which in general is the remedy provided by these Acts, is insufficient to eliminate the abuses and deficiencies

which exist in investment companies, and second, because a large number of such companies have never come under the purview of these Acts.

It is not meant to imply that most investment trusts and investment companies at present operating in this country were guilty of unfair practices or were mismanaged. Nor is it meant to indicate that progress has not been made by the members of the industry voluntarily to eliminate some of the major abuses and deficiencies, and to improve generally standards of practice. However, virtually every representative of investment companies who appeared before the subcommittees of Congress considering the Investment Company Act of 1940 conceded the necessity for, and in fact urged the immediate passage of, effective legislation to regulate investment companies.

Management Investment Companies

The capital structures of management investment companies have often been inordinately complex, and the rights, preferences, and dividend claims of senior securities have in many instances been inadequately safeguarded. By various devices of control, such as special voting stocks issued to distributors and managements, voting trusts, long-term management contracts, control of the proxy machinery, and pyramiding of companies, public investors were effectively denied, in many instances, any real participation in the management of their companies.

The distribution and repurchase of the securities issued by investment companies have on occasion resulted in discrimination in favor of the management or other “insiders” who have been able to acquire the securities and to have the companies repurchase them on a basis more favorable than that accorded public stockholders. In the open-end companies, that is, companies issuing redeemable securities, the method of pricing their securities, which they are continuously selling and redeeming, led at times to substantial dilution of the investors’ equity in the companies, and in some instances was used by persons closely connected with the companies to realize riskless trading profits.

A distinctive feature of the management investment companies is that no, or only limited, restrictions are imposed with respect to the nature, types, and amounts of investment which their managements may make. The absence of any legal requirement for adherence to any announced investment policies or purposes created a major problem. Such policies were often radically changed without the knowledge or prior consent of stockholders. Similarly, after investors had invested in companies on their faith in the reputation and standing of the existing managements control of the public’s funds was frequently transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement of the companies.

“Self-dealing,” -- that is, transactions between officers, directors and similar persons and the investment companies with which they were associated -- presented opportunities for gross abuse by unscrupulous persons.

The small investors in certain investment companies, particularly in unit investment trusts and open-end management companies have been subjected to switching operations from one investment company to another to their pecuniary damage. Similarly, investors have been often powerless to protect themselves against plans of reorganization which have been grossly unfair or have constituted gross abuses of trust on the part of their sponsors.

Finally, particularly with respect to those companies which have not registered their securities under the Securities Act of 1933 or the Securities Exchange Act of 1934, and only a small number has so registered its securities, the investor has been unable to obtain adequate information as to their operations. The accounting practices and financial reports to stockholders of management investment companies frequently were deficient and inadequate in many respects and oft-times were misleading. In many cases, dividends have been declared and paid without informing the stockholders that such dividends represented not earnings but a return of capital to stockholders.

Unit Investment Trusts

In the fixed or unit investment trusts, management discretion is completely or almost completely eliminated. The abuses which characterized particularly this type of company were traceable to the fact that the most important emolument to the promoters of such trusts consisted of the profits to be derived by the methods of pricing and selling the certificates of such trusts to the public. Inequitable pricing of shares, excessive sales loads, hidden loads, and charges were not infrequent.

Periodic Payment Plans

Early in 1930 a somewhat novel variety of investment scheme, called variously “installment-investment plan,” “periodic payment plan,” “thrift plan,” “foundation plan,” etc., was conceived. These plans are, in essence, devices for selling investment trust or investment company securities on a periodic or installment plan. The holder of a periodic payment plan certificate is entitled to receive the asset value of his certificate. This value is based upon the value of the securities in the portfolio of the investment company or investment trust underlying the certificate and may be less than, equal to, or more than the amount paid by the certificate holder, depending upon market prices of these portfolio securities which almost invariably consisted of common stocks. The structure of the plan in

most instances was that of a "trust on a trust" whereby two sets of sales loads were imposed upon the investors, usually without their knowledge. The total loading charges, including trustees' fees and secondary loading charges, often were more than 30 percent of the net amount invested by certificate holders during the period studied. A serious problem was presented by the fact that these substantial sales loads were usually deducted entirely from the payments made in the early months of the periodic payment plan contract. Lapses of certificates in the early period of the contract were frequent. Approximately 40 percent of the total amount payable on periodic payment plan certificates sold in the period 1930-35 was lapsed at the end of 1935. The holders of such certificates were also subject to a variety of switching operations resulting in profits to the sponsor and a loss to the investor by the exaction of another "secondary" sales load on the switches. These periodic payment plan certificates, which were sold for as low as $5 a month, were specifically designed to make their strongest appeal to wage-earning men and women who were not in a financial position to invest or speculate in common stocks.

Companies Issuing Face Amount Installment Certificates

Face-amount installment certificates, in essence, are unsecured obligations to pay either a specified amount to the holder at a specified future date provided the purchaser makes all the payments required by these contracts or a cash surrender value prior to maturity if the certificate is surrendered to the issuing company.

The Commission's study indicated that the lapse experience of investors in such securities was high, particularly during the first and second years when the investor had no surrender value or a surrender value substantially less than the total of the amount he had paid (although the certificates issued by some of the face-amount companies provided for reinstatement with credit for the amount paid in.). The so-called stretch-out practice of depriving the investor pursuant to contract of any interest return on his entire investment during any period in which he has been in default was common. Furthermore, surrender values accrued only as of yearly anniversary dates of the certificates. Monthly payments less than a year and interest on the last attained surrender value would not increase the surrender value above the preceding anniversary date. As a result of the variety in regulatory provisions of the many states in which face-amount companies operate, there was no uniform actuarial reserve system required by law.

GENERAL PURPOSES AND PROVISIONS OF THE INVESTMENT COMPANY ACT OF 1940

The Act regulates three broad categories of investment companies: management investment companies (both open-end and closed-end), face-amount certificate companies, and unit investment trusts including those which issue periodic payment plan certificates. The objectives of the Act, five in number, are, in the main, achieved by affirmative statutory requirements or prohibitions. By and large the rule and regulation making powers of the Commission are confined to implementation of the affirmative requirements of the Act.

(1) Honest and Unbiased Management

The Act provides for a degree of independence in management personnel by restricting bankers, brokers, commercial bankers, principal underwriters etc., who may have a possible bias in the management of the company, to a minority of the beard of directors. It also requires a minority of the board to be independent of the officers of the company. It prohibits self-dealing and exaction of excessive commissions by affiliated persons of investment companies. Insider trading in the securities of investment companies is subject to the same regulation as that contained in the Securities Exchange Act of 1934. It enables the Commission to sue in the courts to prevent gross abuse of trust and gross misconduct and grossly unfair plans of reorganization of investment companies. It makes embezzlement of investment company funds a Federal offense, and prevents investment bankers and other affiliated persons from using their investment companies to assist them in their underwriting activities. It provides that an investment company may maintain its portfolio securities and other property in its own custody or in the custody of brokers only under or pursuant to the regulations of the Commission. Otherwise portfolio securities must be maintained in the custody of a bank. The Act also provides for bonding of employees having access to the company's assets.

(2) Greater Participation in Management by Security Holders

The Act requires investment companies in their registration statements to designate their status as a diversified or non-diversified company as defined in the Act and to set forth therein a precise statement of their investment policies. The status and policies of a company as set forth in its registration statement cannot be changed without an affirmative vote of a majority of the security holders. The Act also requires at least two-thirds of the directors of an investment company to have been elected by the shareholders; restricts the period of effectiveness of management contracts to 2 years; and requires the approval of such contracts, and therefore in effect of the investment adviser, by the shareholders. The Act also requires ratification of the selection of the accountants of the company by the shareholders; investment company proxy solicitation is subjected to Commission regulation; it is further provided that all shares issued by management companies after the effective date of the Act must

be voting shares and requires preferred shares to contain provisions transferring majority voting power to the holders of such stock in the event of default in the payment of dividends.

(3) Adequate and Feasible Capital Structures

The Act restricts, in the case of closed-end management companies, the amount of bonds and preferred stock which may be issued, a restriction which, speaking generally, requires closed-end investment companies issuing senior securities to have at least 50 percent of their assets represented by common stock equity at the time of issuance of such securities. Only one class of bonds and one class of preferred stock may be issued. Open-end companies are not permitted to issue any senior securities but may contract bank loans provided a 300 percent coverage in assets for such loans is maintained at all times. In the case of face-amount certificate companies the Act requires new companies to have a minimum capital of at least $250,000 and to maintain statutory reserves presumably adequate to mature the certificates. Restrictions are placed on the power of face-amount certificate companies to declare dividends where the effect of such declarations may be to injure the financial stability of such companies. In addition, face-amount certificate companies are not permitted to issue preferred stocks without an order of the Commission.

(4) Financial Statements and Accounting

The Act requires investment companies to transmit financial reports containing prescribed information to their security holders at least semiannually. Power is given the Commission to obtain annual and periodic reports including financial statements. The Commission is also empowered to enact rules requiring the preservation of books and records which form the basis of such reports; to require financial statements sent to shareholders and the Commission to be certified by independent public accountants; and to promulgate uniform accounting rules.

(5) Selling Practices

Particularly in the case of open-end companies, periodic payment plans and face-amount certificate companies, numerous abuses in selling practices were disclosed. These the Act remedies in general by requiring investment companies which were not previously required to comply with the registration requirements of the Securities Act to so comply. The Commission is also empowered to correct selling practices of open-end companies which may result in dilution of their shares or in unfair trading profit to insiders and dealers. “Switching” of open-end investment company securities and those of unit investment trusts and face-amount certificate companies on a basis permitting reloading is prohibited in the

absence of an order or rule of the Commission. In addition, sales literature issued by face-amount certificate companies, open-end companies, and unit investment trusts which would include most periodic payment plans, must be filed with the Commission within 10 days after use. Finally, in the case of the Securities Act prospectuses of face-amount certificate companies and periodic payment plans the Commission is empowered by section 24 (c) of the Act to rearrange the form and items of such documents and to require summaries of information which can be prominently displayed in the prospectus. The Act also regulates the sales load which may be charged on periodic payment plan certificates and prescribes the form of trust indentures to be used and the charges which may be made by trustees and sponsors of unit investment trust including those issuing periodic payment plan certificates.

ADMINISTRATION OF THE INVESTMENT COMPANY ACT OF 1940

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

The principal problems faced by the Commission during its administration of the Act can conveniently be grouped into seven categories namely, (1) determining which companies are investment companies subject to the Act and which are not investment companies or are entitled to exemption; (2) the classification of

companies subject to the Act; (3) prescribing the information to be filed with the Commission and that to be transmitted to security holders and the integration of the required information with that furnished under other Acts administered by the Commission so as to avoid duplication; (4) the administration and enforcement of those provisions of the Act which regulate the relationships and transactions of persons who are affiliated with investment companies ; (5) matters relating to the distribution redemption, and repurchases of securities issued by management companies; (6) reorganizations of investment companies; and (7) the treatment accorded certain special types of companies such as unit investment trusts, periodic payment plans, and face-amount certificate companies.

The "Investment Company" Concept

Although the terms "investment company" and "investment trust" have been part of the language of the financial community for some time, a definition precise enough to distinguish them sharply from holding companies on the one hand and operating companies on the other did not exist prior to the enactment of the Investment Company Act of 1940. The distinctive feature of the Act in this connection is its use of a quantitative or statistical definition, expressed in terms of the portion of a company's assets which are investment securities. Thus the statute provides, inter alia, that a company is an "investment company" if it is engaged in the business of investing, reinvesting, owning, holding, or trading in securities, and owns investment securities (defined to exclude securities of majority-owned subsidiaries and of other investment companies) exceeding 40 percent of its total assets (exclusive of Government securities and cash items). However the act provides machinery whereby the Commission may declare by order upon application that a company, notwithstanding the quantitative definition, is nevertheless not an investment company. Thus, companies that believe the application of the quantitative test would unreasonably cause them to be classified as investment companies are given the opportunity of obtaining administrative dispensation by showing that they are primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities, either directly or through majority-owned subsidiaries or through controlled companies conducting similar types of businesses. Since November 1, 1940, about 50 such applications have been filed. Knotty questions have been raised by these applications, including difficult and complicated problems of valuation, especially with respect to the so-called special situation companies.

Such an application was filed on behalf of a company, Bankers Securities Corp., whose portfolio contained securities of companies engaged in a great variety of enterprises: railroads, utilities, banks, newspapers, insurance companies, industrial companies of every kind, hotels, apartment houses, retail establishments, department stores, and many others. Extensive bearings were

held before a trial examiner, briefs were filed and oral argument was had before the Commission.

The company contended that it was primarily engaged in the real estate and department store business because the bulk of its investments were in those fields. Based upon the history and operations of the company, its investments in special situations, its statements of policy, and other relevant factors, the Commission concluded not only that the record before it fell short of sustaining the claim that the company was primarily engaged in noninvestment company business but that the record demonstrated affirmatively that the applicant was organized and always had been operated as an investment enterprise. The applicant appealed from the order of the Commission denying the application to the United States Circuit Court of Appeals for the Third Circuit. On November 21, 1944, that court unanimously affirmed the Commission's order.

Exemption of Companies from the Investment Company Act of 1940

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

In Section 6 (b) the Commission is directed to exempt by order any Employees' securities company from the provisions of the Act, to the extent that such exemption is consistent with certain specified standards.[Footnote: These do not include employees' stock bonus, pension, or profit-sharing trusts which meet the conditions of Section 165 of the Internal Revenue Code, since such trusts are excluded from the definition of "investment company" by Section 3 (c)(13).] The disposition of such applications presents many difficult problems and requires constant use of the Commission's informal conference procedure for Section 6 (b) in effect, directs the Commission to study in detail the history and operations of each such company and to determine the effect which each section of the Act will have on one or more aspects of the applicant's business. After this is done, the Commission, in effect, must accommodate the Act to the particular circumstances of the employees' securities company involved in the light of the considerations enumerated in Section 6 (b).

Section 6 (d) of the Act directs the exemption by rule or order, to the extent consistent with the public interest and the protection of investors, of certain small closed-end investment companies whose securities are offered intrastate.

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

The Commission by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors an the purposes fairly intended by the policy and provisions of this title.

Many of the applications which have been filed seeking orders under this Section requested orders which amounted to little more than the formal expression of minor administrative determinations. This exemptive power vested in the Commission has helped to eliminate many small but irritating inconveniences, particularly these which inevitably occur during the period of adjustment to new regulatory law, without sacrificing substance or principle. Some of the applications filed under Section 6 (e), however, have requested sweeping substantive exemptions. Such applications involve considerations in many respects similar to those discussed in relation to applications filed by employees' securities companies under Section 6 (b). It will be noted that the exemptive function of the Commission may be exercised not only by order on application but also by rule on the Commission's own motion. No rules have been adopted under this Section giving complete exemption to any class of companies.

INFORMATIONAL REQUIREMENTS

Registration Statements

The first step in the general scheme of regulation provided by the Act is the requirement that investment companies shall register with the Commission. A company registers under the Act by filing with the Commission a notification of registration. From the effective date of the Act to June 30, 1944, 489 companies of all types had registered under the Act. One hundred and eighteen of these had for one reason or another ceased to be investment companies, leaving 371 registered investment companies at the end of the past fiscal year.

After registration each company must file with the Commission in accordance with rules, regulations, and forms promulgated for the purpose, a detailed registration statement containing complete information regarding the company Most of the required information is similar to that required in registration statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, however, the Investment Company Act of 1940 requires

the registration statement to contain a recital of the policy of the registrant with respect to certain specified subjects, such as issuing senior securities, borrowing money, engaging in underwriting, making loans, or investing in real estate or commodities. These required statements of policy, which must be as specific as is practicable, constitute one of the keystones of the Act. Once having stated such a policy in its registration statement, a registrant may not deviate from it without the consent of a majority of its outstanding voting securities.

In one case, *Securities and Exchange Commission* v. *Guaranty Income Trust and James S. Gladish*, the Commission obtained an injunction restraining Gladish from further violation of the registration provisions of the Act. The Commission's complaint alleged that Gladish had been using the mails and instrumentalities of interstate commerce in selling, purchasing, redeeming or otherwise acquiring face-amount certificates of the trust and had effected securities transactions for the trust without having the trust registered in accordance with the requirements of the Act.

Periodic Reports to the Commission

Section 30 (a) of the Act provides that registered investment companies must file with the Commission such information, documents and reports as companies having securities registered on a national securities exchange are required to file with the Commission pursuant to Section 13 (a) of the Securities Exchange Act of 1934. Section 30(b) of the act authorizes the Commission to require registered investment companies to file periodic reports on a semiannual or quarterly basis so as to keep reasonably current the information contained in the registration statements of such companies. All registered investment companies which filed detailed registration statements are required to file annual reports on the appropriate form within 120 days after the close of each fiscal year. The annual - report form is designed to bring up to date, as of the close of each fiscal year of the registrant, the information originally furnished by the registrant in its detailed registration statement.

Section 24 (b) of the Act requires the filing with the Commission, within 10 days after the use thereof, of copies of the full text of all sales literature employed by the various types of investment companies registered under the Act.

Reports and Other Information Sent to Security Holders

Under the Act certain information is required to be transmitted to stockholders by registered investment companies at various times and under various circumstances. Thus, reports of condition must be rendered at least semiannually. These requirements have been implemented by appropriate rules. The significance of this requirement cannot be overestimated, when it is

considered in the light of the power given to the Commission to bring about some standardization in the substance of information made public, particularly statements of accounts.

Other provisions designed to keep security holders better informed on matters relating to their investments are likewise important. When a dividend is paid by a registered company from a source other than certain types of income, or accumulated income, the payment to the security holder must be accompanied by a written statement indicating its source.

Financial Requirements

An especially important part of the informational requirements of the Act are those relating to financial statements and accounts. The Act authorizes the Commission to require a reasonable degree of uniformity in the accounting practices of investment companies, and work along this line is already well advanced.

Affiliated Persons

In order to insure that the interests of all classes of security holders are paramount in the operation of investment companies, the act contains a number of provisions imposing limitations and prohibitions with respect to the eligibility and activities of persons affiliated with investment companies and the transactions of such affiliated persons with these companies. It is in relation to these provisions that the Commission is delegated some of its most important administrative functions under the Act.

Eligibility of Officers and Directors

First, there is the provision that a person may not serve as an officer or director of or perform certain other functions for a registered company if he has been convicted of certain crimes involving security transactions, or if by reason of similar misconduct has been enjoined from specified activities. The Commission is directed to give relief from these prohibitions under proper circumstances by order upon application.

Transactions With Investment Companies

By far the most important provision concerning the activities of affiliated persons is that which, with certain exceptions, prohibits any affiliated person, promoter, or principal underwriter of a registered company from selling to, or buying or borrowing property from, the investment company or any company it controls. The prohibition is supplemented by a provision that the Commission shall exempt

by order upon application any proposed transaction if evidence establishes that its terms are reasonable and fair and do not involve overreaching, and that it is consistent with the company's recitals of policy in its registration statement and with the general purposes of the Act. The disposition of such applications requires a nice balance of conflicting factors which points up the need in such cases for the review of a specialized agency. On the one hand, in most of the situations resolved, there was the necessity of a speedy determination because the transactions depended a great deal on movements in the security markets. On the other hand, many of the issues involved in the determination of fairness were of a complicated nature requiring the fullest use of financial experience and a delicate exercise of administrative judgment.

Judicial Sanctions

Another such control is the power vested in the Commission to seek an injunction against any person for gross misconduct or gross abuse of trust in respect of any registered company that such person serves in any of certain designated capacities. In one instance, the Commission believed that the management of an investment company, with knowledge that they intended to dissolve such company, had acquired substantial blocks of the company's preferred stock from the public at a cost less than the value of that portion of the assets of the company to which such stock would be entitled on dissolution. At the suggestion of the Commission the management agreed to surrender to the company the stock they had acquired at a price equivalent to the cost of such shares to the management. As a result, the remaining holders of the company's preferred stock received a substantially higher proportion of the company's assets than they would otherwise have obtained.

Protection Against Theft and Embezzlement

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

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

maintained in their own custody or in the custody of brokers. Where securities are held by brokers, the rule requires the execution of a written contract between the registered company and the broker which provides for physical segregation of the securities, prohibitions against hypothecation of or the creation of liens on such securities, and periodic examinations of such securities by the company's public accountants. In the case where securities are in the custody of the investment company, the rule permits withdrawal of such securities only by specifically designated officers and responsible employees only for specified purposes, and provides for periodic verification of such securities by an independent accountant at least twice each year without prior notice to the company.

DISTRIBUTION, REDEMPTION, AND REPURCHASE OF SECURITIES

Redeemable Securities

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

The Act seeks to prevent these abuses by providing that any securities association registered under the Securities Exchange Act of 1934 may adopt rules setting out methods of computing prices at which their members may purchase, sell, or redeem open-end securities and the minimum time that must elapse between purchases and redemptions of such securities. Such associations may also adopt rules limiting and prescribing the method of computing the commissions their members may take on transactions in the securities in order to avoid excessive sales loads. After 1 year from the effective date of the Act, the power to make rules concerning these matters rests in the

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

Closed-end Companies

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

The Commission has adopted a rule as to repurchases of securities of closed-end companies other than on an exchange or by tender which, in effect, permits a registered investment company to purchase its securities for cash under the following circumstances: The securities involved, if entitled to cumulative dividends, are not in arrears; if not entitled to cumulative dividends, 90 percent of the issuer's net income for the last fiscal year was distributed to security holders; If the securities are junior to securities representing indebtedness, such securities shall have at least 300 percent asset coverage after the purchase, and if the securities are junior to any outstanding stock, such senior securities shall have asset coverage of at least 200 percent immediately after the purchase and shall not be in arrears as to dividends ; the seller is not to the knowledge of the issuer an affiliated person ; the securities are accompanied or preceded by a written confirmation the price paid is not above market or asset value, whichever is lower; the issuer discloses to the seller or his broker the approximate asset coverage per unit of the subject securities; no brokerage commission is paid to any affiliated person of the issuer; the purchase is made without discrimination; and if the security is a stock, notice of intention to purchase must have been given to the stockholders at large.

Plans of Reorganization

In connection with any reorganization [Footnote: The term includes among other things a dissolution, merger, consolidation, a sale of a substantial portion of

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

With respect to the first -- the power to render advisory reports on request -- three such requests have been received. In each case an advisory report was prepared and distributed to the interested security holders. The type of problem involved in these reports is illustrated by the first plan of reorganization presented to the Commission. The plan involved consolidation of two investment companies followed by offers of the consolidated company to exchange its securities for outstanding securities of three other investment companies which were thereafter to dissolve. The companies involved were Standard Investing Corp, International Equities Corp., Central Capital Corp., Atlantic Securities Co. of Boston, and Beacon Participations, Inc. All of these companies were affiliated and were the component companies in a system of investment companies known as the Henderson Group. Standard Investing Corp. and International Equities Corp. were the consolidating companies, the other three the dissolving companies.

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

The underlying assets of these companies, upon the valuation of which depended in a large measure the fairness of the treatment accorded to all the

classes of security holders involved, were as follows: real estate and hotel companies, service companies, a company manufacturing fiber containers, an aviation accessory company, and diversified investment securities.

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

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

This function of the Commission fills a long-felt need. It enables security holders who often do not possess great financial knowledge to obtain an impartial analysis of the effects of a plan of reorganization on their securities, thus enabling them to arrive at an informed judgment as to the merits of the plan. It is important to note that although the Commission has authority to submit advisory reports only when requested by the reorganizing company's management or by 25 percent of its security holders, the existence of its power to seek an injunction restraining any grossly unfair plan of reorganization has resulted in the submission by investment companies of several plans for informal consideration as to fairness before solicitation of security holder approval.

Periodic Payment Plan Certificates and Unit Investment Trusts

As already indicated, since these periodic payment certificates are sold to persons of small means, who frequently default in their payments, the sales load, if it is deducted in its entirety from the early payments, will result in substantial loss to those investors whose payments lapse early in the period of the contract. The Act deals with this problem by providing that the sales load on such certificates shall not be more than 9 percent of the total payments. Not more than one-half of this sum may be deducted during the first year and the balance must be spread proportionately over the entire period of the contract.

Face Amount Certificate Companies

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

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

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

The documents filed under the Investment Company Act in each of the past three fiscal years were as follows:

[table omitted]

Important Judicial Proceedings under the Act

Section 22 (e) of the Act prohibits the suspension of redemption of redeemable securities issued by investment companies for a period of more than 7 days except during certain specified emergency periods or other periods fixed by the Commission. The first action in which the Commission requested and obtained the appointment of a permanent receiver to liquidate an investment company arose under this Section upon the failure by the company to make redemption on its outstanding beneficial shares, to furnish semiannual reports to shareholders or to file quarterly reports with the Commission. In that case, as the court pointed out, [Footnote: *Securities and Exchange Commission* v. *Fiscal Fund, Inc.*, 48 Fed. Supp. 712 (1943) D.C. Delaware.] there was “a complete and irremediable failure of corporate purpose and of corporate management” and “Fiscal (Fiscal Fund, Inc.) is receiving no investment advice and has defaulted in its redemptions. Its shareholders are receiving none of the service for which they bargained.” The court continued:

I can see no substantial hope of ever reviving this business. It cannot continue to function under its present setup. As stated by the Commission in its brief: “The reason for the failure of interested parties to obtain new management and to restore Fiscal to its intended functions is obvious. The management or maintenance fee of $3,000 per annum is too small to attract any disinterested, competent management. Furthermore, any increase in the fee would require unanimous consent of the beneficial shareholders, would substantially alter their investment, would absorb a disproportionate share of Fiscal’s meager income arid would undoubtedly result in a flood of voluntary redemptions which would only aggravate and intensify the situation.”

On July 2, 1943, the Commission filed a complaint in the United States District Court at Minneapolis against Investors Syndicate, Investors Syndicate of America, Inc., and Investors Mutual, Inc., their directors, principal officers and certain key employees charging that they had violated the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940. The corporate defendants are investment companies registered as such with this Commission under the Investment Company Act of 1940. Investors Mutual, Inc., and Investors Syndicate of America, Inc., have effective registration statements on file with the Commission covering their securities pursuant to the Securities Act of 1933. The three companies are affiliated under common management and control. Investors Syndicate is also the principal underwriter and distributor of the securities of Investors Mutual, Inc., and of Investors Syndicate of America, Inc.

The Commission charged that after Investors Syndicate organized Investors Syndicate of America, Inc., and Investors Mutual, Inc., Investors Syndicate in

breach of fiduciary relationship to its own certificate holders devised a scheme to switch its certificate holders into the securities of Investors Syndicate of America, Inc., and Investors Mutual, Inc. The Commission charged that Investors Syndicate induced its certificate holders to terminate such contracts and to reinvest in Mutual Shares of Investors Mutual and in series 1 certificates of Investors Syndicate of America, Inc. These transactions were not only alleged to be in violation of Section 11 of the Investment Company Act of 1940 relating to the making of offers of exchange without first obtaining Commission approval, but were also alleged to be to the financial disadvantage of the companies' security holders who, the Commission claimed, were induced to enter into these transactions by many false and misleading statements. The Commission also charged that Investors Syndicate, as principal underwriter for Investors Syndicate of America, Inc., and Investors Mutual, Inc., was engaged in selling securities of those companies by means of false and misleading statements. The complaint charged gross misconduct and gross abuse of trust on the part of investors Syndicate, its principal officers and directors and the Commission asked for removal of those officers and directors from office as well as for the removal of Investors Syndicate as underwriter for Investors Mutual, Inc., and Investors Syndicate of America, Inc. Since the removal of these officers and directors would leave Investors Syndicate without management, the Commission asked the court to appoint a receiver for that company.

On October 18, 1943, the corporate defendants while denying any misconduct or the violation of any statute, rule, or regulation, consented to the entry of a judgment enjoining them, their officers, directors, and employees in the sale of securities from violating the registration and fraud provisions of the Securities Act of 1933, certain fraud provisions of the Investment Company Act of 1940, as well as from engaging in switching operations and making offers of exchange of the securities of Investors Syndicate of America, Inc., and Investors Mutual, Inc., for the securities of Investors Syndicate contrary to the provisions of the investment Company Act of 1940. After this judgment was entered a voting trust agreement was executed by certain depositing stockholders of Investors Syndicate who owned a majority of its authorized voting stock by Investors Syndicate, itself, and by three voting trustees. This agreement was filed with the clerk of the court on January 17, 1944. None of the voting trustees had ever been connected theretofore with any of the companies. According to the trust agreement no successor trustee may be a person who prior to the date of the voting trust agreement has been an officer, director, agent, servant, or employee of Investors Syndicate or any of its affiliated companies and no voting trustee is permitted to own beneficially more than one share of common stock or a voting trust certificate representing more than one share. The agreement provides that the by-laws of the corporation are to be amended so that the board of directors shall consist of not less than three nor more than five directors and the trustees are required to elect themselves to the board.

The voting trust, which terminates 3 years from the date of its execution, provides that the trustees shall cause the business and operations of Investors Syndicate to be conducted in accordance with all applicable statutes, rules, and regulations and in accordance with good business practices, and, to that end, the trustees as soon as practicable, are to take such action as in their judgment is necessary or desirable for the supervision, selection or retention of personnel of the corporation, including its management and sales personnel, or for the removal of any such personnel as they may deem necessary or desirable to accomplish the purposes of the trust. Under certain circumstances the voting trust may be extended for an additional two years by the trustees. The trustees are to take such action as is necessary or desirable for the employment of sound accounting methods and practices which will fully and fairly reflect the financial condition of the corporation, including adequate provision for certificate amid other reserves in respect of securities issued by Investors Syndicate for the full and fair presentation of financial statements with reference to it and its affiliated companies. The trustees are also to take such action as is desirable for the adequate instruction and education of sales representatives with respect to proper sales practices, and the requirements of statutes, rules, and regulations pertaining thereto, including knowledge and understanding of the terms and provisions of securities previously issued by Investors Syndicate and the securities distributed or being distributed by it as underwriter for any other investment company. So that these purposes may be effectively accomplished, the voting trustees in addition to the taking of any such action by them, are to make such investigations, examinations and surveys as they may deem necessary or desirable; and upon completion of these investigations the trustees are to make a report to all the holders of common stock of Investors Syndicate, which shall include their recommendations for the correction of any practice or any other action with reference to Investors Syndicate or its affairs which they may deem necessary or advisable in order adequately to protect the rights and privileges of all classes of security holders and creditors of the corporation. The trustees, however, are not bound to follow any advice or counsel given to them by the common stockholders of Investors Syndicate.

Following the creation of the voting trust, the Commission moved the dismissal of the action without prejudice as to the matters not encompassed within the terms of the judgment entered on October 18, .943, and an order of dismissal without prejudice was entered by the court.

On. September 9, 1942, invoking for the first time the provisions of Section 36 of the Investment Company Act of 1940, the Commission filed an action in the United States District Court at Kansas City, Mo., against a face-amount certificate corporation known as United Funds Management Corporation (hereinafter sometimes called United), [Footnote: Since 1926 United Funds

Management Corp. had issued and sold to the public several series of face-amount certificates. Various issues of these certificates had been widely distributed and sold in about 22 States.] its officers and directors charging that since January 1, 1941, the individual defendants had known that the reserves of the corporation were not sufficient to provide for the payment of the outstanding certificates at maturity; that the defendants had been and were inducing the certificate holders to surrender their certificates for the cash surrender values, that this method of retirement was calculated to cause considerable loss to the certificate holders and to enrich unjustly the director and officers who were the principal beneficial owners of the preferred and common stock of the company; and that these directors and officers had failed to effect a plan of liquidation which would be fair and equitable to the certificate holders. The Commission charged that the individual defendants in committing such acts were guilty of gross misconduct and gross abuse of trust and were therefore subject to removal from office under Section 36 of the Act. The Commission in addition to asking for the removal from office of the directors and principal officers requested that a receiver be appointed to conserve the assets of the corporation and to hold such assets subject to the order of the court for liquidation and distribution among the creditors, face-amount certificate holders, and stockholders of the company.

Under the terms of his contract each purchaser was required to make installment payments for a specified number of years and at the end of that period was entitled to the face amount or maturity value of that certificate, which amount exceeded the total amount of payments made by the purchaser. After the certificate remained in force for a stated period (usually about 18 months) the holder was entitled to receive at his option, upon surrendering his certificate, the amount fixed in the certificate known as the cash surrender value. Prior to the seventh year in the case of a 10-year certificate, or the ninth year on a 15-year certificate, the cash surrender value was less than the amount paid in by the certificate holder, but from that date on the cash surrender value was greater than the total amount of installment payments made by the purchaser. Many of the surrenders which it was charged were induced by the management involved certificates which had a cash surrender value of less than the amount paid in.

The Commission charged that the purpose of United's campaign was to improve the equity stock of the company by inducing certificate holders to accept less than the amount of their payments to United and to relinquish the benefit of the proportionately greater improvement called for by the certificates as they proceeded to maturity, thus relieving United of the burdensome obligation to improve its certificates. The mechanics of this plan involved, in part, the switching of certificate holders into other securities.

The district court issued a temporary restraining order enjoining the defendant directors and officers from inducing or persuading holders of face-amount

certificates to cash surrender their face-amount certificates; from making loans to certificate holders; from retiring certificates either at the cash surrender value or at the face-amount thereof; and from receiving any money from certificate holders unless such money is immediately segregated in a trust account with a corporate trustee approved by the court; and by order of the court the Commerce Trust Co., Kansas City, Mo., was appointed trustee for this purpose.

While the action was pending United filed a petition in bankruptcy and was duly adjudicated a bankrupt on October 1, 1942. Thereafter on October 23, 1942, the district court invited the Commission to participate in the bankruptcy proceedings as *amicus curiae* and the Commission has acted in that capacity since such invitation.

The bankruptcy having progressed to the point where a trustee had been appointed and practically all of the assets of the company having been converted into cash, and partial distribution having been ordered, the Commission in May 1944 consented to the entry of an order dismissing its action brought pursuant to Section 36 of the Investment Company Act.

Part VII

ADMINISTRATION OF THE INVESTMENT ADVISERS ACT OF 1940

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

ENACTMENT AND GENERAL NATURE OF ACT

The Investment Advisers Act became effective November 1, 1940. Its enactment stemmed largely from a report sent to Congress in August 1939, on "Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services," following a study of such services conducted ancillary to the Commission's investment trust study.

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

Exception from the registration requirements of this Act is provided for: (1) Individuals or organizations which act as investment advisers solely for investment and insurance companies; (2) individuals or organizations all of the clients of which are residents of the State in which they do business, provided no advice is given with respect to securities traded on national securities exchanges; and (3) individuals or organizations which do not hold themselves out as investment advisers generally to the public and which have had during the preceding year less than 15 clients.

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

REGISTRATION OF INVESTMENT ADVISERS

On November 1, 1940, 605 investment advisers became registered. The number has increased since that date, and as of June 30, 1944, a total of 719 were registered under the Act. The following table reflects the registration record for the entire period and for the year ending June 30, 1944.

[table omitted]

The investment adviser is a comparatively new institution in finance, emerging as an independent occupation or profession only after the first World War. Less than 20 of the investment advisers now registered were in business prior to 1919. More than 85 percent commenced their investment advisory activities after 1930. As might be expected, registered investment advisers are concentrated in the larger financial communities. Approximately 85 percent are located in eight States: New York, Ohio, Michigan, Massachusetts, Pennsylvania, New Jersey, Illinois, and California. The largest concentration, approximately 40 percent, is in the State of New York.

Three hundred and seventy-three of the registered investment advisers are also engaged in other business enterprises or professions; 172 are also registered as brokers and dealers. Among the other 201 are accountants, engineers, lawyers, doctors, dentists, college professors, insurance brokers, and persons engaged in business and estate management.

The Act prohibits an adviser from representing that he is an "investment counsel" and from using the name "investment counsel" as descriptive of his business unless he is primarily engaged in giving continuous advice as to the investment of funds on the basis of the individual needs of each client and unless his application so states. Three hundred and twenty-eight registered investment advisers represent in their applications that they are primarily or exclusively engaged in this type of business. The services of 85 registered investment advisers consists solely of information and advice through publications and 118 others also issue publications in one form or another. The following tabulation with respect to the general character of the services provided has been. abstracted from applications for registrations:

Tabulation showing general character of services rendered by investment advisers registered as of June 30, 1944

Number of registrants who are engaged in giving continuous advice on the basis of the individual needs of clients:
Exclusively or primarily: 276
Exclusively and also issue uniform publications: 13
Primarily and also issue uniform publications: 39
Substantially: 105
Substantially and also issue uniform publications: 32
Incidentally: 86
Incidentally and also issue uniform publications: 34
Number of registrants who issue publications but do not give continuous advice on the basis of the individual needs of clients: 85

Number of registrants who are not engaged in giving continuous advice on the basis of the individual needs of clients and who do not issue publications: 49
Total: 719

The Commission's duties with respect to registration of investment advisers are substantially similar to its duties relating to registration of over-the-counter brokers and dealers under the Securities Exchange Act. The disclosures required for registration of investment advisers, however, are somewhat broader than those required on the application for broker-dealer registration. Although the Commission has no authority under the Act to pass upon the qualifications of an investment adviser, the Act requires an applicant for registration to disclose information concerning the education of the principals in the firm and information concerning all of their business affiliations for the preceding ten years, including, of course, present business affiliations. Comparable information is not required in the application for broker-dealer registration, except to the extent that brokers and dealers must disclose a ten-year history or previous connections in the securities business. The added requirement recognizes that professional qualifications, although not a prerequisite to registration, may be material to investors who seek the services of investment advisers. The requirement that such information should be available in a public record follows the general disclosure philosophy underlying other Acts administered by the Commission.

Compensation for services rendered by investment advisers varies. "Investment counselors," that is those registered advisers engaged primarily in giving continuous advice as to the investment of funds on the basis of the individual needs of each client and who so state In their applications, generally charge either a fixed fee or a fee computed at a certain percentage of the aggregate value of the assets managed. A number scale their rates according to the size of the fund supervised. Investment advisers whose services consist only of uniform publications charge fixed subscription prices for such publications. The Act does not prescribe any method for computing fees but it prohibits fees computed on a profit-sharing basis.

COOPERATION BETWEEN STATE COMMISSIONS AND THE SECURITIES AND EXCHANGE COMMISSION

It is the established policy of the Securities and Exchange Commission to foster effective cooperation with the State Commissions in all matters where their respective jurisdictions interlock and in all additional matters where such cooperation is desirable and appropriate in the case under consideration. The purpose of the Holding Company Act is, in large part, to free operating companies from the absentee control of holding companies, thus permitting them to be regulated more effectively by the State. This fundamental purpose of the Holding Company Act -- the facilitating of State regulation -- underlies the

Commission's efforts to work cooperatively with the various State commissions in the administration of the Act.

The protection of State regulation is specifically provided for in several sections of the Act. For example, certain issues of securities by registered holding companies and their subsidiaries are exempted by Section 6 (b) from Section 6 (a) if they have been approved by the State commission, subject to such terms and conditions as the Securities and Exchange Commission may deem appropriate in the public interest or for the protection of investors or consumers. Certain security and utility asset acquisitions are likewise exempted under Section 9 (b) from the provisions of Section 9 where they have been approved by a State commission. Moreover, the commission may not authorize security issues [Section 7 (g)] or the acquisition of assets [Section 10 (f)] unless applicable State laws have been complied with. Section 8 prevents the ownership of both electric and gas utility properties in violation of State law, while Section 20 (b) requires that accounting standards established by the Commission shall not be inconsistent with the provisions of applicable State law.

A number of specific sections of the Act reflect the Congressional intent that the Commission's work should be coordinated with the work of State commissions. Section 19 of the Act, for example, expressly provides that in any proceeding before the Commission, the Commission, in accordance with such rules of practice as it may prescribe, shall admit as a party any interested State, State commission, municipality or any political subdivision of the State. Pursuant to this provision, the Commission uniformly notifies interested State commissions of proceedings before it which may affect the work of such commission. Many State commissions have taken advantage of this provision and have intervened in proceedings before the Commission and in these and other cases there has been an interchange of ideas and information between the Securities and Exchange Commission and the State commission concerned. In one instance, although there is no specific statutory authority for joint hearings by the Commission and a State commission, a joint hearing was, in fact, held by the Securities and Exchange Commission and the Public Utilities Commission of the District of Columbia.[Footnote: See *Potomac Electric Power Company*, Holding Company Act Release No. 2283.]

Section 18 of the Act places at the disposal of the State commissions the investigatory power of the Securities and Exchange Commission in regard to the business, financial condition, or practices of registered holding companies and their subsidiaries and Section 18 (a) authorizes the Commission to make available to State commissions the results of its own investigations made pursuant to the Act. Pursuant to this and other provisions of the Act, the Commission was requested on September 19, 1942, by the Public Utilities Commission of the District of Columbia to undertake an investigation of the

various relationships between Washington Railway & Electric Co. and the North American Co., its parent. The investigation was completed in accordance with the request of the District of Columbia Commission.

The Securities and Exchange Commission through its jurisdiction over intersystem service charges, has been in a position to render significant assistance to State commissions in this field, and such assistance, in fact, has been rendered in several notable instances. Under Section 13 (d) of the Act, the Commission, upon the request of the State commission, is authorized, after notice and opportunity for hearing, to require by order " a reallocation or reapportionment of costs among member companies of a mutual service company if it finds the existing allocation inequitable and may require the elimination of a service or services to a member company which does not hear its fair proportion of costs or which, by reason of its size or other circumstances, does not require such service or services."

Illustrative of the workings of this provision of the statute was the proceeding which the Securities and Exchange Commission instituted at the request of the Vermont Public Service Commission in 1940 concerning servicing arrangements between the New England Power Service Co., a subsidiary of New England Power Association, and associate operating companies in Vermont. A hearing was held at Montpelier, Vt., at which representatives of the Vermont commission participated as well as Commissioner Healy of this Commission. The results of the proceeding, described in Holding Company Act Release No. 3135, were the complete reorganization of the service company, including a reduction of its personnel from 1,048 employees to 626; in addition, the service company pay roll was cut approximately in half, and numerous other changes were made in its accounting and operating practices. Those results are indicative of the type of assistance which the Securities and Exchange Commission can render to State commissions with regard to the functioning of service organizations.

Again, in the *American Water Works and Electric Company, Incorporated*, *Service Company* case, [Footnote: Holding Company Act Release No. 4749.] a proceeding was instituted by the Commission at the request of the New Jersey Board of Public Utility Commissioners. The New Jersey commission was concerned with the service charges made to New Jersey subsidiaries of American Water Works. The Securities and Exchange Commission exercised its power under Sections 13 and 18 of the Holding Company Act to investigate the service arrangements within the American Water Works System, to determine what action was required by Section 13 and, at the same time, to obtain information which would be available for the use of the New Jersey commission. To that end, the Commission directed that the first hearings be held in the offices of the New Jersey commission in Newark. At the hearing, Commissioner Healy of the Securities and Exchange Commission sat jointly with members of the New.

Jersey commission. Representatives of the Public Utilities Commission of Connecticut, which had jurisdiction over some of the American Water Works subsidiaries, also appeared at the hearing in New Jersey. During the pendency of the proceedings, conferences were had among the staffs of the commissions concerned and between representatives of the staffs and representatives of American Water Works. An agreement was reached as to changes in future servicing activities, and after the hearing in New Jersey, American Water Works filed an application for approval of the organization and conduct of business of a new subsidiary service company. Hearings on that application and on the proceedings instituted by the Commission were held in Philadelphia beginning in April 1943. Representatives of New Jersey arid Connecticut commissions became parties in these proceedings, and representatives of the Public Utility Commission of Pennsylvania also participated.

There have been many other instances of close cooperation between the Securities and Exchange Commission and State commissions. In the Laclede Gas Light Co. reorganization proceedings, for example, a plan was filed with the Securities and Exchange Commission and the Missouri Public Service Commission for the reorganization of the Laclede Gas Light Co. and the sale to Union Electric Co. of Missouri of the electric properties operated by Laclede Power & Light Co. These transactions could not be consummated without the approval of the Missouri Public Service Commission and the Securities and Exchange Commission. The case was characterized by the very closest cooperation between the two commissions and between the staff of this Commission and representatives of the Public Utilities Department of the city of St. Louis.

In the Portland Electric Power Co. reorganization proceedings, the Securities and Exchange Commission had to pass upon a plan of reorganization of the company pursuant to the Bankruptcy Act, as required by Section 11 (f) of the Public Utility Holding Company Act. The public utilities commissioner of Oregon and the Washington Department of Public Service had jurisdiction over transactions which constituted important parts of the plan. Hearings before the Securities and Exchange Commission were started in Washington, D. C. Both the Oregon and Washington commissioners intervened in the proceedings, and the Oregon commissioner participated in the examination of company witnesses. In February 1943, at the request of the Washington and Oregon commissions, the hearing was reconvened in Portland, Oreg. Both State commissions were represented by counsel and introduced evidence in the proceeding. In addition, many conferences were held between the Securities and Exchange Commission staff and the staffs of the State commissions involved. The active cooperation among the commissions was particularly helpful in the entire proceedings. The above examples illustrate the pattern of cooperation between the Securities and Exchange Commission and State commissions. This Commission has found

such cooperation most helpful in its own work and believes it has been helpful also to the State commissions.

LITIGATION UNDER THE HOLDING COMPANY ACT

The Commission's record of litigation under the Public Utility Holding Company Act of 1935 dates back to September 1935, 2 _ months before the effective date of the Act. Between that time and December 1935, 58 proceedings were brought by or on behalf of holding companies to enjoin enforcement of the Act and for declaratory judgments holding all of its provisions unconstitutional. None of these proceedings resulted in a decision on constitutionality by the Supreme Court. However, in the test case instituted by the Commission on November 26, 1935, to enjoin Electric Bond and Share Co and the intermediate holding companies in its system from violating the registration provisions of the Act, the Supreme Court, on March 28, 1938, held that only the registration provisions of the Act could be challenged by an unregistered holding company; that the registration provisions are applicable solely to registered holding companies and their subsidiaries; and that the registration provisions are constitutional. [Footnote: *Electric Bond and Share Co*. v. *S.E.C.*, 18 F. Supp. 131 (S.D.N.Y., 1937); 92 F (2d) 580 (C.C.A. 2, 1937); 303 U.S. 419 (1938).] This decision effectively terminated the flood of litigation over the constitutionality of the Act and resulted in registration by all companies affected by the Act, excepting those companies that claimed exemption from its provisions. [Footnote: A sweeping decision of the District Court of Maryland holding the act unconstitutional in its entirety was limited by the fourth circuit to the specific facts of the American States Public Service Co. reorganization proceeding. *Burco, Inc.* v. *Whitworth*, 81 F. (2d) 721. The Government, as amicus curiae, urged the Supreme Court to certiorari in that case on the ground that the case was collusive and not a proper vehicle for determining constitutional questions which could be better considered in the Electric Bond and Share case. The Supreme Court denied certiorari.]

(b) Exemptions

The first problem to arise under the Act involved applications for exemption from the registration and regulatory provisions of the Act. The first case to deal with this problem and, indeed, the first instance in which a circuit court of appeals was petitioned to review an order of the Commission under the Holding Company Act, was *Lawless* v. *Securities and Exchange Commission*. [Footnote: Lawless v. Securities and Exchange Commission, 105 F. (2d) 574 (C.C.A. 1, 1939).] There a holding company, which had been granted a temporary exemption from the requirements of the Act, applied to the Commission while its application for permanent exemption was pending, for a report on a plan of recapitalization and an order exempting the Company from the provisions of the Act applicable to the

proposed plan. The Commission issued the report and granted the order, Commissioner Haley dissenting. On review the order was reversed on the ground that unregistered companies are not entitled to the benefits conferred by the Act, and accordingly, the Commission was without power or authority to issue the order in question.

By June 30, 1944, 565 applications for exemption had been filed with the Commission, 164 had been approved, 317 had been withdrawn or dismissed, and 52 had been denied by order of the Commission. In almost all of these cases the right to exemption has depended upon whether the applicant is a holding company, subsidiary, or affiliate with respect to another company. This question under the statute is answered in terms of the existence or absence of control or controlling influence of one company over the other. The Commission's orders denying exemption applications of Hartford Gas Co., Public Service Corp. of New Jersey, Detroit Edison Co., Pacific Gas & Electric Co., [Footnote: *Hartford Gas Co*. v. *S.E.C*., 129 F. (2d) 794 (C.C.A. 2, 1942), 2 S.E.C. Jud. Dec. – (C.C.A. 2, No. 250, 1942); *Public Service Corporation of New Jersey* v. *S.E.C*., 2 S.E.C. Jud. Dec. – (C.C.A. 3, No. 7879 (1941), 129 F. (2d) 899 (C.C.A. 3, 1942); 317 U.S. 691; 63 S. Ct. 266 (1942); *Detroit Edison Company* v. *S.E.C*., 119 F. (2d) 730 (C.C.A. 6, 1941; 314 U.S. 618; *Pacific Gas & Electric Co.* v. *S.E.C*., 127 F. (2d) 378 (C.C.A. 9, 1942), 139 F. (2d) 298 (C.C.A. 9, 1943). The Supreme Court has affirmed the decision of the circuit court of appeals in the latter case.] and Koppers United Co., [Footnote: *American Gas & Electric Co*. v. *S.E.C*., 134 F. (2d) 633 (App. D>C. 1943); 319 U.S. 763 (1943); *Koppers United Co*. v. *S.E.C*., 138 F. (2d) 577 (App. D.C. 1943)] have been subjected to judicial review and in these cases the Commission's orders were affirmed by the Circuit Courts of Appeals for the Second, Third, Sixth and Ninth Circuits, and the Court of Appeals for the District of Columbia, respectively.

(e) Corporate Integration and Simplification

The most significant litigation under the Holding Company Act since the *Bond and Share* case was the group of review proceedings involving the constitutionality of the corporate integration and simplification provisions of the Act (Secs. 11 (b) (1) and (2)). In three of these cases, filed by the North American Co., United Gas Improvement Co., and Engineers Public Service Co., [Footnote: *North American Co*. v. *S.E.C*. 133 F. (2d) 148 (C.C.A. 2, 1943); 318 U.S. 750; 63 S. Ct. 764; *United Gas Improvement Co.* v. *S.E.C*., 138 F. (2d) 1010 (C.C.A. 3, 1943); *Engineers Public Service Co*. V. *S.E.C*., 138 F. (2d) 936 (App. D.C. 1943).] the second and third Circuits and the Court of Appeals for the District of Columbia in unanimous decisions upheld the constitutionality of Section 11 (b) (1), [Footnote: In the *North American* case the Supreme Court has granted a petition for write of certiorari but has been unable to hear arguments in the case because of the lack of a quorum of justices qualified to hear it. In the

Engineers Public Service Company case, a petition for writ of certiorari has been granted by the Supreme Court.] while the constitutionality of Section 11 (b) (2) was similarly sustained by the first and third circuits and the Court of Appeals for the District of Columbia [Footnote: The *American Power & Light Company, Electric Power & Light Corporation* case is now pending before the Supreme Court on petition for a writ of certiorari.] in review proceedings instituted by American Power & Light Co., and Electric Power & Light Corp. (one case) , Commonwealth & Southern Corporation, and Central & Southwest Utilities Co. [Footnote: *American Power & Light Co. and Electric Power & Light Corporation* v. *S.E.C.*, 141 F. (2d) 606 (C.C.A. 1, 1944); *Commonwealth & Southern Corp.* v. *S.E.C.*, 134 F. (2d) 747 (C.A.A. 3, 1943), 2 S.E.C. Jud. Dec. – (C.C.A. 3, No. 8052, 1943); *Central & South West Utilities Co.* v. *S.E.C.*, 136 F. (2d) 273 (App. D.C. 1943), 2 S.E.C. Jud. Dec. – (App. D.C. No. 8333, 1943).] In addition to upholding the constitutionality of Sections 11 (b) (1) and 11 (b) (2), these decisions have affirmed, in virtually all respects, the Commission's views as to matters of statutory interpretations.

To assist holding companies and operating subsidiaries in achieving voluntary compliance with the corporate simplification and integration provisions of the Act, the Commission has, at the request of companies concerned, instituted 15 proceedings in Federal district courts under Section 11 (e) of the Act to enforce and carry out voluntary plans of reorganization previously approved by the Commission as fair and equitable and necessary to effect the corporate simplification and integration provisions of the Act. In these cases involving *Community Power and Light Company* (D. N. Y.), *Great Lakes Utilities Company* (D. Pa.) *Jacksonville Gas Company* (D. Fla.), *United Light and Power Co.* (D. Del.), *Puget Sound Power & Light Co.* (D. Mass.), *Southern Colorado Power Co.* (D. Colo.), *North Continent Utilities Corp.* (D. Del.), *Columbia Oil & Gasoline Corp.* (D. Del.), *North American Gas and Electric Company* (D. Del.), *Central States Power & Light Corp.* (D. Del.), *Consolidated Electric and Gas Co.* (D. Del.), *Clarion River Power Co.* (D. Pa.), *American Gas and Power Co.* (D. Del.), *The Laclede Gas Light Co.* (D. Mo.), and *International Utilities Corporation* (D. N. Y.), the courts have not only assisted in effectuating the congressional policies expressed in the Act but, in so doing, have accomplished a uniformity of reorganization procedures. [Footnote: *In re Community Power and Light Company*, 33. F. Supp. 901 (S.D. N.Y., 1940): *In re Great Lakes Utilities Company*, 2 S.E.C. Jud. Dec. – (E.D. Pa. No. M 989, 1942); *In re Jacksonville Gas Co.,* 46 F. Supp. 852 (D.C. Fla., 1942), 2 S.E.C. Jud. Dec. – (S.D. Fla. No. 483-J, 1942); *In re United Light and Power Co.*, 51 F. Supp. 217 (D.C. Del., 1943); *In re Puget Sound Power & Light Co.*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re Southern Colorado Power Company*, 2 S.E.C. Jud. Dec. – (D. Colo. No. 670, 1944). Affirmed on appeal by the Tenth Circuit Court of Appeals. *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del., 1944); *In re Columbia Oil and Gasoline Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 290,

1942). 50 F. Supp. 965 (D. Del., 1943), 134 F. (2d) 265 (C.A.C. 3, 1943); *In re North American Gas and Electric Company*, 2 S.E.C. Jud. Dec. – (D. Del., No. 352, 1944); *In re Central States Power & Light Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 354, 1944); *In re Consolidated Electric & Gas Co.*, 57 F. Supp. 211 (D. Del., 1944); *In re Clarion River Power Co.*, 2 S.E.C. Jud. Dec. – (W.J.) Pa. No. 2903, 1944); *In re American Gas and Power Co.*, 55 F. Supp. 756 (D. Del., 1944); *In re The Laclede Gas Light Co.*, 57 F. Supp. 997 (D.C.E.D., Mo., 1944) – now on appeal; *In re International Utilities Corporation*, (D.C.S.D.N.Y. Civ. 25-260 (1944)).] Beginning with the *Community Power and Light Company* case decided in 1940, the Commission's orders approving Section 11 (e) plans have been upheld by the courts with respect to both holding companies and operating subsidiaries. In these proceedings the settled practice of the courts has been to consider the plan solely upon the evidence presented before the Commission, and to consider new evidence only for the purpose of determining whether it could and should have been considered by the Commission. In addition, the Commission, in a number of cases, has passed upon, pursuant to Section 11 (f) of the Act, plans of reorganization of holding companies and subsidiaries in proceedings under Chapter X and former Section 77B of the Bankruptcy Act.

A corollary to the reorganization of holding companies and their subsidiaries under the Holding Company Act is the Commission's determination to prevent holding companies from escaping the requirements of the Act by liquidating under State procedures. This policy of requiring that the reorganization of holding company systems shall be in accordance with plans which are fair and equitable and comply with the purposes of the Act is illustrated by the Commission's injunction suit against the North American Co. and its subsidiary, North American Light & Power Co., to prevent Light & Power from dissolving or liquidating under State law. The case was ultimately dismissed by stipulation and the liquidation of Light & Power is proceeding under the Act.

A comparable problem has arisen in several cases wherein stockholders of registered holding companies in process of reorganization or liquidation under the Holding Company Act have filed derivative actions in State and Federal courts, asserting claims either on behalf of the company in reorganization or in the interest of one or more of its subsidiaries. These suits have generally been based upon charges of corporate waste, alleged improper acts of the company through its directors and officers, and other causes of action generally falling in the category of breaches of fiduciary duty. The Commission has taken the position that where a fair, equitable, and feasible plan of reorganization cannot be effectuated without considering and giving effect to such causes of action, they should properly be asserted as claims in the Commission's reorganization proceeding. To protect its jurisdiction, the Commission has intervened or appeared as amicus curiae in certain of these civil cases to request that they be dismissed or stayed pending determination of the issues in the Commission's

proceeding. The courts have recognized the importance of having this type of litigation adjudicated in the context of a complete reorganization proceeding and have in the exercise of judicial discretion, stayed the cases before them. Typical of these cases are *Dederick* v. *The North American Company* (D. N. Y.) and *Illinois Iowa Power Company* v. *North American Light & Power Co*. (D. Del.). [Footnote: *Dederick* v. *North American Light and Power Co*. 48 F. Supp. 410 (S.D.N.Y., 1943); *Illinois Iowa Power Co*. v. *North American Light and Power Co*., 49 F. Supp. 277 (D. Del., 1943).]

In cases arising out of the Commission's Section 11 (e) proceedings a number of novel and highly significant issues have been raised and settled in accordance with the views of the Commission. For example, thoroughgoing reorganizations of operating subsidiaries have been sustained upon the premise of correcting an inequitable distribution of voting power in the subsidiary, pursuant to the last sentence of Section 11 (b) (2). *Jacksonville Gas Company* (D. Fla.), *Puget Sound Power & Light Co.* (D. Mass.), *Southern Colorado Power Co*. (D. Colo.) [Footnote: *In re Jacksonville Gas Co*., 46 F. Supp. 852 (D.C. Fla., 1942), 2 S.E.C. Jud. Dec. – (S.D. Fla. No. 483-J, 1942); *In re Puget Sound Power and Light Company*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re Southern Colorado Power Company*, 2 S.E.C. Jud. Dec. – (D. Colo. No. 670, 1944).]

Now pending before the Supreme Court is the important question of the meaning and application of the "fair and equitable" standard prescribed in Section 11 (e), in determining the proper allocation of securities in a reorganization or liquidation under the Act, between the preferred and common stockholders of the company. The case in which that problem is posed is *Otis & Co.* v. *Securities and Exchange Commission*, which involves the Commission's holding, discussed in the section on integration and simplification of holding company systems, that the allocation should be based upon the entire bundle of rights of both classes of stock with primary reference to their relative expectations of participation in income under the existing structure, rather than exclusively upon the basis of the charter liquidation preference of the preferred stock.

Another similar case involving a plan for the reorganization of Southern Colorado Power Co. is now pending on appeal before the Circuit Court of Appeals for the Tenth Circuit under the title of *Disman* v. *Securities and Exchange Commission*. [Footnote: Since this writing, the Supreme Court has rendered a decision in *Otis & Co.* v. *S.E.C.* approving the Commission's holding (3 Justices dissenting). 65 S. Ct. 483 (1945).]

Federal district courts which have considered plans of reorganization following this same allocation principle have without exception approved and enforced the plans before them. *In re Puget Sound Power and Light Co*. (D. Mass.), *In re North Continent Utilities Co.* (D. Del.), *In re Central States Power & Light Corp*.

(D. Del.), *In re Consolidated Electric & Gas Co.* (D. Del.), *In re The Laclede Gas Light Co.* (D. Mo.), and *In re International Utilities Corp.* (D. N. Y.). [Footnote: *In re Puget Sound Power and Light Company*, 2 S.E.C. Jud. Dec. – (D. Mass. No. 2308, 1943); *In re North Continent Utilities Corporation*, 54 F. Supp. 527 (D. Del., 1944); *In re Central States Power & Light Corporation*, 2 S.E.C. Jud. Dec. – (D. Del. No. 354, 1944); *In re Consolidated Electric & Gas Co.*, 55 F. Supp. 211 (D. Del., 1944); *In re The Laclede Gas Light Co.*, 57 F. Supp. 997 (D.C.E.D. Mo., 1944); *In re International Utilities Corporation* (D.C.S.D.N.Y. Civ. 25-260 (1944)).]

A cognate problem which has resulted in two review proceedings (*New York Trust Co.* v. *Securities and Exchange Commission*, *City National Bank & Trust Co.* v. *Securities and Exchange Commission*) [Footnote: *New York Trust Co.* v. *S.E.C.*, 131 F. (2d) 274 (C.C.A. 2, 1942); *City National Bank & Trust Co. of Chicago* v. *S.E.C.*, 134 F. (2d) 65 (C.C.A. 7, 1943).] and in several district court decisions in voluntary plan enforcement proceedings (*In re North Continent Utilities Corp., In re Consolidated Electric & Gas Company*),[Footnote: *In re North Continent Utilities Corp.*, 54 F. Supp. 527 (D. Del., 1944); *In re Consolidated Electric & Gas Co.*, 55 F. Supp. 211 (D. Del., 1944) concerns the contractual right of debenture holders to receive a premium upon premature retirement of the debentures in the liquidation of their company, where liquidation takes place pursuant to a Section 11 (e) plan designed to comply with the mandate of Section 11 (b) (2). As noted in the section on integration and simplification of holding company systems, the second and seventh circuits and the District Court of Delaware in these cases upheld orders of the Commission's determination that it would be unfair and inequitable to the other security holders of the companies to give the debenture holders a premium or other compensation for premature termination of their rights in the context of a reorganization or liquidation required by the Act.

Another reorganization problem under the Holding Company Act not yet finally settled by the courts, is whether a plan of reorganization prepared and negotiated by a management group is fair and equitable and not detrimental to the interests of investors and the public, where the plan permits the management to profit either in terms of control or pecuniary gain from stock of the corporation which the management has purchased during the course of the reorganization proceeding. In *Chenery* v. *Securities and Exchange Commission*, [Footnote: Chenery Corporation v. S.E.C., 128 F. (2d) 303 (App. D.C., 1942), 318 U.S. 80 (1943).] the Commission held, with respect to a voluntary plan proposed by Federal Water Service Corporation, that equity decisions as to the fiduciary obligations of corporate managers forbade managerial profit from such transactions. The Appellate Court for the District of Columbia held that the Commission exceeded its statutory authority in so deciding. On further appeal the Commission's order was set aside and remanded to the Commission by the Supreme Court (three Justices dissenting), on the ground that the equity

precedents upon which the Commission had relied were not applicable to the case. The Supreme Court held that the Holding Company Act empowered the Commission to correct reorganization abuses arising in proceedings under the Act and that the Commission was authorized to consider the problem posed in this case in the light of the statutory purposes and its experience with reorganization practices in proceedings under the Act. The case is now pending before the Commission upon the remand. [Footnote: On February 8, 1945, the Commission issued its findings and opinion reaffirming its previous determination. Holding Company Act Release No. 5584.]

A corollary to this problem of fiduciary responsibilities under the act was presented in *Morgan, Stanley & Co. Inc.* v. *Securities and Exchange Commission*, [Footnote: *Morgan, Stanley Co*. v. *S.E.C.*, 126 F. (2d) 325 (C.C.A. 2, 1942).] where the second circuit affirmed an order of the Commission prohibiting Dayton Light & Power Co. from paying underwriter's fees to Morgan, Stanley, on the ground that Morgan, Stanley and the company stood in such relation to each other that there was likely to have been an absence of arm's-length bargaining in the transaction.

(d) Judicial Review Procedure

Judicial opinions in cases under the Holding Company Act have resulted in settling important general questions bearing upon the conduct of the Commission's proceedings and the rights of "aggrieved" persons to obtain judicial review of Commission orders. One such question related to the proper method of disposing of two or more petitions filed in different circuit courts to review the same or parts of the same order issued by the Commission. Relying upon the statutory provision that the Court in which the Commission shall file its transcript of record shall have exclusive jurisdiction to affirm, modify, or set aside the Commission's order in whole or in part, the Commission has contended that when two or more petitions for review are filed in different courts the Commission must determine which review proceeding will best serve the public interest and file its transcript in that court, thereby giving it exclusive jurisdiction over the Commission's order. The procedure has been judicially established that petitions filed in courts other than that in which the Commission files the transcript of the record are to be dismissed unless the petitioners desire to intervene in the proceeding before the court which has been given exclusive jurisdiction over the Commission's order. To protect the rights of such petitioners, there has been developed the judicial procedure of transferring and transmitting to the court of exclusive jurisdiction the petitions for review filed in the other courts.

More recently the analogous question has arisen as to the disposition of petitions for review filed by stockholders of companies directly or indirectly affected by the Commission's orders under the Holding Company Act. The Commission has

been upheld by reviewing courts in its contention that before a stockholder can claim to be "aggrieved" by the Commission's order his petition must show that he has complied with the general rules applicable to stockholders' derivative actions, i.e., that he has made a demand upon his corporation to file a petition for review and that the corporation has refused to do so for improper reasons. [Footnote: *Okin* v. *S.E.C.*, 143 F. (2d) 943 (C.C.A. 2, 1944) and *American Power & Light Company* v. *S.E.C.*, No. 470 (C.C.A. 1, 1944)

(e) Political Contributions

The provision of the Holding Company Act which makes it unlawful for any holding company or subsidiary to give political contributions was held constitutional by the eighth circuit in *Egan and Union Electric Company of Missouri* v. *U.S.* [Footnote: *Egan* v. *U.S.* and *Union Electric Co. of Missouri* v. *U.S.*, 137 F. (2d) 369 (C.C.A. 8, 1943), 64 S. Ct. 195 (1943).] In that case, which was the outgrowth of an extensive investigation conducted by the Commission, the circuit court affirmed the conviction of the company on charges of making political contributions in violation of the provisions of the Holding Company Act, and that of its former president, for conspiracy to violate the same section. The evidence showed that the defendants had established a "slush fund" accumulated by kickbacks and legal lees, payments to contractors and insurance agents, and the padding of expense accounts. Three other officials of the company had previously been convicted of perjury in their testimony before officers of the Commission during the course of the investigation.

APPENDIX TO PART III

Status of Each of the Major Holding Companies Under Section II

A brief summary of the status of each of the major holding companies under the more important aspects of section 11 at the close of the past fiscal year follows:

1. Electric Bond and Share Co.

Electric Bond and Share is the largest system registered under the Holding Company Act. The parent, Electric Bond and Share Co. (Bond and Share), controls five major subholding companies: American and Foreign Power Co., Inc. (American Foreign), American Gas and Electric Co. (American Gas), American Power & Light Co. (American) Electric Power & Light Corp. (Electric), and National Power & Light Co. (National).

On May 9, 1940, the Commission instituted Section 11 (b) (2) proceedings directed to Bond and Share and certain of its subsidiaries. [Footnote: Holding Company Act Release No. 2051.] On August 23, 1941, the Commission found that National served no useful function, that it served as the central tier in a

pyramid which enabled Bond & Share to control the National system with practically no investment and that it violated Section 11 (b) (2) because it constituted an undue and unnecessary complexity in the Bond and Share system. As a result National was ordered to dissolve. [Footnote: Holding Company Act Release No. 2962.] Considerable progress has been made in getting National's affairs in shape for liquidation. All of its bonds were retired through the use of cash on hand and its preferred stock was eliminated through a voluntary exchange of common stock of Houston Lighting & Power Co. and by sale of the remainder of the Houston stock and the use of the proceeds together with treasury cash to retire the remaining National preferred stock at $100 per share plus accumulated dividends. The last of the preferred stock was retired in January 1944 pursuant to an authorization of the Commission dated January 4, 1944. [Footnote: Holding Company Act Release No. 4811.] The principal assets remaining for disposition are the common stocks of three operating companies. Birmingham Electric Co., Carolina Power & Light Co., and Pennsylvania Power & Light Co.

On August 5, 1942, [Footnote: Holding Company Act Release No. 3832.] the Commission acting under Section 11 (c) granted National an extension of 1 year from August 22, 1942, for compliance with the order of dissolution but conditioned its action upon National's filing plans for resolution of the voting power and accounting problems of its subsidiaries. Such plans have been filed by National. After several amendments the plan filed by Carolina Power & Light Co. was approved by the Commission on December 11, 1943. [Footnote: Holding Company Act Release No. 4746.] Similarly the plan for Birmingham Electric Co. as amended was approved on March 21, 1944. [Footnote: Holding Company Act Release No. 4955.] In both of these cases the operating Companies, through capital contributions by National and accounting and voting power adjustments were able to conform their accounts and structures to the standards of the Act so as to be ready for disposition. Final action has not been taken with respect to Pennsylvania Power & Light Co. largely by reason of uncertainty as to the classification of the accounts of that company An order to show cause with respect to that company, directed toward a disposition of its accounting problems, was instituted by the Federal Power Commission on December 17, 1943. At the close of the past fiscal year, this proceeding was pending.

On August 22, 1942, American and Electric were ordered dissolved on grounds similar to those set forth above with respect to National. [Footnote: Holding Company Act Release No. 3750.] These two companies appealed to the United States Circuit Court of Appeals for the First Circuit which on March 17, 1944, affirmed the order of the Commission [Footnote: *American Power & Light Co.* v. *S.E.C.*, *Electric Power & Light Co.* v. *S.E.C.*, 141 F. (2d) 606.] and on April 18, 1944, denied an application of the companies for a rehearing. Thereupon the

companies petitioned the Supreme Court for a writ of certiorari on which the Court has not yet acted.

The Commission instituted proceedings under Section 11 (b) (2) and various other sections of the Act directed to American and its subsidiary, Florida Power & Light Co. (Florida), on July 10, 1941. Issues were raised as to the distribution of voting power among the security holders of Florida, the existence of large amounts of write-ups in its accounts, and the validity and rank of the $22,000,000 of its debentures held by American. On September 17, 1941, respondents filed a refinancing plan, in part to meet the allegations in the Commission's order for hearing. The matters were consolidated and hearings were held. Prior to the final determination of the case by the Commission, however, American and Florida submitted amendments to their previous proposal. The proposal as so amended , which provided for substantial adjustments to the accounts of Florida, the surrender by American to Florida as a capital contribution of $17,000,000 of the debentures held by it and certain other securities, and the retirement of all publicly held securities at their contract prices from treasury cash and the proceeds of issuance of new securities, was approved by the Commission on December 28, 1943. [Footnote: Holding Company Act Release No. 4791.]

On November 15, 1943, American filed an application and declaration with respect to the conversion of its outstanding stock, consisting of $5 and $6 preferred stock and common stock into a new common stock. The company stated in its filing that while it was contesting the constitutionality of Section 11 (b) (2) and the Commission's order of dissolution directed to it thereunder it believed that the proposed transaction would be appropriate to the carrying out of such order, if upheld. The Commission consolidated the proceedings with respect to the filing with the proceedings under Section 11 (b) (2) directed to American and set forth as among the issues, whether the allocations of the equity of American among the respective classes of security holders as filed or as hereinafter modified could appropriately form the basis of a plan for the dissolution of American in accordance with the previous order of the Commission to that end. [Footnote: Holding Company Act Release No. 4695.] Hearings have been held in this consolidated proceeding and the matter is pending.

United Gas Corporation, a subsidiary of Electric, filed an application on May 5, 1941, with respect to a proposed refinancing, and in connection therewith the repayment of $52,025,000 in debt claims held by Bond and Share. On May 31, 1941, the Commission ordered hearings on this application and instituted proceedings pursuant to Section 11 (b) (2) and other sections of the Act. [Footnote: Holding Company Act Release No. 2790.] The Section 11 (b) (2) proceedings raised issues as to the necessity for a reorganization of United Gas, and as to the validity and rank of the debt claims held by Bond and Share. A consolidated hearing was ordered with respect to the application and the Section

11 (b) (2) proceedings and extensive hearings were held. After the close of the record on the major issues in the consolidated proceedings a Section 11 (e) plan was filed on March 6, 1944, which provided for a comprehensive reorganization of United Gas and a compromise settlement of the debt claims of Bond and Share together with its stock interests in United Gas for $44,000,000 in cash. After hearings on this plan the Commission issued its findings and opinion, and order approving the plan as necessary to effectuate the provisions of Section 11 (b) (2) and as fair and equitable. [Footnote: Holding Company Act Release No. 5271.] In accordance with the request of the companies the Commission has applied to the United States District Court for the District of Delaware for enforcement of the plan. [Footnote: The plan has been approved by the court.]

On March 8, 1943, Utah Power & Light Co., a subsidiary of Electric, filed a refinancing plan and the Commission instituted 11 (b) (2) proceedings which it consolidated with the proceedings on the plan. [Footnote: Holding Company Act Release No. 4157.] On November 20, 1943, the Commission approved the refinancing and ordered a recapitalization of Utah involving the conversion of its preferred and common stocks into a single class of common stock and directed that adjustment be made in the accounts of Utah and its subsidiary companies. [Footnote: Holding Company Act Release No. 4716.]

On September 1, 1943, the Commission approved the sale by Electric of its entire common stock interest in the Idaho Power Co. to underwriters for resale to the public. [Footnote: Holding Company Act Release No. 4527.] Electric received $10,361,250 for the stock. The Commission has subsequently approved the use of portions of these proceeds for the investment of Electric in the common stocks of two of its remaining subsidiaries Mississippi Power & Light Co., [Footnote: Holding Company Act Release No. 5237.] and Arkansas Power & Light Co. [Footnote: Holding Company Act Release No. 5294.] The increase of Electric's investment in these subsidiaries through the use of this cash together with the portion of their senior securities held by Electric enabled them to make necessary accounting adjustments and substantially improve their structures

On May 18, 1943, the Commission issued its notice of and order reconvening the hearings with respect to the Section 11 (b) (2) proceedings directed to Bond and Share and its subsidiaries, raising as an issue the question as to whether or not Bond and Share is an undue and unnecessary complexity with respect to American Gas and Electric Co., and its subsidiaries and American Foreign and its subsidiaries respectively, and also raising an issue with respect to the necessity for a reorganization of American Foreign under Section 11 (b) (2) of the Act. [Footnote: Holding Company Act Release No. 4305.] The notice and order directed that the issue with respect to Bond and Share's relation to American Gas be first considered. Hearings have been held but the matter has not been completed by reason of the request of Bond and Share that it be permitted to

formulate and present a plan for its disposition of its stock interest in American Gas. After the close of the fiscal year, American Foreign filed a plan of reorganization on which hearings are being held. [Footnote: Holding Company Act Release No. 5388.]

2. The North American Co.

Proceedings pursuant to Section 11 (b) (I) were instituted March 8,1940, with regard to the North American Co. (North American) and its subsidiaries [Footnote: Holding Company Act Release No. 1960.] and on December 2, 1941, pursuant to Section 11 (b) (2) with regard to North American Light & Power Co. [Footnote: Holding Company Act Release No. 3168.] (Light & Power), a subsidiary of North American. Under date of December 30, 1941, the Commission ordered the dissolution of Light & Power. [Footnote: Holding Company Act Release No. 3233.]

The Commission's opinion and order in the 11 (b) (1) proceedings was rendered April 14, 1942, [Footnote: Holding Company Act Release No. 3405.] and dealt with the status of each registered holding company in the system, including subsidiary holding companies of Light & Power but not including Light & Power since its liquidation had been previously ordered. The Commission's order directed that North American confine its operations to a single integrated electric system based upon Union Electric Co. of Missouri, and allowed North American 15 days in which to state an alternative choice. No such choice was made but North American filed a petition requesting modification of the order, which petition was denied June 25, 1942. [Footnote: Holding Company Act Release No. 3630.] North American appealed to the United States Circuit Court of Appeals for the Second Circuit, which affirmed the Commission's order on January 12, 1943. [Footnote: 133 F. (2d) 148.] The Supreme Court granted a writ of certiorari on March 1, 1943, [Footnote: On August 22, 1941, the Commission instituted proceedings with respect to Illinois-Iowa Power Co, (now Illinois Power Co.) pursuant to section 11 (b) (2) of the act, determination of which has been retarded by the claims of Illinois Power against its parents.] to review the decision of the Second Circuit, but on April 15, 1943, indefinitely deferred hearing the case because of the lack of a qualified quorum. Until the Supreme Court has disposed of this case, the difficulties, practical and otherwise, with respect to enforcement of that part of the order awaiting review are obvious.

Subsequently, on August 4, 1943, North American submitted a plan, under Section 11 (e) of the Act, proposing several regional holding companies and the final dissolution of North American. Hearings have been held on this plan, but the Commission has reserved decision because of the pendency of related questions which have not been resolved.

North American has disposed of substantially all of its holdings in Detroit Edison Co. common stock and has reduced its holdings in Washington Railway and Electric Co. and Pacific Gas and Electric Co. by the payment of shares of these companies as regular dividends to the common stockholders of North American, enabling North American to use the cash so conserved to reduce its outstanding debt from $70,000,000 to approximately $30,000,000. As a result, North American has been able to refund its entire debt with a 2 percent bank loan. maturing serially over a 5-year period.

The determination of a fair and equitable plan of liquidation for Light & Power has been delayed pending the disposition of certain claims asserted against it by Illinois Power Co., an indirect subsidiary. [Footnote: 134 F. (2d) 65.] In the interim, Light & Power has taken steps toward liquidation through the retirement of $3,376,500 publicly held debentures (without the payment of redemption premiums), such action having been appealed by the trustees under the indentures securing such debentures to the United States Circuit Court of Appeals for the Seventh Circuit, which upheld the order of the Commission; [Footnote: 134 F. (2d) 65.] and further, by the deposition of its investment in certain subsidiary companies, including Western Illinois Ice Co., Blue River Power Co., Power & Light Securities Co., and McPherson Oil & Gas Development Co.

3. The United Gas Improvement Co.

The commission instituted proceedings with regard to the United Gas Improvement Co. (U. G. I.) and its subsidiaries, pursuant to Section 11 (b) (1), on March 4, 1940. Pursuant to a request by U. G. I., the Commission issued, on January 18, 1941, a statement of tentative conclusions as to the application of the Provisions of Section 11 (b) (1) to the holding company system of U. G. I., in which the Commission stated tentatively that the system's single integrated public utility system was composed of the electric properties of its subsidiaries in the Pennsylvania-Delaware-Maryland area. [Footnote: Holding Company Act Release No. 2500.] Divestiture orders were issued on July 30, 1941 and May 7, 1942, based upon this interpretation. [Footnote: Holding Company Act Release Nos. 2913 and 3511.] U. G. I. appealed these orders to the United States Circuit Court of Appeals for the Third Circuit. The court sustained the orders in a unanimous decision on November 17, 1943. [Footnote: 138 F. (2d) 1010.]

After argument before the court but before its decision, U. C. I. and its subsidiary, Philadelphia Electric Co., filed applications under Section 11 (e) for the purpose of enabling the U. G. I. holding company system to effect partial compliance with Section 11 (b). The plan provided for the distribution to U. G. I. 's preferred and common stockholders of $30,600,000 in cash and substantially all its stockholdings in Philadelphia Electric and Public Service Corp. of New Jersey,

two subsidiaries with combined assets of $1,200,000,000. The plan was filed in December 1942, was approved by the Commission March 18, 1943, [Footnote: Holding Company Act Release No. 4173.] by the common stockholders April 19, 1943, and was declared effective as of June 18, 1943. By effecting the retirement in this manner of its preferred stock, U. G. I. made possible the further distribution of investments or cash to its common stockholders.

Subsequent to the distribution of its interest in Philadelphia Electric Co. and Public Service Corp. of New Jersey, the United Gas Improvement Co. effectuated a series of transactions which enabled it to distribute to its stockholders in May of 1944 its holdings of the securities of Delaware Power & Light Co. and subsidiaries which had consolidated assets of $52,334,642 [Footnote: Holding Company Act Release No. 4505.]

4. The Commonwealth & Southern Corp.

Section 11 (b) (1) proceedings were started with respect to The Commonwealth & Southern Corp. and its subsidiaries on March 6, 1940. This proceeding was later consolidated with Section 11 (b) (2) proceedings instituted on April 8, 1941. On April 9, 1942, [Footnote: Holding Company Act Release No. 3432.] the Commission, under Section 11 (b) (2), ordered Commonwealth to reduce its outstanding preferred and common stock to a single class of common stock. Commonwealth appealed the order to the Circuit Court of Appeals for the Third Circuit which, on March 31, 1943, upheld the Commission's order in all respects. [Footnote: 134 F. (2d) 747] Commonwealth filed a recapitalization plan on April 20, 1943, designed to comply with the order. The plan as originally filed provides for reclassifying the existing preferred and common stocks into a single class of new common stock and for the distribution to its stockholders (or earlier sale) of the common stock of one of its northern subsidiaries. The plan contemplates that the remaining subsidiaries would continue to be owned by Commonwealth, pending the outcome of the Section 11 (b) (1) proceedings.

On February 26, 1944, Commonwealth filed an amended plan which, in substance, changed two basic features of the original plan, namely the 80-20 percent plan of allocation was changed to an 85-15 percent allocation for the preferred and common stockholders respectively and the proposed distribution of the common stock of Consumers Power Co. was changed to the proposed distribution of the common stocks of all of the northern subsidiaries to the preferred and common stockholders.

Hearings on the amended plan were concluded on March 27, 1944, and the staff filed its proposed findings on May 29, 1944, approving the basic features of the amended plan but recommending that certain amendments be made. Briefs have

been filed and oral argument held on the issues involved and the case is presently under advisement by the Commission.

Like many other holding companies Commonwealth has refinanced most of its utility subsidiaries and in the process has materially improved their financial condition.

5. Cities Service Co.

On July 3, 1941, the Commission instituted a Section 11 (b) (1) proceeding with respect to Cities Service Co. (Cities), the top company in this system, and all its subsidiaries. Hearings were completed and the Commission issued its opinion and order on May 5, 1944. [[Footnote: Holding Company Act Release No. 5028.] The order directed Cities to comply with Section 11 (b) (1) by reducing the operations of its system, to certain gas distribution properties located in the Mid-Continent section and certain gas production and transmission properties found retainable therewith. [Footnote: Cities Service itself has not appealed this order.] The order provided, however, that the retention in the Cities' system of all of its nonutility holdings was not foreclosed if Cities should choose to comply with Section 11 (b) (1) by disposing of its holdings in all utility holding companies. Subsequent to the issuance of that order, Cities filed a petition requesting that the order of May 5, 1944, be supplemented or modified so as to provide in substance that in lieu of compliance with the provisions of this order Cities may comply with requirements of Section 11 (b) (1) by disposing of its interests in utilities without prejudice to the right of Cities to apply for an exemption from the previsions of the Act under Section 3, and be exempt as a registered holding company, after it has disposed of its interest in utilities to the extent where it becomes entitled to such exemption and discharge. At the end of the fiscal year no action had been taken on this petition.

The order of May 5, 1944, was also directed to Arkansas Natural Gas Corp., a subsidiary holding company of Cities, and required that company to confine its operations to the production, transmission and distribution of natural gas conducted by Arkansas Louisiana Gas Co., its only utility subsidiary, and required it to dispose of its interests in its nonutility subsidiaries including its interests in Arkansas Fuel Oil Co. Arkansas Natural Gas Corp. has filed a petition to review the order of the Commission in the Circuit Court for the Fifth Circuit, which petition was pending at the end of the fiscal year,

On March 4, 1940, the Commission instituted a proceeding under Section 11 (b) (1) with reference to the holding company system of Cities Service Power & Light Co. (Power & Light), principal holding company of Power & Light. The Commission's decision in that case was issued on August 17, 1943, [Footnote: Holding Company Act Release No. 4489.] and required Power & Light to confine

its operations to the electric utility business conducted by certain subsidiaries in the State of Ohio. The order also required Federal Light & Traction Co. to confine its operations to certain electric utility businesses conducted by subsidiaries in the States of New Mexico and Colorado.

In compliance with the requirements of that order, Power & Light has disposed of its interests in several subsidiaries, the Principal one being Public Service Co. of Colorado and its subsidiaries, [Footnote: Holding Company Act Release No. 4699. Commissioner Healy dissented.] and Federal Light & Traction Co. has disposed of its interests in Olympic Public Service Co. and Rawlins Electric Co. [Footnote: Holding Company Act Release No. 4820.]

By order dated August 29, 1942, a proceeding was instituted under Section 11 (b) (2) respecting Power & Light and certain of its subsidiaries. In December 1943 Power & Light filed a Section 11 (e) plan designed to effect partial compliance with Section 11 (b) (2). On March 14, 1944, the Commission approved the plan which included a proposal to retire the publicly held senior securities of Power & Light through the use of treasury cash (obtained principally through sales of subsidiaries) and a $20,000,000 short term bank loan. [Footnote: Holding Company Act Release No. 4944.] Reference has already been made above concerning the reorganization of Empire Gas and Fuel Co. under Section 11.

6. Associated Gas & Electric Co.

The Commission, on September 4, 1941, instituted a Section 11 (b) (1) proceeding with regard to the trustees of Associated Gas and Electric Corp. (Agecorp) who controlled directly or indirectly, 175 subsidiaries of which 68 were public utilities as defined by the Act. To meet the issues raised by the Commission the trustees proposed to create out of the system 4 groups of properties to be disposed of as units in the liquidation of Agecorp. One of these 4 groups of properties is located in Florida and Georgia, while the other 3 are in New York, Pennsylvania, and New Jersey.

On August 13, 1942, the Commission issued an order requiring the trustees to divest themselves of all interest in a long list of utility and nonutility companies reserving for future consideration questions relating to the composition of the groups of properties as single integrated systems, additional systems, and permissible nonutility businesses. [Footnote: Holding Company Act Release No. 3729.] The trustees filed a petition for leave to file an amended supplemental answer relative to the retainability of certain additional properties and companies in each of the four groups. On February 17, 1944, the Commission permitted respondents to file the amended supplemental answer and adduce additional evidence in regard to the issues thus raised.

On February 3, 1941, the Commission initiated Section 11 (b) (2) proceedings with respect to General Gas and Electric Corp (Gengas), a registered holding company subsidiary of Agecorp. [Footnote: Holding Company Act Release No. 2543.] Subsequently, Section 11 (e) plans for the reorganization of Gengas were filed by Gengas [Footnote: Holding Company Act Release No. 2598, March 7, 1941.] and by Agecorp, [Footnote: Holding Company Act Release No. 4382, June 24, 1943.] the hearings on which were consolidated with the Section 11 (b) (2) proceedings. After the close of the fiscal year a revised plan was filed jointly by Agecorp and Gengas. [Footnote: Holding Company Act Release No. 5228.] This plan provided for the distribution by Gengas of certain assets among its public security holders, after which there would remain no claims against Gengas except those held by the trustees of Agecorp, who proposed to turn in all their securities of, and claims against, Gengas and receive in exchange an entire issue of new common stock. Hearings on the joint plan have been completed and the matter is under advisement.

Section 11 (b) (2) proceedings were directed to Virginia Public Service Co., a subsidiary of General Gas and Electric Corp. (Gengas), on August 12, 1941, raising, among others, the issue as to whether the voting power was fairly and equitably distributed among its security holders. In answer to these proceedings, Virginia filed a Section 11 (e) plan which, after modification, was approved by the Commission on November 2, 1943. [Footnote: For the history of these proceedings, see Holding Company Act Release Nos. 4823, 3562, 4618, 4654.] Subsequently, however, on April 29, 1944, the Commission issued an order granting applications and whereby, among other things, Virginia was merged with Virginia Electric and Power Co., a subsidiary of Engineers Public Service Co., a nonaffiliated registered holding company. [Footnote: Holding Company Act Release No. 5021.]

On February 10, 1943, the Commission instituted Section 11 (b) (2) proceedings with regard to Georgia Power & Light Co., another subsidiary of Gengas. On April 24, 1944, Georgia, together with its parent, Gengas, and an associate company, Florida Power Corp., filed a joint application-declaration wherein, among other things, Georgia was to be recapitalized. It is proposed that Florida donate $1,400,000 in cash to Georgia. These funds are to be used in part to reduce the mortgage debt of Georgia and provide for a cash settlement in the amount of $150 a share in full satisfaction of the interests of the public holders of the preferred stocks of Georgia. The matter was pending at the close of the fiscal year.

On September 29, 1943, the Commission instituted 11 (b) (2) proceedings with regard to Tide Water Power Co., another subsidiary of Gengas, raising, among others, the issue as to whether the voting power of Tide Water was fairly and

equitably distributed among its security holders. [Footnote: Holding Company Act Release No. 4594.] An answer and a supplemental answer were filed, and hearings were held. Subsequent to the end of the fiscal year, the Commission issued its findings and opinion and order directing Tide Water to file a plan, providing, among other things, for a recapitalization of the company by substituting for the present classes of stock a single class of common stock. [Footnote: Holding Company Act Release No. 5238.] On August 11, 1944, Tide Water filed a plan providing, among other things, for its recapitalization to comply with the Commission's one-stock order. After hearing, the plan was approved subject to reservation of jurisdiction as to the percentage of the new common stock issued to be received by Gengas. [Footnote: Holding Company Act Release No. 5512.]

On June 14, 1943, a thoroughgoing reorganization plan was filed jointly by the Trustee of Associated Gas and Electric Co. and the trustees of Associated Gas and Electric Corp. [Footnote: Holding Company Act Release No. 4399.] The plan, filed pursuant to Section 11 (f) of the Act, was designed to extricate these companies from bankruptcy proceedings which have been pending since January 10, 1940, in the United States District Court for the Southern District of New York under Chapter X of the Bankruptcy Act and to compromise and settle the respective rights of the security holders of the two companies to the assets nominally held by Agecorp alone. Extensive hearings were held and oral argument heard. On April 14, 1944, the Commission entered an order approving the plan. [Footnote: Holding Company Act Release No. 4985.] After the close of the fiscal year, the plan was also approved, pursuant to Chapter X of the Bankruptcy Act, by the United States District Court for the Southern District of New York, An appeal was taken to the Circuit Court of Appeals for the Second Circuit and was argued on December 8, 1944.

On September 30, 1941, the Commission instituted Proceedings under Section 11 (b) (2) with respect to New England Gas and Electric Association (Negea), a registered holding company, Subsequent to the close of the hearings but prior to a final order of the Commission, the Trustees of Ageco and Agecorp and a subsidiary company in the Associated systems inspirited suits in both a State court and a Federal court, in Massachusetts against Negea. The suit in the State court involved consideration of the status of indebtedness, in the amount of 5 $14,583,290 which had been cancelled in 1930 through the issuance by Negea of equity securities. The suit in the Federal court involved an accounting for alleged profits received by Negea in, and resulting from, the transfer of certain stock and indebtedness of Electric Associates, Inc. from Agecorp to Negea in 1932.

It appeared to the Commission that the subject matter of the suits against Negea were relevant to any determination of a proper allocation of securities under any

plan of recapitalization of Negea. Hence, on February 17, 1943, the Commission instituted further proceedings under various sections of the Act, including Section 11, for the purpose of determining (1) whether, and to what extent, the trustees of Ageco and Agecorp and its subsidiary had valid claims against Negea, and (2) in the event that any claims were deemed to be valid, the rank of such claims in relation to the claims of publicly held securities of Negea. [Footnote: Holding Company Act Release No. 4124.]

The issues in this matter were subsequently broadened to include consideration of whether and to what extent the trustees of Ageco and Agecorp, and their subsidiaries have claims against Negea for unjust enrichment as the result of any transfers or diversions to Negea of assets of the Associated system. Hearings in the matter have been completed and argument was heard. At the close of the fiscal year the Commission's findings and opinion and order were in preparation

7. Standard Power and Light Corp.-Standard Gas and Electric Co.

On March 6, 1940, the Commission instituted proceedings pursuant to Section 11 (b) (1) with regard to Standard Power and Light Corp. (Standard Power) and Standard Gas and Electric Co. (Standard Gas) and their subsidiaries, and on June 5, 1940, pursuant to Section 11 (b) (2) with respect to Standard Power. At subsequent hearings counsel for Standard Power acknowledged that the Company performed no useful functions and on June 19, 1942, the Commission ordered it to liquidate and its existence terminated. [Footnote: Holding Company Act Release No. 3607.] After the close of the fiscal year, the Commission approved a dissolution plan for Standard Power filed jointly by Standard Power and Standard Gas. [Footnote: Holding Company Act Release No. 5625.]

Standard Gas, under date of March 24, 1943, filed a plan pursuant to Section 11 (e) for the purpose of enabling it to comply with the provisions of Section 11 (b) and on the same date the Commission instituted proceedings pursuant to Section 11 (b) (2), 15 (f), and 20 (a) and directed consolidation of the two hearings. Hearings were completed, briefs submitted, oral argument heard, and under date of May 31, 1942, the Commission issued findings and opinion, [Footnote: Holding Company Act Release No. 5070.] stating that it could not make the findings necessary for approval of the plan, for the reasons stated therein. It withheld entering its order for 90 days to give Standard Gas an opportunity to file an amendment in accordance with views expressed in the findings and opinion. Subsequent to the end of the fiscal year, Standard Gas submitted an amended plan providing for the distribution of its holdings in all its subsidiary companies except Philadelphia Company (selected as its principal system), Louisville Gas and Electric Co. (Delaware), Louisville Gas and Electric Co. (Kentucky), Wisconsin Public Service Corp., Public Utility Engineering and Service Corp, and a foreign subsidiary. An amendment to the amended plan

provides for the distribution of the securities of Wisconsin Public Service Corp. (Holding Company Act Release No. 5279.) This plan was approved by the Commission in its Findings and Opinion dated November 18, 1944. [Footnote: Holding Company Act Release No. 5430.]

On June 5, 1942, Northern States Power Co. (Delaware) filed its plan of liquidation pursuant to Section 11 (e) and on the same date the Commission instituted proceedings pursuant to Section 11 (b) (2) and other sections of the Act with respect to that Company and each of its subsidiary companies. Hearings were held, subsequent to which the Company submitted an amended plan, upon which extensive hearings were also held, briefs submitted, and argument heard. The decision of the Commission is pending.

On June 30, 1942, Southern Colorado Power Co., a subsidiary of Standard Gas, filed a plan pursuant to Section 11 (e) for recapitalization and, on July 2, 1942, the Commission instituted proceedings under Section 11 (b) (2) and ordered consolidated hearings thereon. On August 3, 1943, the Commission approved the plan subject to certain modifications, which were satisfied by amendments filed October 21, 1943. The amended plan was approved by the Commission on November 24, 1943, [Footnote: Holding Company Act Release No. 4501.] and by the United States District Court in Colorado on December 31, 1943. [Footnote: Enforced without opinion.] Appeal was taken therefrom to the United States Circuit Court of Appeals for the Tenth Circuit, which has rendered its decision upholding the Commission's approval of the plan.

8. Columbia Gas & Electric Corp.

Proceedings initiated by the Commission on August 25, 1941, with regard to Columbia Gas & Electric Corp. (Columbia) and several of its subsidiaries including Columbia Oil & Gasoline Corp., pursuant to Sections 11 (b) (1) and 11 (b) (2), were consolidated with a Section 11 (e) plan by order dated July 14, 1942. The plan involved, among other things, the sale by Columbia Oil & Gasoline Corp (Columbia Oil), a subsidiary of Columbia, of its interest in Panhandle Eastern Pipe Line Co. (Panhandle), the transfer of its five oil and gasoline subsidiaries to Columbia Gas, and the liquidation of Columbia Oil. The Commission in an order [Footnote: Holding Company Act Release No. 3829.] and opinion [Footnote: Holding Company Act Release No. 3885.] dated October 2, 1942, approved the plan. On March 23, 1943, the United States Circuit Court of Appeals, Third Circuit, affirmed the Commission's order [Footnote: 134 F. (2d) 822.] and 6 days later the United States District Court for the District of Delaware entered its order approving the plan. [Footnote: 50 F. Supp. 965.] Columbia's relationships with certain of its subsidiaries had involved it in a long series of legal difficulties. Among other results, consummation of Columbia's plan had the effect of divorcing Panhandle from the Columbia system, a step which the

Commission had found to be necessary to effectuate the provisions of Section 11 (b) (1), extricated some of the companies and other interested parties from problems which they faced under the antitrust laws, and terminated a complex tangle of private litigation.

Further proceedings were instituted by the Commission on May 2, 1944, with regard to Columbia and its remaining subsidiaries pursuant to Sections 11 (b) (1) and 11. (b) (2). Initial hearings were held before the Commission on June 15, 1944, at which time various suggestions as to methods of compliance by Columbia with Section 11 (b) were made by the parties. Subsequent to this hearing, and after conferences among members of the staff of the Public Utilities Division and certain of the parties to the proceedings, Columbia requested the Commission to issue its tentative conclusions as to the status of Columbia in relation to the requirements of Section 11 (b) (1). The Commission acquiesced in this request, and on August 10, 1944, issued its tentative conclusions. [Footnote: Holding Company Act Release No. 5213.] Subsequent to the close of the fiscal year, the Commission issued its findings, opinion, and order in this matter, [Footnote: Holding Company Act Release No. 5455.] in which it found that Columbia Gas could retain the distribution operations of the Charleston, Pittsburgh, and Columbus groups of properties as well as the production and transmission properties owned and operated by the companies within each such group. The Commission further held that certain other properties, including the properties owned by the Cincinnati Gas & Electric Co. and the Dayton Power & Light Co, were not retainable and should be divested. Jurisdiction was reserved as to the retainability of certain other designated properties.

9. Niagara Hudson Power Corp.

The Commission instituted Section 11 (b) (2) proceedings in August 1942 with respect to Niagara Hudson Power Corp., Buffalo, Niagara and Eastern Power Corp., and their subsidiary companies.

During the course of the hearings, the Commission held a public conference to explore the means whereby dividend payments on the preferred stocks of the two holding companies in the system, which were discontinued in the fall of 1942, could be resumed. The management formulated an over-all plan of reorganization, filed in June 1943 under Section 11 (e) of the Act, providing for the consolidation of the principal public utility companies in the system and Buffalo, Niagara and Eastern Power Corp. into one operating company, and the dissolution of Niagara Hudson Power Corp. The plan further provided for the payment in cash of all accrued and unpaid dividends.

On January 21, 1944, the New York Public Service Commission denied the petition of the companies involved to consolidate as contemplated by the plan.

The Securities and Exchange Commission on June 19, 1944 denied the application of Buffalo, Niagara and Eastern Power Corp., a subsidiary of Niagara Hudson, for exemption as a holding company from the provisions of the Act insofar as applicable to the provisions of Section 11 (b) (2) , and further ordered that Buffalo, Niagara & Eastern change its capitalization by substituting for its outstanding $ 1.60 cumulative preferred stock, class A stock and common stock one class of stock, namely, common stock. [Footnote: Holding Company Act Release No. 5115.] The order further required that appropriate voting rights be extended to the $5 preferred stock of Buffalo, Niagara & Eastern.

10. International Hydroelectric System

Proceedings under Section 11 (b) (2) of the Act involving International Hydroelectric System (IHES) were instituted on June 17,1940. IHES is a Massachusetts trust which owns directly the equity in New England Power Association, also a registered holding company, the equities in Gatineau Power Co., a Canadian public utility company, and in two wholesale electric utilities operating in the United States.

On January 17, 1941, the Commission ordered that all of the common stock and all of the class B stock of IHES held by certain trustees for the benefit of International Paper Co., and International Paper & Power Co. be surrendered to IHES for cancellation, the Commission having found such stocks to be of no value. [Footnote: 8 S.E.C. 485.] On June 18, 1941, this order was complied with by the trustees and the class B and common stocks were thereafter cancelled.

On July 21, 1942, IHES itself was ordered to liquidate and dissolve, the Commission finding that IHES performed no useful function and constituted an unnecessary complexity in. the system. [Footnote: Holding Company Act Release No. 3679.]

On March 17, 1943, the Commission, pursuant to Section 11. (b) (2), ordered that Massachusetts Utilities Associates Common Voting Trust be liquidated and dissolved and that Rhode Island Public Service Co., Massachusetts Utilities Associates, Massachusetts Power & Light Associates and North Boston Lighting Properties be eliminated as subholding companies in the New England Power Association and IHES system. [Footnote: Holding Company Act Release No. 4168.]

Paul H. Todd, a stockholder and director of IHES, filed petitions on September 19, 1942, and December 20, 1942, in the United States Circuit Court of Appeals for the Sixth Circuit, for the review of the Commission’s order of July 21, 1942, directing the liquidation and dissolution of IHES and asking the court to remand the proceedings to the Commission for further investigation of certain alleged

rights of action of IHES against International Paper Co. The Commission contended that dissolution was the appropriate action in the light of the applicable statutory standards and that the alleged claims against Paper Co. would be fully explored, but that such exploration was not a necessary prerequisite to the issuance of the dissolution order. IHES intervened in the review proceeding and supported the validity of the Commission's order. The court denied the application to adduce additional evidence and dismissed the petition for review, thereby sustaining the Commission's order. [Footnote: 137 F. 475 (C.C.A. 6, 1943).

In July 1943 IHES notified the Commission that because of the asserted claims against International Paper Co., former parent of IHES, and the imminence of the maturity of its bonds, it would be impossible for it to comply with the Commission's order of July 21, 1942, without the aid of court enforcement thus virtually inviting the Commission to apply to the court. On August 12, 1943, the Commission instituted a proceeding pursuant to Section 11 (d) of the Act in the United States District Court for the District of Massachusetts to enforce compliance with its liquidation order, and on October 11, the court took jurisdiction over IHES and its assets and appointed a special counsel to investigate the claims asserted against International Paper Co. This investigation is still in progress. On March 6, 1944, New England Power Association and its subsidiary holding companies filed an application for approval of a plan of simplification of the New England Power Association holding company system for the purpose of complying with the simplification provisions of Section 11 (b) (2) of the Act and with the Commission's order of March 17, 1943. This plan provided for the elimination of the Massachusetts Utilities Associates Common Voting Trust and for the substitution of a single holding company in lieu of New England Power Association, Rhode Island Public Service Co., Massachusetts Utilities Associates, Massachusetts Power & Light Associates, and North Boston Lighting Properties. Hearings on the plan were completed shortly after the termination of the fiscal year.

11. The Middle West Corp.

The Commission instituted Section 11 (b) (1) proceedings with regard to The Middle West Corp. (Middle West) and its subsidiaries on March 1, 1940. On January 24, 1944, the Commission ordered Middle West to sever its relations with its subsidiary companies, except Central Illinois Public Service Co., and its subsidiaries, Kentucky Utilities Co., South Fulton Power & Light Co., Old Dominion Power Co., and Dixie Power & Light Co. [Footnote: Holding Company Act Release No. 4846.] On May 9, 1944, a rehearing was granted to permit the introduction of further evidence with respect to the question of what constitutes the integrated system of Central & South West Utilities Co. (Central) and with respect to the retainability of the other businesses of the following subholding

companies, American Public Service Co. (American), Arkansas-Missouri Power Corp., and Central. Hearings with respect to the issues of the rehearing have been completed and arguments have been presented. Sales by Middle West of its subsidiaries, Kansas Electric Power Co. [Footnote: Holding Company Act Release No. 4532.] and Missouri Gas & Electric Service Co., [Footnote: Holding Company Act Release No. 4782.] were approved by the Commission on August 31, 1943, and December 27, 1943, respectively. Sale of the gas properties of Southwestern Gas & Electric Co. was approved September 25, 1943. [Footnote: Holding Company Act Release No. 4782.]

In February 1940, Central and American, two subsidiaries of Middle West, filed a joint application proposing a consolidation of the two companies. On December 5, 1940, the Commission instituted proceedings under Section 11 (b) (2) and ordered that the hearings of the two cases be consolidated. The consolidation issue in the case centered around the question of whether the new corporation should issue any preferred stock. The proponents of the plan submitted by the companies contended that preferred stock was necessary in the new company in order to preserve the priorities of the holders of the prior lien and preferred stocks of Central and the preferred stock of American. The Commission on June 4, 1942, ruled that the new corporation could have only common stock. [Footnote: Holding Company Act Release No. 4585.] The respondents filed a petition for review in the United States Court of Appeals for the District of Columbia, which upheld the Commission in its opinion of June 7, 1943. [Footnote: 136 Fed. (2d) 273.] On August 2, 1943, Central and American filed an amended plan of merger to be effectuated through the issuance of a single class of capital stock. Hearings on this matter have been held.

The Commission on June 9, 1941, instituted proceedings pursuant to Section 11 (b) (2) which raised issues as to the equitable distribution of voting power among security holders of the North West Utilities Co. (North West) system, and also as to the continued existence of North West. The proceeding was consolidated on June 11 , 1941, with a plan of recapitalization of North West which had been submitted by North West and Middle West. The Commission on September 10, 1043, held that the proposed plan of recapitalization fell short of effectuating the provisions of Section 11 (b) and ordered that North West be liquidated. [Footnote: Holding Company Act Release No. 4552.]

12. The United Light and Power Co.

Three major Section 11 proceedings involving The United Light and Power Co. (United Light) were consolidated in 1941, namely: a Section 11 (b) (1) proceeding instituted on March 8, 1940, proceedings with respect to a recapitalization plan filed by United Light, and Section 11 (b) (2) proceedings started December 6, 1940. United Light is the top holding company astride two

subsidiary tiers of holding companies in an excessively pyramided holding company system. United Light performs no necessary or useful function. No dividends have been paid since the first quarter of 1932 on its outstanding $60,000,000 preferred stock issue. Under the standards of Section 11, its liquidation was necessary and was ordered by the Commission. [Footnote: Holding Company Act Release No. 2636.] The company subsequently filed a number of applications covering action necessary to accomplish liquidation, now in its final stage. One of the most important steps involved the distribution by United Light of its principal asset, all of the common stock of a subsidiary holding company, The United Light and Railways Co. (Railways), to the preferred and common stockholders of United Light on a fair and equitable basis. The original plan filed by the company provided that 91.2 percent of the common stock of Railways should be distributed to the preferred stockholders of United Light and 8.8 percent to the common stockholders. In an opinion rendered April 5, 1943, the Commission disapproved this distribution, but approved the plan when it was amended to allow the preferred stockholders approximately 95 percent of Railways' common. [Footnote: Holding Company Act Release No. 4215.] Commissioner Healy dissented on the ground that the preferred stockholders were entitled to receive all the assets. The order of the Commission approving the plan of distribution was confirmed by Judge Leahy of the United States District Court of Delaware on June 30, 1943, and was affirmed by the United States Circuit Court of Appeals, Third Circuit, on April 10, 1944. [Footnote: In re Securities and Exchange Commission (Otis & Co., intervener) 142 F. (2d) 411 (1944).] A petition for certiorari in the United States Supreme Court was granted on June 12, 1944. [Footnote: The Supreme Court has rendered its decision affirming the Commission's approval of the plan (three Justices dissenting) 65 S Ct. 483 (1945).]

The United Light and Power system has taken several major steps in compliance with the Section 11 (b) (1) order which the Commission issued with respect to this system on August 5, 1941. [Footnote: Holding Company Act Release No. 2923 (9 S.E.C. 833.).] United Light and Railways Co., on September 12, 1941, sold its stock interest in Northern Natural Gas Co. to underwriters for resale. Proceeds from the sale, $10,533,000 were applied on the purchase from United Light of common stock of Iowa-Illinois Gas & Electric Co. in order to facilitate the dissolution of United Light. A number of other divestments of properties by subholding companies in this system, including the sale on October 24, 1942 by American Light & Traction Co. of its holdings in San Antonio Public Service Co., are summarized in appendix table 17.

13. American Water Works and Electric Co., Inc.

This was the first registered holding company to file a corporate simplification plan pursuant to Section 11 (e). The plan contemplated the elimination of several

"second degree" holding company relationships, the continuance of which is forbidden under the terms of Section 11 (b) (2) of the Act. Its consummation was contingent upon the accomplishment of certain refinancing. No change in the actual physical utility properties of the system was involved. The Commission approved the plan on December 31, 1937, reserving for future consideration the question of adjustments of write-ups of system properties and investments. [Footnote: 2 S.E.C. 972.] The refinancing was postponed because of changed market conditions, and the major simplification provisions of the plan have not been put into effect.

14. Engineers Public Service Co.

Section 11 (b) (1) proceedings were instituted with regard to Engineers Public Service Co. (Engineers) and its subsidiaries on February 28, 1940. On July 23, 1941, the Commission ordered Engineers to dispose of its interest in Puget Sound Power & Light Co. and the Key West Electric Co., and on the same date initiated Section 11 (b) (2) proceedings against the Western Public Service Co. (a Maryland corporation), a subsidiary of Engineers. [Footnote: Holding Company Act Release Nos. 2897 and 2898.]

On June 27, 1944, the United Corp. filed a plan pursuant to Section 11 (e) which provided for the exchange of substantially all of holdings of the common stocks of Philadelphia Electric Co. and Delaware Power & Light Co., plus cash for approximately one-half of its outstanding preferred stock. [Footnote: Holding Company Act Release No. 4870.] The plan was subsequently amended to provide for the exchange of only the Philadelphia Electric common stock and an increased amount of cash. The plan, as amended, was approved by the Commission on November 24, 1944 [Footnote: Holding Company Act Release No. 5440.] and has since been consummated.

16. Midland United Co. and Midland Utilities Co.

On February 19, 1943, a reorganization plan, as amended for Midland United Co. and its subsidiary company, Midland Utilities Co., was filed, pursuant to the requirements of Section 11 (f) of the Act, by the trustee of Midland United Co. Hearings on that plan were held from time to time. On September 20, 1943, a separate plan for the reorganization of Midland Utilities Co. alone was filed by the trustees of Midland Utilities Co. Thereafter, on November 9, 1943, a plan of reorganization for both Midland United Co. and Midland Utilities Co. was filed jointly by the trustee of Midland United Co. and the trustees of Midland Utilities Co. Hearings were held, briefs were filed by a number of interested persons, and oral argument heard on May 15 and May 16, 1944. On September 27, 1944, the Commission entered its Preliminary findings and opinion approving this joint plan subject to certain conditions (Holding Company Act Release No. 5317). The

trustees of the two estates having filed an amended plan satisfying the conditions, an order approving the amended plan was entered on October 5, 1944, and the definitive findings and opinion was filed on October 24, 1944 (Holding Company Act Release Nos. 5335 and 5317A) The reorganization court also found the amended joint plan fair and equitable and feasible, and on December 11, 1944, filed its order approving the plan. On December 22, 1944, an appeal was taken to the Circuit Court of Appeals for the Third Circuit.

17. Standard Oil Co. (New Jersey)

Subsequent to the denial by the Commission of an application by Standard Oil Co. (New Jersey) for an exemption from the provisions of the Act pursuant to Section 3 (a) (3), on the ground that it was “only incidentally a holding company” with respect to four gas utility subsidiaries, [Footnote: Holding Company Act Release No. 3312.] Standard Oil conceded that, under the requirements of Section 11 (b) (1), it could not retain its interest in both the petroleum and natural gas utility business. The company thereupon elected to divest itself of control of its gas utility subsidiaries. As a preliminary step thereto, Standard Oil caused Consolidated Natural Gas Co. to be organized and to register under the provisions of the Act. Thereafter, on August 12, 1943, Standard Oil also filed notification of registration as a holding company.

On October 11, 1943, the Commission issued its order approving a joint 11 (e) plan filed by Standard Oil and Consolidated providing for the transfer to Consolidated of all the outstanding stock of Standard Oil’s four gas utility subsidiaries, Hope Natural Gas Co., East Ohio Gas Co., Peoples Natural Gas Co., River Gas Co., and the stock of New York State Natural Gas Corp., a nonutility pipeline subsidiary in exchange for all of the capital stock of Consolidated. The latter stock was then distributed to the common stockholders of Standard Oil as a dividend, and subsequent to such distribution Standard Oil was declared not to be a holding company under the Act.

18. New England Public Service Co.

On May 2, 1941, the Commission issued an order pursuant to Section 11 (b) (2) directing New England Public Service Co. to recapitalize on a one-stock basis or to liquidate. On December 6, 1941, the company filed a plan for compliance with this order, involving, among other things, the elimination of two public utility operating companies and the distribution of all its holdings in the remaining public utility subsidiaries to its security holders. During a previous fiscal year, one public utility operating company (Cumberland County Power & Light Co.) had been eliminated by merging it into Central Maine Power Co. During the past fiscal year, a Section 11 (e) plan was filed for the purpose of eliminating Twin State Gas & Electric Co. by calling its preferred stock and conveying its New

Hampshire properties to Public Service Co. of New Hampshire and its Vermont properties to Central Vermont Public Service Corp. This plan was approved by the Commission in its order of November 25, 1943. [Footnote: Holding Company Act Release No. 4711.]

19. Federal Water and Gas Corp.

On December 31, 1942, proceedings were instituted by the Commission against Federal Water & Gas Corp. (Federal) and its subsidiaries under Sections 11 (b) (1) and 11 (b) (2). On the same date, Federal and certain of its subsidiaries filed a plan under Section 11 (e) for the purpose of complying with Section 11 (b), which plan, in general, provides for the disposition by Federal of all its interests in subsidiary companies and its subsequent elimination either by dissolution or by merger with an appropriate company, the recapitalization of certain subsidiaries, and the elimination of certain other unnecessary subsidiaries. On February 10, 1943, the Commission approved Federal's plan and directed in general that steps be taken to carry out the provisions of the plan. [Footnote: Holding Company Act Release No. 5052.] Among other things, the Commission's order directed Peoples Water and Gas Co., Scranton-Spring Brook Water Service Co., and New York Water Service Corp. be recapitalized. In addition, Federal, Pennsylvania Water Service Co., and Scranton-Spring Brook Water Service Co. were directed to cause the elimination of Pennsylvania Water Service Co. and the 63 inactive subsidiaries of Scranton-Spring Brook Water Service Co. Since the entry of the afore-mentioned order Federal has sold its interests in one subsidiary, has caused another subsidiary to dispose of part of its properties, and has caused Scranton-Spring Brook Water Service to eliminate 62 of that company's 63 inactive subsidiaries. In addition, New York Water Service Corp. and Scranton-Spring Brook Water Service Co. have filed recapitalization plans under Section 11 (e) of the Act which are presently pending before the Commission.

20. Ogden Corp.

Ogden Corp. (Ogden) is the successor corporation to Utilities Power & Light Corp., which went into bankruptcy in 1937. The plan of reorganization of the latter company, approved by this Commission in 1939 [Footnote: 5 S.E.C. 483.] and approved and confirmed by the United States District Court for the Northern District of Illinois in 1940, provided among other things, that Ogden, the successor, would take the necessary steps to divest itself of all interests in utility companies.

Proceedings initiated by the Commission on March 22, 1943, with regard to Ogden and certain of its subsidiaries pursuant to Section 11 (b) (1) and 11 (b) (2), were consolidated with a Section 11 (e) plan of Ogden. On May 20, 1943, the

Commission entered an order approving certain provisions of the plan, and directing that certain steps, provided for in the plan, be taken in order to achieve compliance with Sections 11 (b) (1) and 11 (b) (2). [Footnote: Holding Company Act Release No. 4307.] Ogden was ordered, among other things, to divest itself of all its interests in holding and public utility companies and to cause its elimination as a public utility holding company; provided that, in the cases of Central States Power & Light Corp. (Central States), Interstate Power Co. (Interstate) Laclede Gas Light Co. (Laclede Gas), and Missouri Electric Power Co. (Missouri Electric) such divestment not to be effected through the sale of securities prior to the recapitalization of such companies. Central States, Interstate and Laclede Gas were ordered to recapitalize, but, in the case of Central States it was directed that such recapitalization need not be effected if the company is liquidated and dissolved.

Substantial progress has since been made by the Ogden system with the view of complying with the directions of our order as well as the provisions of its plan. Ogden divested itself of all its interests in its directly owned subsidiaries, Derby Gas & Electric Corp. [Footnote: Holding Company Act Release No. 4768.] and Missouri Natural Gas Co. [Footnote: Holding Company Act Release No. 4847.] Central States, an indirect subsidiary of Ogden, consummated the sale of all of its assets and orders were obtained from the United States District Court for the District of Delaware approving and enforcing plans previously approved by the Commission [Footnote: Holding Company Act Release Nos. 4735 and 5481] providing for the retirement of its first mortgage bonds out of the proceeds of such sales and for the maturity extension of Central States 5 percent debentures The assets of the company now consist only of cash, which will be distributed to the remaining security holders of Central States after the Commission and the Federal enforcement court determine the rights of the various classes of security holders, including the issue of whether the securities of Central Slates held by Ogden should not be subordinated, in whole or in part, to the claims of the public security holders. Interstate has caused the liquidation of its subsidiary, Eastern Iowa Electric Co., and has divested itself of its interest in its wholly owned subsidiary Interstate Power Co. of North Dakota, [Footnote: Holding Company Act Release No. 4440.] and its Bemidji-Crookston properties. [Footnote: Holding Company Act Release No. 5351.]

In an opinion dated May 24, 1944, [Footnote: Holding Company Act Release No. 5062.] and in an opinion and order dated May 27, 1944, [Footnote: Holding Company Act Release No. 5071.] the Commission approved a comprehensive plan of reorganization of Laclede Gas, involving, among other things, substantial reduction in the debt of Laclede Gas, the elimination of preferred stock arrears, the conversion of its outstanding preferred and common stocks into a single class of stock, and the divestment by Ogden of its interest in Laclede upon consummation of the reorganization. The Commission also approved that portion

of the plan which provided for the discharge and satisfaction of the company's bonds by payment in cash of their full principal amount but without the premium payable in the event of voluntary redemptions, the Commission finding that the retirement of the bonds was not " voluntary" but was due to the compulsion of Section 11 of the Act. The order of the Commission approving the plan was confirmed in an opinion handed down on August 25, 1944, by Judge Hulen of the United States District Court for the Eastern Division of the Eastern District of Missouri. Since certain of the holders of such bonds had indicated their intention to appeal from the Commission and the court's decision in regard to the nonpayment of the redemption premiums, Laclede Gas, in order to consummate the plan while such appeals were pending, amended the plan to provide for the deposit in escrow of sufficient funds to pay such premiums in the event that it should be ultimately determined that the premiums were due and payable. By order dated December 2, 1944, the Commission approved the plan as so amended [Footnote: Holding Company Act Release No. 5429.] and on December 4, 1944, the Federal court entered its findings and order approving the plan as so amended.

21. Lone Star Gas Corp.

On March 4, 1942, the Commission instituted proceedings under Section 11 (b) (1) with regard to the Lone Star Gas holding company system and consolidated such proceedings with a plan filed by Lone Star under Section 11 (e) providing for a comprehensive system reorganization. By order dated October 22, 1942, the Commission approved such plan and directed Lone Star to divest itself of its interests in Council Bluffs Gas Co., Northern Natural Gas Co., and the Galveston and El Paso Gas properties of Texas Cities Gas Co. Prior to the past fiscal year Lone Star effectuated the major portion of its reorganization program including the mentioned divestments and during the year consummated the remainder of its plan. [Footnote: Holding Company Act Release Nos. 4783 and 4812]

As a result of the effectuation of its Section 11 (e) plan, Lone Star's operations are now confined to an integrated natural gas system, including production, transmission, and distribution facilities. Its corporate structure has been greatly simplified; the Delaware holding company (Lone Star Gas Corp.), has been eliminated, and, in place of five operating subsidiaries, the system now consists of a single transmission and distribution company (Lone Star Gas Co., a Texas corporation) which has only one subsidiary (Lone Star Producing Co., also a Texas corporation) operating all the production facilities of the system. Lone Star's capitalization now consists only of bank loans and a single class of common stock. In addition, pursuant to its plan, Lone Star eliminated approximately $20,000,000 of questionable items from its combined property accounts. The company was the first major holding company system to comply

completely with Section 11 (b) and is now no longer subject to the Act as a holding company.

Part VIII

THE COMMISSION'S FIRST DECADE IN THE COURTS

INTRODUCTION

This review of the Commission's first 10 years in the courts summarizes the Commission's efforts to effectuate the policies of the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940. [Footnote: A detailed review of the significant decisions has been given in the chapters relating to each of the statutes administered by the Commission. A tabulation of the cases indicating the sections of the statutes involved is given in appendix table 32.] Enforcement of the provisions of the Trust Indenture Act of 1939 and the Investment Advisers Act of 1940 has been well-nigh entirely a matter of administrative procedure, with an almost complete absence of court review or court enforcement.

The greater portion of the Commission's work in administering those statutes never reaches the courts. Thus, in the administration of the 1933 and 1934 Acts, general rules, opinions and orders, interpretative opinions, and full and free communication with the Commission and its staff, enable all those concerned with the issuance and marketing of securities to avoid violations; while investigations, and even knowledge of the prospect of investigation, deter as well as disclose offenses. In the administration of the Holding Company Act the day-to-day regulation of the activities of holding companies is mainly a matter of licensing transactions which meet the standards of the Act. Indeed, most of the Commission's formal orders have not been challenged in the courts, either because the orders granted the relief sought by the persons who might have been aggrieved by an adverse order, or because what would otherwise have been disputed issues were satisfactorily adjusted at the administrative level, before the orders were issued. Thus, although the Commission has issued more than 2,000 formal orders under the Acts, only about 100 petitions for review have been filed, and approximately half of those were dismissed on motion or stipulation of the parties before decision on the merits.

Through the cases in which it has participated, the Commission has obtained a basic set of precedents interpreting its statutory powers and duties. Many of these cases have not only affected the Commission's own work but have also played a significant part in the development of general administrative and corporate law.

GENERAL RESULTS

By June 30, 1944, the Commission had instituted 508 civil actions under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. These were for the most part actions in the Federal district courts to enjoin apparent or threatened violations of the Securities Act and Securities Exchange Act; the balance included district court proceedings to enforce subpoenas issued in the course of investigations under the Securities Act and the Securities Exchange Act, applications to carry out voluntary plans of compliance with the corporate integration and simplification provisions of the Holding Company Act, and a small number of miscellaneous legal proceedings. Of these cases, 479 were closed and 30 were still pending at July 1, 1944.

During the same period, 188 legal proceedings were instituted against the Commission. The actions against the Commission were principally petitions for review in the circuit courts of appeals and the Court of Appeals for the District of Columbia of Commission orders under the Securities Act, the Securities Exchange Act, the Public Utility Holding Company Act, and the Investment Company Act, and Federal district court proceedings to enjoin enforcement of those acts and subpoenas issued by the Commission in investigations thereunder; the remainder comprised a small number of miscellaneous actions in State and Federal courts against the Commission or its officers. Of the foregoing actions against the Commission, 169 were closed and 19 were still pending at July 1, 1944.

In the private suits in which the Commission was permitted to appear as intervener, and in various cases wherein the Commission participated as *amicus curiae*, the Commission undertook to defend the constitutionality of the Acts, to express its views as to the respective fields of jurisdiction of the Commission and the courts, and to obtain judicial interpretation of the Acts, rules and orders involved in such suits, consonant with the public interest.

The record of civil actions in Federal district courts instituted by and against the Commission (including the intervener and *amicus curiae* cases) comprises more than 500 cases, of which only 10, or less than 2 percent, resulted in adverse decisions.

In addition to these cases, approximately 100 proceedings for judicial review of Commission orders have been instituted in the circuit courts of appeals and the Court of Appeals for the District of Columbia. Of these proceedings, which are actually original suits filed in those normally appellate courts, 84 cases resulted in either denial of the objections raised on the merits or dismissal of the petition on

motion or stipulation of the parties, [Footnote: The dismissal of review proceedings by stipulation or on motion of the petitioners (about 50 cases) is considered as a tacit upholding of the Commission's order, since in such cases the effect is to leave the Commission's order unreversed and required to be carried out. Court orders affirming Commission orders on the merits and, as well, those dismissing petitions for review on motion of the Commission on legal grounds not going to the merits, are considered alike as upholding the Commission's position, since in both situations the result is that the Commission's order finally stands unreversed. Motions to dismiss not granted by the courts are not reversals, however, since in all such cases the court proceeds to consider the case on the merits, and it is that final decision which affirms or sets aside the Commission's order] 13 cases are still pending, [Footnote: One of the 13 cases still pending is *Engineers Public Service Company* v. *S. E. C.*, 138 F. (2d) 936 (App. D. C., 1943), wherein although the major portions of the Commission's divestments order were upheld by the court of appeals, the order was actually set aside on one point relating to the Commission's interpretation of the "other business" clauses of the Holding Company Act. This case is treated as pending since the Supreme Court has granted certiorari on the petitions of both the Commission and the company. No action has been taken by the Court, however, to set the case for hearing.] and only 3 concluded cases have resulted in decisions setting aside the Commission's orders in whole or in part. [Footnote: In *Lawless* v. *S.E.C.*, 105 F. (2d) 574 (C.C.A. 1, 1939), the court set aside a Commission order which sought to grant relief requested by International Paper & Power Company, although the company was not then registered under the Holding Company Act. In *Charles C. Wright* v. *S.E.C.*, 112 F. (2d) 89 (C.CA. 2, 1940), the court set aside a Commission order expelling Wright from various securities exchanges for violation of the antimanipulation provisions of the Securities Exchange Act. In a subsequent case, *Wright* v. *S.E.C.*, 134 F. (2d) 733 (C.C.A. 2, 1943), which is included among the 84 review proceedings wherein the Commission's orders were upheld, the circuit court of appeals sustained the Commission's order of expulsion which was issued upon a rehearing of the same charges against Wright. In *S.E.C.* v. *Chenery Corporation, et al.*, 318 U.S. 80 (1943), the Supreme Court held that the Commission had erred in relying on equity precedents for its decision that managers of a registered holding company could not profit through a reorganization under the Holding Company Act with respect to stock purchased by them during the course of the reorganization. The Commission's order was set aside and in February 1945, the Commission issued its findings, opinion and order reaffirming its prior decision. At this writing, the time for review has not yet expired. This proceeding is not treated as a pending case, since it is not pending before a court.]

Appellate litigation under the statutes administered by the Commission involved appeals to the circuit courts of appeals from judgments of the Federal district courts in civil cases brought by and against the Commission and in criminal

cases prosecuted by the Department of Justice. Of 50 appeals in civil cases instituted by or against the Commission, the records disclose the successful outcome of 43 appeals. Only three appellate decisions resulted in reversal of lower court judgments favorable to the Commission, and four appeals are still pending. [Footnote: In civil appeals from injunctions obtained by the Commission, the occasional instance of an affirmance as to only some of the defendants does not reflect failure of the Commission's efforts to prevent violations of the statutes administered by it but is, rather, a decision that fewer persons than originally considered had actually been proved to have participated in the wrongful acts.]

BASIC QUESTIONS SETTLED

Fundamental, of course, to any consideration of the Commission's record in the courts is the question of how the courts have dealt with issues of constitutionality. Only the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935 have been challenged on constitutional grounds, and, with the exception of one case involving the constitutionality of the Holding Company Act, to which the Commission was not a party, the courts have uniformly sustained the constitutionality of the provisions of these Acts in all cases in which the question has arisen.

The registration, fraud, and investigatory provisions of the Securities Act have been sustained in civil and criminal cases by the Second, Fifth, Sixth, Seventh, Ninth and Tenth Circuit Courts of Appeals and numerous Federal district courts. The Second and Seventh Circuits and the Court of Appeals for the District of Columbia and several district courts have upheld the constitutionality of various provisions of the Securities Exchange Act. While the Supreme Court has not undertaken to pass upon the constitutionality of any of the provisions of the Securities Act or the Securities Exchange Act, it has denied certiorari to review a number of the decisions of circuit courts of appeals upholding those acts in civil and criminal cases.

With respect to the Public Utility Holding Company Act, the Supreme Court has sustained the constitutionality of the registration requirements; the First, Second and Third Circuit Courts of Appeals, the Court of Appeals for the District of Columbia, and at least one Federal district court has upheld the constitutionality of the corporate simplification and integration provisions; and the Eighth Circuit has affirmed on constitutional grounds a criminal conviction for violation of the anti-political-contributions provision of the Act. In three cases the Supreme Court has granted certiorari to settle constitutional questions arising under the corporate simplification and integration provisions of the Holding Company Act and two other cases are now pending on petitions for certiorari, None of these cases, however, has yet been argued before the Supreme Court

Part IX

CRIMINAL PROCEEDINGS

GENERAL

The statutes administered by the Commission provide for the transmission of evidence of statutory violations to the Attorney General, who may, in his discretion, institute appropriate criminal proceedings. As a matter of practice, the Commission, largely through its 10 regional offices, thoroughly investigates all suspected violations and prepares detailed investigation reports which go to the Attorney General whenever the investigations disclose a basis for criminal proceedings. When it is decided to institute criminal proceedings the Commission assigns such of its employees as have participated in the investigation to assist in the preparation of the case for presentation to the grand jury, in the conduct of the trial, and in the preparation of briefs on appeal. Where the investigation discloses violations of statutes other than those administered by the Commission, reference is made to an appropriate Federal or State agency.

Up to June 30, 1944, 342 criminal cases were developed by the Commission and prosecuted by the Department of Justice, and a total of 2,316 defendants were indicted in these cases. Of the criminal cases which have been concluded, 95 percent were successfully prosecuted as to one or more of the defendants named in the indictments. In two-thirds of these cases no trial was necessary because of the entry of a plea of guilty or *nolo contendere*. Sixteen cases resulted in either dismissal of the indictments or in verdicts of not guilty as to all of the defendants.

In cases of appeals verdicts of guilty were reversed as to all defendants in only six cases. With respect to those six cases, however, the Government was successful in five cases in obtaining new convictions on retrial; and while several new appeals were taken they all resulted in affirmance of the convictions. In 59 appeals verdicts of guilty were affirmed, at least as to major defendants. Seven criminal cases are still pending in the appellate courts.

The Commission’s investigations have not been limited to activities in and about the great financial centers, but have extended throughout the Nation. Recently, during the course of a single fiscal year, cases were instituted or tried in approximately 40 of the Federal district courts. In any given year the cases under investigation or being prosecuted included matters affecting investors residing in each of the 48 States.

Most of the cases developed by the Commission involve fraud in the sale of securities. These are prosecuted for the most part under Section 17 (a) of the Securities Act of 1933, and the reach of this statute is indeed considerable, as has been shown, in view of the broad definition given to the term "security." In the last few years there has been a distinct increase in prosecutions under the Securities Exchange Act, particularly Sections 10 (b) and 15 (c). Many of the fraudulent sales were made possible, in part, by the deliberate failure of the promoters to file registration statements and prospectus material with the Commission, as required by the Securities Act. Hence a large number of the criminal cases also charge violation of the registration provisions of that act which appear in Section 5.

TYPES OF CASES

The frauds and other statutory violations encountered by the Commission in its investigations under the various acts are as varied as human imagination and ingenuity can contrive. Many of the cases have entirely novel features or present a new "twist" of one kind or another. As a rule, however, the cases fall into certain broad patterns, set out below:

(1) Express misrepresentations -- The most common type of fraud is the simple promotion based upon express misrepresentations which does not involve any of the complex and refined devices not infrequently employed in securities schemes. The promotion of mining ventures, usually gold mines, and the sale of oil and gas interests frequently present opportunities for perpetration of this type of fraud. Thus, in the case of *United States* v. *Samuel J. Mustain, et al.* (S. D. N. Y.), three individual defendants and four corporate defendants, among the latter a company known as Continental Securities Corp., were convicted in connection with fraudulent sales of oil royalty securities. In the course of such sales it had been falsely represented to investors that they were certain of a definite income for life if they purchased the oil interests; that they could have their money back at any time if not satisfied; that their principal would be fully returned within 2 1/2 years; and that the securities were being purchased by banks.

The alleged fraudulent promotion is also encountered in the exploitation of so-called inventions. Thus, convictions have been obtained in promotions of a new type of revolving top for commercial buildings, *United States* v. *Charles Thelman Rice, et al.* (D. N. M.), and of a vessel said to be capable of attaining speeds of 80 to 100 miles per hour, *United States* v. *Mark L. Gilbert, et al.* (S. D. Ohio). An indictment is currently pending with respect to a pinless diaper promotion, *United States* v. *Philip A. Frear, et al.* (D. C.).

In a number of the mining company cases, securities have been sold by persons resident in Canada and operating from across the border without compliance with

the statutes of this country. The Commission has been cooperating with the State Department and the Department of Justice in efforts to secure a treaty with Canada, which would permit extradition from Canada of persons violating the Federal securities laws and cognate statutes. The treaty was ratified in the United States Senate in 1942, but to date it has not been ratified by the Canadian Parliament.

(2) "Ponzi" schemes -- This type of case, a perennial favorite of the securities swindler, involves the payment of "profits" or "dividends" out of capital. The apparent success of the venture makes the investor susceptible to further investment, a process sometimes colloquially described as "reloading." The "Ponzi" system is a recurrent motif in fraudulent small loan company ventures. Illustrative of these cases is *United States* v. *Dewitt T. Simpson, et al.* (S. D. Ga.), involving Standard System Investment Corp., a holding company which had obtained control of a number of industrial loan companies operating in various cities in Georgia. Prominent business and professional men who were not aware of the scheme were persuaded to act on the board of directors. Actual control, however, was exercised by Simpson and two associates, who made fictitious book entries and paid dividends out of capital, despite lack of real earnings. All three were convicted in 1943, in Savannah, Ga., for violations of the fraud provisions of the Securities Act of 1933, and for other statutory offenses.

The "Ponzi" method is sometimes employed in vending machine promotions. Thus, in *United States* v. *Maurice A. Levine, et al.* (D. Mass.), cigarette and peanut vending machines were sold to investors under a lease-back arrangement whereby the promoters were to operate the machines for the investors on a profit-sharing basis. "Profits" were paid periodically out of capital until the entire structure collapsed, leaving the victims with machines worth far less than they had paid for them. Six defendants pleaded guilty in this case.

(3) "Switch" schemes -- Some individuals sell their victims bona fide securities, thereby cultivating their trust and confidence, and then persuade them to dispose of their holdings and to substitute securities which are frequently worthless. In other cases the scheme is to obtain lists of persons previously sold a security and then induce them to accept a new security in exchange. This "switch" device was one aspect of the fraudulent scheme involved in *United States* v. *John Factor, et al.* (N. D. Iowa), a bottling contract case, in which John (Jake the barber) Factor and a group of confederates, operating through United Bottling & Distributing Co., a Delaware corporation, defrauded some 250 investors to the extent of an estimated $1,000,000. The owners of whisky warehouse receipts were induced to exchange them for bottling contracts, by the terms of which United Bottling was to hold the whisky until it matured, see to its bottling and distribution, and transmit the profits, less a stated service fee, to the investor. In a number of instances, persons who did not own whisky warehouse receipts were

sold such receipts and then “switched” into bottling contracts. United Bottling was a mere paper organization, and the whisky warehouse receipts were sold or hypothecated as soon as possession was obtained. Eleven defendants pleaded guilty and received substantial prison sentences, Factor himself being sent to the Federal penitentiary at Leavenworth for a term of 10 years.

(4) Front money schemes -- This device involves the exploitation of small business enterprises upon a promise to procure for them needed financing. Perhaps the most important of the “front money” cases developed by the Commission was that of *United States* v. *F. J. Hill, et al.* (N. D. Ohio), stemming from an intensive investigation conducted in cooperation with the Post Office Department and the Department of Justice. It was disclosed that, for approximately 6 years, hundreds of enterprises or prospective entrepreneurs had been victimized by the operations of this racket. The victims had been induced to pay advance fees estimated to total some $1,000,000 for various services in connection with incorporation, registration and the preparation of sales literature. This was accomplished by false and misleading representations as to the ability of the respondents to secure financing and capital upon the payment of an advance fee; actually, the investigation failed to disclose a single instance in which a share of stock had been sold or a dollar of capital secured for the victims. Ten persons were convicted in this case.

(5) Bucket shops -- This type of fraudulent activity was the subject of intensive enforcement work in the early days of the Commission, and the “bucket shop” as such has become a comparative rarity. The scheme consists of pretending to purchase securities for a customer on a full payment or margin payment basis, with the broker deliberately failing to acquire the securities; in short, “bucketing” the transaction. In the case of a margin purchase, if the price drops, the customer is “sold out” and the customer’s payment is pocketed. If the customer pays in full, and the price drops, the security is purchased and delivered to the customer. On the other hand, if the price rises the customer is persuaded to sell out and invest in another security. The process is continued until the customer’s funds are depleted. A considerable number of convictions for “bucket shop” activity have been obtained. Examples are *United States* v. *Turivas & Co., et al.* (E. D. La.), and *United States* v. *Harold J. Kattelman, et al.* (E. D. Mo.).

(6) Investment advice -- Dishonest investment advisers range from tipsters with “inside” information to spurious purveyors of purportedly impartial investment services. In the recent case of *United States* v. *John W. Hession* (S. D. N. Y.), a railroad bond trader who wrote a column which appeared as a regular feature in a financial newspaper, was convicted for violations of the fraud provisions of the Securities Act of 1933. The indictment charged that he had pretended to have “inside” information derived from a Government source concerning action to be taken by the interstate Commerce Commission in connection with the

reorganization of a certain railroad, and that by the dissemination of this and other false information, he had induced widespread purchases and caused a rise in the market price of the bonds. Hession's appeal was dismissed.

Another type is epitomized by the case of *United States* v. *Robert J. Boltz* (E. D. Pa.). Boltz, an investment counselor, was a member of the Philadelphia bar and of that city's most exclusive clubs and institutions. He used his name and position to induce some 200 persons to entrust to him more than $2,500,000 in funds and securities. Contrary to agreements with his customers, he ran a margin trading account, executed short sides, and used customers' funds to speculate in securities and commodities for his own account, with very large losses to the customers. Such was the confidence engendered by Boltz in his clients that when, in response to inquiry from customers, Boltz said their funds were being used for his own purposes, the customers assumed he was merely jesting. Boltz pleaded guilty to all counts of an indictment alleging violations of Section 17 (a) of the Securities Act of 1933, Section 15 (a) of the Securities Exchange Act of 1934, and Section 215 of the Criminal Code (mail fraud). He was sentenced to 20 years' imprisonment, the longest sentence ever imposed under any of the Acts administered by the Commission.

(7) Investment trusts -- Abuses in the investment company industry led to the adoption of the Investment Company Act of 1940, as described elsewhere in this report. Prior to that legislation, however, the Commission had initiated successful prosecutions in a number of cases involving investment trusts and their managers. Among these were *United States* v. *Foundation Plan, Inc., et al.* (S. D. N. Y.); *United States* v. *Sidney J. Dillon, et al.* (S. D. Iowa); *United States* v. *S. W. Gongoll et al.* (D. Minn.). In the last-named case, seven defendants were convicted of fraud in connection with the sale of several million dollars face amount of investment contracts and other securities issued by a large number of investment companies, many of them controlled by the defendants. These sales were made on a coast-to-coast basis by S. W. Gongoll & Co. of Minneapolis, and numerous misrepresentations were charged in connection with such sales. When it was forced into bankruptcy, S. W. Gongoll & Co. owed $2,800,000 to its clients and had cash assets of but $4,600.

(8) Fraternal organizations -- The religious beliefs and social proclivities of prospective investors have been utilized as a basis for promotional ventures which were made the subject of prosecution in such cases as *United States* v. *C. F. Davis, et al*. (N. D. Ill.) (Universal Order of Plenocrats), and *United States* v. *H. B. Monjar, et al.* (D. Del.). The latter case involved the Mantle Club, a nationwide fraternal organization with 30,000 members, devoted to moral betterment and other ethical ideals. A deep sense of personal loyalty to Monjar, the founder, was fostered among the membership. Monjar was represented as a financially astute individual who would extend pecuniary benefits to persons proving themselves

worthy. Many of the club's members were induced to make personal loans to Monjar, aggregating some $1,340,000, on the representation that their financial independence in future years would thereby be assured. After trial on charges of violating the fraud provisions of the Securities Act and cognate statutes, Monjar and 10 other defendants were convicted and given jail sentences and fines. Subsequent to the close of the tenth fiscal year, the United States Circuit Court of Appeals for the Third Circuit upheld the convictions.

(9) Manipulations -- The manipulation of securities prices is, generally speaking, another class of fraudulent practice. Any successful manipulation results in a false representation to the investor concerning the value and marketability of a particular security. Manipulation on securities exchanges is specifically outlawed by Section 9 (a) (1) and (2) of the Securities Exchange Act of 1934, and examples of successful prosecution under these sections are *United States* v. *George J. Morrison, et al.* (S. D. N. Y.) which involved "rigging" of the market for the common stock of B/G Sandwich Shops, Inc., on the New York Produce Exchange; *United States* v. *Norman W. Minuse, et al.* (S. D. N. Y) involving a stock "jiggle" in the class A capital stock of Tastycast, Inc., a security listed on the New York Curb Exchange; and *United States* v. *David A. Smart, et al.* (N. D. Ill.), involving manipulation in the common stock of Esquire-Coronet, Inc., on the New York Curb Exchange.

Manipulation in the over-the-counter markets have been successfully prosecuted, under the antifraud provisions of the Securities Act of 1933, in such cases as *United States* v. *M. D. Haynes, et al.* (E. D. Mich.), involving a secondary distribution of a refining company stock to the public through a firm of over-the-counter dealers in Detroit, Mich.; and *United States* v. *James H. Collins, et al.* (S. D. Cal.), involving the sale of stock of Union Associated Mines of Salt Lake City, Utah. Appeals are pending in the latter case.

Over-the-counter manipulation was also involved in *United States* v. *Edmond B. Bronson, et al.* (S. D. N. Y.), in which convictions were obtained in connection with the sale of a mining company's treasury stock at artificial prices greatly in excess of the amount the company received from those distributing the stock. The Circuit Court of Appeals for the Second Circuit sustained the convictions on December 14, 1944, holding that the sale of treasury stock was, for practical purposes, like the sale of a new issue, and that the practice of charging prices far in excess of what the company was to receive was per se a fraud on those to whom the stock was sold.

(10) Broker-dealer cases -- While manipulation cases can and sometimes do involve brokers or dealers, they are not limited to such persons, and others have been successfully prosecuted for manipulation. On the other hand, there are a number of statutory offenses peculiar to brokers and dealers. Thus, the

hypothecation of customers' securities in contravention of Section 8 (c) of the Securities Exchange Act of 1934 was the basis for two convictions in *United States* v. *F. F. Morrison, et al.* (N. D. Cal.), while violation of the margin provisions of that Act and excessive trading in a discretionary customers' account resulted in a conviction in *United States* v. *Russell W. McDermott* (S. D. Ind.). The Circuit Court of Appeals for the Seventh Circuit affirmed the latter conviction in an opinion reported in 131 F. (2d) 313, upholding the constitutionality of the margin provisions. Certiorari was denied by the United States Supreme Court in 318 U. S. 765.

During the last fiscal year, convictions were obtained in *United States* v. *Otto B. Dagg, et al.* (W. D. Wash.), the first *criminal* case in which fraud in the sale of securities was predicated upon sales by securities dealers to their customers at prices not reasonably related to the prevailing market prices, without appropriate disclosure. Indictments based on the same theory of fraud were returned during the fiscal year in *United States* v. *Guaranty Underwriters, Inc., et al.* (S. D. Fla.), and *United States* v. *Florida Bond and Share, Inc., et al*. (S. D. Fla.). Another case during the fiscal year marked the first instance of a successful criminal prosecution for the failure of a broker-dealer to keep books and records in the manner prescribed by the Commission pursuant to Section 17 (a) of the Securities Exchange Act of 1934, *United States* v. *Samuel S. Alexander* (S. D. N. Y.).

OTHER IMPORTANT CASES

One of the outstanding cases of the past 10 years, and probably the most spectacular, was the McKesson & Robbins case (*United States* v. *F. Donald Coster, et al.* (S. D. N. Y.)). The enormous fraud perpetrated by Philip M. Musica, alias F. Donald Coster, president of McKesson & Robbins, together with certain co-conspirators, attracted widespread attention. The effect of the case upon auditing practices is discussed in the accounting section of this report. Some $21,000,000 of the listed assets of the company, representing close to one-fourth of its total book assets, were discovered to represent a wholly fictitious foreign crude drug business. Through the medium of this fictitious enterprise large sums were allegedly siphoned from the corporation. Philip M. Musica committed suicide. Seven persons were convicted, including Musica's three brothers, George, Arthur, and Robert. Among the statutory violations upon which the case was based were the filing with the Commission and the New York Stock Exchange of false reports and statements in violation of Sections 13 and 32 of the Securities Exchange Act of 1934. The comptroller of the company, who was also convicted, appealed, contending, among other things, that the reporting provisions of the Act and the Commission's regulations and rules thereunder were unconstitutional. The Circuit Court of Appeals for the Second Circuit

affirmed the conviction, without opinion. *United States* v. *McGloon*, 116 F. (2d) 285, cert. denied, 312 U. S. 702.

Section 12 (h) of the Public Utility Holding Company Act of 1935, which forbids political contributions by utility holding companies and their subsidiaries, was involved in *United States* v. *Union Electric Company of Missouri and Louis H. Egan* (E. D. Mo.). An intensive investigation by the Commission resulted in the conviction of Union Electric Co. of Missouri for violation of that Section and for conspiracy to do so, while Louis H. Egan, its president during the period involved, was convicted on the conspiracy count alone. The convictions were sustained in *Egan* v. *United States*, 137 F. (2d) 369 (C. C. A. 8, 1943), certiorari denied, 320 U. S. 788. The Commission's investigation had disclosed the long existence of a "slush fund" which was accumulated through various artifices, such as the padding of expense accounts, kickbacks on legal fees, and payments to contractors and insurance agents. Three officials of the company were convicted for perjury in connection with their testimony before the Commission investigators.

Fraudulent practices in the development of a large public utility holding company system were involved in *United States* v. *Howard C. Hopson, et al.* (S. D. N. Y.). Hopson was the leading figure in the Associated Gas & Electric system, which mushroomed in the 1920's until it comprised companies rendering services to a population of over 7,000,000 persons in more than 6,200 communities in some 20 States and the Philippine Islands. The acquisition of those holdings was largely financed by the sale to the public of securities of Associated Gas & Electric Co. and subsidiary companies to the extent of $1,000,000,000. The outcome of this venture is discussed more fully in the section of this report dealing with the administration of the Holding Company Act. Hopson was indicted and convicted for violation of the mail fraud statute and sentenced to 5 years' imprisonment.

Dishonest promoters have sometimes sought to organize chains of "investment" offices, as in the case of *United States* v. *John J. Burke, et al.* (N. D. Ga.), affirmed in part and. reversed in part, *sub nom. Kopald-Quinn & Co.* v. *United States*, 101 F. (2d) 628 (C. C. A. 5, 1939), certiorari denied, 307 U. S. 628. The scheme in this case involved the organization or acquisition of investment firms and corporations, among them Kopald-Quinn & Co., which would maintain offices in various cities and places for the sale, at retail, and on the partial payment plan of stocks which were more or less worthless.

The case of *United States* v. *B. F. Buckman, et al.* (W. D. Wis.) involved fraudulent practices in connection with the operation of B. E. Buckman & Co., one of the largest security firms in the Middle West. Buckman and Louis C. George, officers of the firm, had organized and dominated the affairs of a number

of corporations and sold the stock of certain of these corporations to their customers at a time when the issuing companies were insolvent. Both Buckman and George were convicted and sentenced to terms of imprisonment.

United States v. *Central Securities Corporation, et al.* (N. D. Ind.) was a successful prosecution in connection with a fraudulent scheme for the redemption of municipal bonds issued by the cities of Gary, Hammond, and East Chicago, Ind. A registered broker-dealer known as Central Securities Corporation, induced its customers to surrender their bonds at from 25 to 70 percent of their values, on the representation that purchasers had been found who were willing to pay such amounts, which were the best prices that could be obtained. These bonds were thereafter redeemed in full through the intercession of the then treasurer of Lake County, Ind., in return for the payment to him of bribes totaling 20 percent of the aggregate amount of principal and interest received by the corporation in the redemption of the bonds. All the defendants in this case, including the county official, were convicted upon pleas of *nolo contendere*.

Part X

ACTIVITIES OF THE COMMISSION IN THE FIELD OF ACCOUNTING AND AUDITING GENERAL

The several Acts administered by the Commission empower it to prescribe rules and regulations with respect to the form and content of financial statements to be filed and the accounting principles and auditing practices to be observed in their preparation. During the past decade the Commission has had to examine critically more than 80,000 sets of financial statements. These statements reflect the financial affairs of all kinds and sizes of companies, including commercial, industrial, financial and utility companies, as well as security brokers and dealers. Under the 1933 Act and 1934 Act financial statements are filed primarily for the benefit of the investing public. In other cases, notably under the 1935 Act, financial statements constitute, in addition, an important segment of the information on which the Commission bases its regulatory actions.

The past 10 years witnessed a major acceleration in the rate of development of accounting. Under the impact of forces generated by the preceding financial debacle and evidenced by the Securities Acts, fundamental changes have been made in the approach of companies and their accountants toward their accounting problems. Accountants' public responsibilities have been recognized mere fully and they have assumed new and heavier responsibilities under the Securities Acts. As a result, during this period, public accountants have sought to free themselves from any stigma of managerial influence in their selection or

approval of accounting principles and in the determination of the proper scope of their examination. Furthermore, the profession has had to seek a "philosophy of accounting" for the purpose of establishing the rationale of its principles and eliminating to the fullest extent possible, the conflicting and irreconcilable treatment of identical transactions. Finally, this period was characterized by acceptance of the need for full disclosure in financial statements. Brief and uninformative balance sheets, income statements that revealed little more that the net profit for the period, and the failure to supply adequate supplementary data and explanatory footnotes became accepted ground for a refusal to certify. Concomitantly with an increase in the public interest in the profession of accounting, there has been a growth in emphasis on standards of professional conduct.

The Commission's efforts to improve financial statements through exercise of its statutory powers have resulted in the adoption of a basic accounting regulation governing the form and content of most of the financial statements currently filed under the Securities Acts, the promulgation of uniform systems of accounts for public utility holding companies and service companies, the detailed consideration of particular cases culminating in some instances in formal Commission opinions, and the issuance of a number of opinions on accounting matters by the Commission's Chief Accountant.

At all times, the Commission has drawn heavily on the experience and counsel of the accounting staffs of the companies filing with it, as well as professional associations of accountants and individual accountants. Cooperating committees and governmental agencies interested in the problems of accounting, auditing, and standards of professional conduct have been particularly active in this work and have contributed substantially to the progress that has been made.

It is the purpose of this section to review the principal lines of development and to note the various landmarks which reflect progress achieved.

ACCOUNTING PRINCIPLES AND PRACTICES

A notable development of the past decade in the field of accounting has been the growth of a body of authoritative literature with respect to accounting principles. At the time the Commission was established there was no way of determining the propriety of any accounting principle or practice with any degree of finality or authority. In recent years, however, accounting classifications issued by various regulatory agencies, the Commission's accounting rules, decisions and opinions and comprehensive statements on accounting principles issued by professional accounting societies have resulted in the establishment of improved accounting standards and have clarified the application of these standards to numerous questions on which accountants had held divergent opinions for many years.

[Footnote: In 1936 the American Accounting Association issued a "Tentative Statement of Accounting Principles Affecting Corporate Reports." This bulletin was revised in 1941. The Committee on Accounting Procedure of the American Institute of Accountants instituted a series of bulletins in 1939 known as Accounting Research Bulletins. This series now comprises more than 20 bulletins.] This progress is of the greatest significance to persons who rely on financial statements. The several Acts administered by the Commission have made possible a further contribution - the express sanctions of these acts have provided an effective means of securing general adherence to the standards developed.

The Commission has established requirements as to the form and content of financial statements filed under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. While these requirements are comprehensive, they do not seek to prescribe in every situation the accounting practices to be followed or the disclosures to be made of business transactions. Instead the Commission has required that generally accepted accounting principles be followed in recording the many transactions not specifically covered by its rules. For the most part the Commission's accounting requirements under these Acts have been integrated into a single regulation, Regulation S-X. This regulation, promulgated in 1940, superseded the accounting requirements contained in the various individual reporting forms and has proved to be a most helpful simplification in the Commission's reporting requirements.

These accounting rules and regulations of the Commission have evolved under the influence of decisions in particular cases, and discussions and correspondence with registrants and their accountants. Some of these cases have been the subject of formal Commission decisions and mark significant progress made in this decade. Inflated asset valuations, improper determinations of income, overstatements of contributed capital or accumulated earned surplus, as well as other accounting improprieties, have been found in various cases formally decided by the Commission. A comprehensive review of these formal decisions would not be feasible, but specific mention should be made of several cases in which the Commission found that the financial statements were in large part misleading and deceptive devices employed for the purpose of benefiting persons in control of the reporting company. In In the Matter of Resources Corporation, International the registrant served as a medium by which the controlling officer was able to unload large amounts of his holdings of the company's stock on the public. Tire financial statements did not disclose the enormous profits this officer was reaping from these sales nor did they adequately disclose the character of the inflated valuations which had been reflected in the balance sheet and which contributed to the carrying out of his scheme. Another such case was In the Matter of Associated Gas and Electric

Company. This company was the top holding company in a public utility holding company system which ultimately collapsed after financial frauds had been committed which cost investors millions of dollars and sent the principal perpetrator, Howard C. Hopson, to the penitentiary. In its decision the Commission severely criticized the accounting practices that had been employed by the company in its financial statements for the years 1934 through 1937. The Commission felt that the principal purpose of these financial statements was to mystify, baffle, mislead, and conceal, and found that the statements failed to give any indication of the fraudulent transactions that had been effected and the inconsistent and improper accounting practices that had been followed. Another case involving fraudulent financial statements was that of McKesson-Robbins, in which a wholly fictitious crude drug business provided a vehicle by which the perpetrators of the fraud were able to siphon away from the company several million dollars in cash.

These several cases were important because of the size of the companies involved, the large public interest therein, and the scope of the accounting problems involved. There were, however, numerous cases of smaller dimensions that came before the Commission during this ten-year period. The stop orders or delisting orders that have been issued in such cases represent an important service that has been rendered to the investing public.

In addition to its rules, regulations, and decisions on accounting matters, the Commission has authorized the issuance of releases in an Accounting Series to serve certain specialized purposes. They afford a medium for making known to registrants and to the public established Commission policy on particular accounting questions. Such policy determinations should not be the privileged knowledge of a favored few registrants or their advisers, but instead should be made available to the fullest possible extent to all who have dealings with such an agency. Accounting Series releases constitute the Commission's principal instrument, other than its formal decisions and reports, for informing the public as to its basic policy in accounting matters. These releases have also been valuable in dealing with specialized types of cases which are so unusual or complex that establishment of a general and inflexible rule is deemed inadvisable. The disclosure requirements of the Commission have also influenced the character of the financial statements included in annual reports to stockholders. The financial collapse in 1929 was in no small measure traceable to the fact that investors had been inadequately and, in many instances, incorrectly informed about the affairs of the companies in whose securities they were investing. Annual reports that had been furnished to stockholders were often uninformative; but ordinarily no other source of reliable information was open to those not on the "inside." The Securities Acts were a direct result of this system of inadequate disclosure. Another result was that an increasing number of business men and accountants recognized the need for furnishing stockholders with adequate financial

information. The influence of these individuals has been felt but it seems clear that the rapidity and pervasiveness of the improvements in financial reporting that have occurred in the past 10 years have in no small measure arisen because fairly complete financial statements had to be filed publicly with the Commission.

The Public Utility Holding Company Act of 1935 gave the Commission the power to regulate the accounting and record-keeping practices of public utility holding companies and certain subsidiaries and affiliates thereof. Pursuant to this authority the Commission in 1937 promulgated uniform systems of accounts for public utility holding companies and their mutual and subsidiary service companies. Until then, such companies had generally been free from regulation by State or Federal utilities commissions. These systems of accounts represented a first step in attempting to introduce uniformity into the accounting of these companies to the extent that they were subject to the jurisdiction of this Commission.

In administering the Public Utility Holding Company Act of 1935 the Commission has decided many cases involving accounting problems of all degrees of complexity. One of the most significant of these cases, accountingwise, was In the Matter of Associated Gas and Electric Corporation. [Footnote: 6 S.E.C. 605 (1940). At a later date the Commission issued an opinion under the 1934 Act in which it discussed similar and related accounting questions.] It was in this case that the Commission first discussed at length the nature and accounting implications of a quasi-reorganization, a procedure by which a company, among other things, eliminates a deficit in its accumulated earnings and establishes a new point of departure for the accumulation of an earned surplus account. Other decisions of the Commission under the Public Utility Holding Company Act of 1935 have dealt with a great variety of accounting matters, including the accounting treatment to be accorded investments under various circumstances, proper accounting for fixed property in mergers or otherwise, and proper accounting for the constituent elements of capital stock and surplus.

Under, the Securities Exchange Act of 1934 the Commission is empowered to prescribe the books and records that shall be kept by security brokers and dealers and to require these persons to file periodic reports. In 1939, after long study and consultations with a large number of individuals and all interested organizations, the Commission, in collaboration with the State blue sky commissions, devised and prescribed rules relating to the business records that must be maintained by broker-dealers subject to its jurisdiction. Also the Commission in 1942 promulgated . financial reporting form for these firms. Subsequently a number of State regulatory bodies and national securities exchanges have either adopted this form or have indicated their willingness to accept it in satisfaction of their reporting requirements for brokers and dealers,

thereby effecting a considerable saving in effort and expense for the reporting firms.

The various rules, regulations, decisions, and other releases on accounting questions that have been referred to above represent the more readily observable results of the Commission's activities in accounting matters. Underlying this outward evidence is a large amount of research and critical review of experience directed toward the establishment of sound policies on accounting matters. The largest part of the Commission's accounting work, however, consists of the critical examination of financial statements filed with it for the purpose of ascertaining whether these statements appear to be acceptable or whether specific deficiencies should be cited against them. As pointed out above, this procedure and the resulting conferences with registrants have been powerful factors in improving the quality of financial statements filed with the Commission as well as financial statements prepared for other purposes.

AUDITING PRINCIPLES AND PRACTICES

Financial statements included in a registration statement or annual report filed under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940 must in most instances be certified by an independent public accountant. Such a certification, if it is to provide adequate assurance that the financial statements fairly present the affairs of the company, must be based on an impartial and expert review of the financial statements and the underlying records and procedures. Such certification of financial statements, based on a reasonably comprehensive audit of the underlying books and records, is one of the principal services rendered by the public accounting profession and operates as an important line of defense against intentional or inadvertent misstatements or omissions in financial statements prepared by management.

The accountant's certificate in general use at the time the Commission was organized did little more, in describing the scope of the audit made, than to refer to the fact that the accountants had examined or tested accounting records of the company. There was no listing of detailed procedures employed. Moreover, no authoritative accounting literature existed which clearly indicated the type of auditing procedures normally employed by certifying accountants. [Footnote: In 1936 the American Institute of Accountants published a bulletin, "Examination of Financial Statements by Independent Public Accountants," which sketched briefly the general outline of an acceptable examination. This bulletin was an enlargement and revision of a bulletin which was first published in 1917 by the Federal Reserve Board and was revised and republished in 1929 under the joint sponsorship of the Federal Reserve Board and the American Institute of Accountants.]

Initially, the Commission accepted the customary certificates under the sanctions of the several Acts. This course of action placed nearly the entire responsibility for the adequacy of auditing procedures in the express sanctions of the Act under which a certificate was filed. As a result, auditing procedures were subjected to Commission inquiry only in cases in which evidence came to light that the financial statements had been improperly drawn or carelessly certified. In these particular cases, through field investigations, hearings, and conferences with the registrant and its accountants, the Commission ascertained the adequacy of the auditing procedures that had in fact been followed.

The early experience with financial statements filed with the Commission appeared to justify this approach. There were only a few cases in which particular accountants were criticized for a failure to follow necessary auditing procedures or for a failure to disclose in their certificates various improprieties in the financial statements being certified or inadequacies or limitations in the scope of the audits on which their certificates were based. Of special significance was the Interstate Hosiery Mills case in which the Commission set forth its views as to the relative responsibilities of a registrant and a certifying accountant in assuring the accuracy of financial statements. The Commission stated in its decision that the fundamental and primary responsibility for the accuracy of information filed with the Commission rests upon management, and the employment of independent public accountants, however reputable, is not a substitute for management's accounting of its stewardship but, instead, serves as a check on that accounting.

That is not to say that the responsibilities of the certifying accountant are in any way lessened. The accountant has duties and responsibilities of an order distinct from those of management. As the Commission pointed out in In the Matter of Cornucopia Gold Mines (4 S.E.C. 706 (1939)), an accountant's certificate performs the high function of giving meaning and reliability to financial statements and of increasing the likelihood that those statements will not be misleading or untrue. In short, when the accountant submits his certificate he takes full responsibility for the opinions expressed therein with respect to the propriety of the financial statements.

These early cases scarcely presaged the developments that grew out of the fraud perpetrated by Coster-Musica and others in the McKesson-Robbins case. The fact that, notwithstanding an annual audit by a reputable firm of certifying accountants, officials of this company had through collusive machinations been able to milk the company of millions of dollars, overstate its assets by almost $20,000,000 and each year report large profits from the operations of a nonexistent crude drug business, raised serious doubts as to the adequacy of existing auditing procedures. As a result of the Commission's preliminary

investigation it issued an order directing that public hearings be held to inquire into the auditing aspects of the case.

Disclosure of the fraud resulted in an unprecedented public interest in the adequacy of the protection afforded investors by the certification of financial statements. It also engendered serious and searching discussions in professional accounting circles. As the facts of the case unfolded, it became apparent that the fraud could not have been perpetrated had the accountants physically inspected inventories and corresponded directly with debtors to confirm amounts reported as accounts receivable. The testimony of expert witnesses at the Commission's hearing indicated that these procedures, while frequently employed and generally recommended by accountants, were not considered normal and necessary procedures by the accounting profession. However, several months later the membership of the American Institute of Accountants, in an action directly traceable to the impact of the McKesson-Robbins case, approved a statement entitled "Extensions of Auditing Procedure" which contained the recommendation that physical inspection of inventories and confirmation of receivables should thenceforth be considered standard auditing procedure.

At the conclusion of its hearings the Commission published a transcript of the testimony of the expert witnesses and a report on its investigation. In its report the Commission found that the accountants bad "failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking." Also the Commission recommended a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined would be to a greater extent checked by the auditors through physical inspection or independent confirmation. Particularly it was the Commission's opinion "that auditing procedures relating to the inspection of inventories and confirmation of receivables, which, prior to our hearings, had been considered optional steps, should, in accordance with the resolutions already adopted by the various accounting societies, be accepted as normal auditing procedures in connection with the presentation of comprehensive and dependable financial statements to investors."

Another direct result of the McKesson case was a thorough overhauling of the accountant's certificate with a view to clarification and improvement. The bulletin, "Extensions of Auditing Procedure," contained certain recommendations in this regard. However, the Commission's report on the McKesson investigation recommended far-reaching changes which were adopted in Accounting Series Release No. 21 as an amendment of Regulations S-X. The new rules required the certifying accountant to add certain clear-cut representations to his certificate. He was thereafter called upon to make a positive representation as to whether the audit he performed was in conformity with generally accepted auditing

standards applicable in the circumstances -- that is, was at least equal in the scope of procedures followed and the manner of their application to that which other professional accountants would consider essential in the circumstances. In order to assure that audit programs would be well suited to the circumstances of particular cases the certifying accountant was also called upon to state whether any procedure had been emitted which in his own individual judgment should have been employed. It was further required that departures from “normal” procedures should be expressly described. This approach was adopted in preference to its alternative, the enumeration of the specific procedures followed, since the latter would result in a cumbersome catalog of technical phrases of little value to the ordinary investor in indicating the adequacy of the audit. On the contrary, the disclosure of specific “normal” procedures that have been omitted and disclosure of supplementary procedures employed, together with the reason therefore, is a most practicable and helpful means of characterizing the scope of the audit performed by the certifying accountants.

These requirements with respect to accountants’ certificates were of course, mandatory in certificates filed with the Commission but were not at first generally observed in certificates prepared for other purposes. However, about two years later the membership of the American Institute of Accountants voted in favor of eliminating this “double standard” in accountants’ certificates and adopted the substance of the Commission’s requirements.

Subsequent to the McKesson case the Commission issued a number of decisions in which it criticized auditing practices of particular accountants. Of these more recent cases the two of outstanding significance were In the Matter of Resources Corporation International and In The Matter of Associated Gas and Electric Company. In the Resources case, decided in 1940, the Commission found that a representative of the certifying accountants had at one time entertained serious doubts as to the legitimacy of the operations of the registrant and had communicated those doubts to the supervising partner of the accounting firm. The Commission found that the certifying accountants failed in the performance of their duties by not extending their examination to resolve these doubts. The Commission also found that the certifying accountants were at fault in that they were aware of certain additional facts which were of material significance to investors but which were not disclosed.

The Commission also criticized the accountant’s certificate furnished in the Resources case. The certificate exempted from its purview all but $35,000 of assets out of total stated assets of mere than $9,000,000. The Commission held that such a report is not a “certificate” within the meaning of the Commission’s rules. In 1939 the American Institute of Accountants adopted a similar position, stating that an accountant should not express an opinion on financial statements if his exceptions or reservations are so material as to negative his opinion.

In In the Matter of Associated Gas and Electric Company the Commission severely criticized the work of the certifying accountants. The Commission found in this case that the audits were inadequate in scope. Moreover, the opinions expressed in the accountants' certificate were not clear and were so qualified by exceptions and explanations as to render those opinions nugatory. As stated above, the Commission was of the opinion that the financial statements filed by the registrant were principally intended to mystify, baffle, mislead and conceal. The Commission went on to say that the audits and certificates of the accountants did nothing to prevent the accomplishment of that purpose.

The most recent developments in the field of auditing have related primarily to new and serious problems that have arisen as a result of the war. All concerned with auditing problems are agreed that high standards of auditing procedure must be maintained and that the progress recently achieved must not be lost. A principal difficulty has been the less by most accounting firms of trained personnel to other phases of the war effort. Furthermore, a similar loss of accounting personnel by private business, frequently coupled with a large new volume of war work, has meant that internal accounting and auditing controls upon which the public accountant must rely in many respects, have in many instances suffered and hence, with a smaller or less experienced staff, the public accountant may often be faced with the necessity of being even more painstaking in his audit.

Members of the Commission's staff have cooperated with registrants and public accountants in exploring various means of meeting the situation and specific proposals have been put into effect. Study of these problems continues and, as occasion warrants, informal conferences are held with individual accountants and with the appropriate committees of professional societies.

STANDARDS OF PROFESSIONAL CONDUCT

The maintenance of high standards of professional conduct on the part of the public accountants who certify financial statements is a matter of the utmost importance to persons who rely on these statements. The reader of a financial statement has a right to expect that the certifying accountant has done his work expertly and impartially and that his opinion as to the financial statements is forthright and unbiased. Organizations of professional accountants have recognized the importance of high standards of professional conduct and have established certain self-disciplines for the purpose of protecting the interests of third persons and to help insure that the accounting profession will continue to merit the confidence and trust that has been placed in it.

One cornerstone of proper professional conduct is that the accountant shall be independent of the client whose financial statements he certifies. This view has long been held by many individual accountants but was explicitly introduced in the Securities Act of 1933 as a necessary prerequisite to the certification of financial statements filed under that Act. This need for independence has also been given statutory recognition in the other principal acts administered by the Commission. The goal of such a principle is obvious -- the accountant's opinion, if it is to be valuable to the reader of financial statements, must be arrived at objectively and expressed impartially.

The problem of deciding whether or not an accountant is independent in a given case is often most difficult and has been the subject of a number of releases and decisions. Some persons have contended that the independence of an accountant should not be questioned unless there is evidence in the form of misstatements or omissions that his opinion is not honest and impartial. The Commission, however, has viewed the requirement of independence not only as a safeguard against conscious falsification but also as a preventive of impalpable and impalpable biases in the exercise of his professional judgment which may arise as a result of incompatible interests or relationships. Consequently, the Commission has found an accountant to be lacking independence with respect to a particular registrant if the relationships which exist between the accountant and the client are such as to create a reasonable doubt as to whether the accountant will or can have an impartial and objective judgment on questions confronting him.

The Commission has not attempted to catalog all the relationships that are incompatible with independence. However, the Commission has indicated that it expects the certifying accountant to operate as an outside cheek on the accounting of management to assure that the accounting is accurate, complete and unbiased. Certain relationships have been designated as clearly inconsistent with this conception of the accountant's function. For example, an accountant who has a substantial financial interest in a client can scarcely view that company's financial reports with an impartial eye. Furthermore, if an accountant has been connected with a business in a capacity such as a director, officer, employee, or voting trustee, it is unlikely that be will be able to dissociate himself from these managerial activities and conduct an audit and render a report that would be unaffected thereby. Consequently, the Commission has stated in its rules that relationships of this kind will necessitate a finding that the accountant is lacking independence. [Footnote: Regulation S-X, Rule 2-01 (b).]

The Commission has further clarified its concept of independence through its decisions in particular cases and by opinions expressed in Accounting Series releases. There have been several cases in which the Commission has found that an accountant has taken over responsibilities that properly belong to

management and thereby has destroyed his independence. For example, where the accountant plays a leading role in the original accounting determinations of his client, his subsequent audit is in large part a mere rubber stamping of his own work and is not an independent verification of management's representations Likewise where an accountant has actively participated in the formation and execution of management decisions he is apt not to review with sufficient objectivity the management's disclosure of these matters in the financial statements.

Also, the Commission has indicated that the failure of an accountant to discharge his responsibilities in a professional manner may he further evidence of a lack of independence. Acceptance of unverified information furnished by management as to the validity or propriety of particular items, or the condoning or negligent overlooking of material omissions or improper disclosures in the financial statements has been held to cast serious doubt on his independence. The Commission has also said that an accountant who is subservient to his client and "consistently submerges his preferences or convictions as to accounting principles to the wishes of his client is not in fact independent." In Accounting Series Release No. 22 the Chief Accountant of the Commission expressed the opinion that an accountant who had been indemnified by a registrant against all losses or damages arising out of his certification other than those resulting from his willful misstatement or omission, cannot be considered independent since such an indemnification may remove or greatly weaken one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement.

The Commission in its decisions has indicated a number of other relationships that may destroy an accountant's independence. For example, financial relationships which go beyond the normal accountant-client relationship or which involve the accountant and responsible persons affiliated with his client, may adversely affect the accountant's independence. Also, it has been held that tine use of the accountant as a cloak to cover certain private business dealings, or a continued disregard of an accountant's protests against management's improper use of his name in its reports may be further evidence of a lack of independence.

These formal decisions of the Commission have been supplemented by Accounting Series Release No. 47 which summarized the facts in a number of cases in which informal rulings were issued finding particular accountants to be lacking in independence.

The Commission has consistently distinguished the responsibilities and duties of the accountant from those of management relationships that destroy this separation of responsibility or impair its effectiveness will destroy or impair the accountant's status as an independent expert. Moreover, the Commission has

from the first indicated that in deciding a question of independence, it will inquire into all the pertinent relationships between accountant and client and will not direct its inquiry solely to relationships existing in connection with the filing of reports with the Commission. This last proposition was made explicit by the adoption of a rule to that elicit in Regulation S-X. The decision to make Commission policy explicit on this point was prompted by cases in which significant information relative to particular practices of management was set forth in statements filed with the Commission but was not disclosed in statements otherwise made public. The Commission's release pointed out that complaisant accession to the wishes of management in such matters raises a serious question as to whether the accountant is in fact independent.

The Commission has followed the practice of bringing to the attention of appropriate accounting societies and State agencies each case in which it has publicly criticized the work or professional conduct of accountants practicing before it. These societies and agencies have recognized the necessity of maintaining high standards of professional conduct and to that end have established codes of ethical standards. Violations of these standards, established after appropriate hearings, may be grounds for public admonition, suspension or expulsion from the societies or, in the case of State regulatory agencies, for revocation of the license to practice.

The disciplinary machinery of professional societies and State agencies together with the Commission's requirement of independence have done much to strengthen the standards of professional conduct observed by accountants. However, the Commission has necessarily reserved to itself under its Rules of Practice appropriate disciplinary authority to deal with cases in which accountants practicing before it engage in improper professional conduct or are found not to possess the requisite qualifications to represent others.

The Commission has invoked these sanctions against accountants in three cases. In two of these cases the privilege of the accountant to practice before the Commission was suspended for several months. In the third case the accountant was permanently denied the privilege of practicing before the Commission. Each of the cases involved a willful disregard both of Commission rules and of proper standards of professional conduct.

Part XI

OTHER ACTIVITIES OF THE COMMISSION UNDER THE VARIOUS STATUTES

THE ECONOMIC WARFARE UNIT

The Commission's initial share in the national defense effort began with the lending of facilities and personnel to various agencies even before the declaration of a full national emergency in the summer of 1941. This participation was increased in 1942, when arrangements were made for the assignment of a number of members of the Commission's staff to work on the procurement of information needed by the Board of Economic Warfare in connection with its analyses and operations against the economies of Axis countries.

The Board of Economic Warfare and its successor, the Foreign Economic Administration, have engaged in collecting in the United States and abroad a wide range of information regarding the economic resources of our enemies in Europe and the Far East. Working closely with the War and Navy Departments, the State Department, the British Ministry of Economic Warfare, and with other American and combined agencies, it has maintained current inventories of enemy strengths and weaknesses for the use of the military. It has also devised and carried out measures to enforce the blockade and cut the enemy from neutral war resources. Among the various agencies contributing to this joint effort, the Commission was in a particularly good position to make use of certain types of information sources.

To take its part in this work with the most effectiveness, the Commission established an Economic Warfare Unit with a liaison office in Washington, and from this unit directed the work of regional offices in the investigations involved and in the preparation both of replies to spot intelligence requests and of long-term basic studies. Contact with the Board of Economic Warfare (and, later, with the Foreign Economic Administration) was maintained through the Economic intelligence Division of that agency. The activities carried out by the Economic Warfare Unit consisted mainly in examining at various places in the United States the files and records of enemy alien business firms and of American business houses, and of interviewing throughout the country American engineers and other business and professional men who had lived in enemy-controlled areas and hence might have information of value to the Nation's war effort. During the early stages of the war, these examinations and interviews were directed chiefly toward securing information which would enable the Allied Governments to form accurate estimates of our enemies' economic capacities, and to put their finger important weak spots. Some of this information was eventually used by the armed forces in selecting targets for strategic bombing and in making ether military decisions. The rest of the information was used, as already indicated, for the less spectacular but important purpose of carrying out blockade and related measures. These included assistance to the State Department in establishing and maintaining The Proclaimed List of Certain Blocked Nationals, known as the "blacklist," which comprised the names of persons and firms, principally in neutral countries, that had been found to be cooperating with the enemy; the tightening

of controls over exports to neutrals; measures to counteract German smuggling, which became particularly active after Allied control of the seas put an end to surface vessels running the blockade; assistance to the State Department in negotiating War Trade Agreements by which neutral nations, in exchange for permission to obtain certain essential supplies limited to the needs of their own people, have found themselves to prohibit the re-export of any of these supplies to Germany, and to limit or prohibit their exports to Germany of critical materials which they produce; and, finally, in carrying out preclusive buying in neutral countries to prevent vital supplies from getting into the hands of our enemies.

As the Allies shifted from the defensive to the offensive, the pace of economic warfare was stepped up and heavier demands were made upon the Commission. At the same time the character of the work changed, as a larger share of the services performed by the Economic Warfare Unit began to relate to the identification of “intelligence targets” within enemy-controlled territory.

The projects undertaken by the Commission were of such a varied nature that a generalized description is not possible. Moreover, in many cases specific details cannot yet be revealed, for reasons of national security. Some interesting examples, however, may be given.

In 1943 the Commission was requested to send trained investigators to participate in the examination of seized files of the American offices of Japanese trading companies in New York, Seattle, Los Angeles, and San Francisco. The Japanese Companies involved were Mitsui, Mitsubishi, Okura, Aseno-Bussan, Ataka, Iwai, and others. In these files many important papers and pictures were found, some of which revealed detailed enemy shortages in specific strategic materials, and others of which were used in selecting bombing targets.

Another important project was the collection of extensive information on the coke ovens of Europe, including those in France, Belgium, the Saar-Lorraine, and the Rhineland. Other projects related to the light metals industry of Germany, the glass industry of Japan, the machine-tool industry of Germany and the hydroelectric plants of Japan.

An interesting short-term project assigned to the Commission was to determine whether a particular section of railway in enemy territory had been double-tracked. This information was needed in estimating the amount of damage that could be done by bombing and in gauging the capacity of the line in terms of shifting enemy men and materiel from one area to another to meet an attack, After an extensive search the Commission succeeded in obtaining the information from a man who had traveled over that section of the road as late as 1942.

As this report is written, the Commission is planning new assignments, in Connection with postwar economic controls.

STATISTICS AND SPECIAL STUDIES

Saving Study

The Commission, on April 15, 1942, inaugurated a series of quarterly releases on the volume and composition of saving by individuals in the United States. These releases show the aggregate volume of individuals' savings, that is, the increase in their assets less the increase in their liabilities, exclusive of gains or losses from revaluation of assets. The figures show also the components contributing to this total, such as changes in securities, cash, insurance, consumers' indebtedness, and consumers' durable goods.

In addition to the estimates of saving by individuals, the Commission also made public on June 9, 1944, the first of a new series of quarterly releases on the working capital position of corporations in the United States, exclusive of banks and insurance companies. These releases give comparative figures back through 1939 and show the principal components of current assets and current liabilities. It is intended in subsequent reports to present more detailed data on the sources and uses of corporate funds, thus giving a complete picture of the volume and composition of corporate saving as well as an up-to-date analysis of the financial condition of corporations. In that way information concerning the more important segments of the saving of the national economy will be available.

The data on which these releases are based have been compiled by the Commission from many different sources and are the result of a long period of research in this field. The interest of the Commission in data on the total volume and components of saving originally developed as a result of its concern with corporate financing and the capital markets. Information of this type, however, has acquired increased importance due to the war effort, since current observation of the various forms of saving and forecasts of the probable volume and distribution of saving in the immediate future are essential in the determination of fiscal policy. As a result, the above series have been widely used both by other Government agencies and by business management and financial institutions. Apart from the wartime usefulness of these data, they provide valuable insight into the internal and external sources of funds for business for purposes of reconversion and postwar financing.

Survey of American Listed Corporations

Since 1936 certain data contained in the registration statements of securities on national securities exchanges and the annual reports supplemental thereto filed under the Securities Exchange Act of 1934 have been abstracted and summarized in a series of reports known as the "Survey of American Listed Corporations." Originally conducted as a Work Projects Administration project, sponsored and supervised by this Commission, its work has been continued by the Commission's staff since the discontinuation of the WPA in February 1943.

The project has as its objective a series of compilations which would make more readily available to Federal bureaus and agencies and to the general public some of the financial information filed with the Commission. The project as constituted covers approximately 2,000 corporations, which is somewhat more than 85 percent of the companies having securities listed and registered on national securities exchanges at December 31, 1943. The results of the survey are being presented in two forms, individual industry reports and special statistical studies. The individual industry reports contain both combined and individual data for registrants from 1934 to 1943, inclusive.

Until 1942 most reports of the survey were made available to the public, but during the past a years budgetary limitations and the paper shortage have made it necessary to limit distribution to Government agencies engaged in furthering the war effort. Copies of all public reports, however, have been made available for general use and inspection in the offices of the Commission in Philadelphia and in the Commission's regional offices as well as in 540 depository libraries. Photocopies may also be obtained of all or parts of these reports at the regular rates.

In addition to 175 published reports made publicly available, many special studies have been made for the Commission and other Government agencies, particularly in connection with various aspects of the war effort. Among the more important reports contained in the survey have been studies of corporate profits and operations for the Price Adjustment Boards of the War Department, Navy Department, Maritime Commission, Reconstruction Finance Corporation, Treasury Department, and the Contract Review Branch of the War Production Board and the Treasury Department's Bureau of Internal Revenue; a special study of the meat packing industry for the Office of Economic Stabilization, a study of remuneration for the Salary Stabilization Unit of the Treasury Department; a study of ownership and control of foreign corporations for the Office of Economic Warfare; and a study of airframe manufacturers for the War Department Army Air Corps.

As part of the Survey, the Commission's staff is presently engaged in compiling data for various Government agencies covering the balance sheet data of 150

companies for 5 years, at the request of the Bureau of Budget's Inter-agency Committee on Financial Needs of Government Agencies.

During the year 1943, the coverage of the Survey was extended to those corporations registered under the Securities Act of 1933 which file annual reports. During 1944, the scope of the Survey's studies was extended further to investment companies registered with the Commission under the Investment Company Act of 1940.

Capital Market Statistics

During the past 10 years the staff of the Commission has developed a considerable body of statistical information on the capital market. Some of these statistics have been commented upon elsewhere in the text and summarized in tables 1 to 4 of the appendix, namely, data on cost of flotation of securities, on the volume of issues registered under the Securities Act of 1933, and on all new issues of securities offered for cash sale in the United States, including issues not registered with the Commission. In addition, studies have been made of the extent to which actual sales of issues of securities have varied from the amounts registered for sale. Also data have been gathered on retirements of securities, which together with the statistics on new issues, have provided estimates of changes in the volume of securities outstanding and in the amount of saving by individuals directly in the form of securities. In cooperation with other public and private agencies, considerable data have been accumulated on the investment and market performance of corporate bonds.

PUBLICATIONS

Public Announcements

Under the various acts it is the Commission's duty to publish its decisions and generally to inform Congress and the public of its activities. Its releases are classified into various categories so that a person may receive the material relating only to those phases of the Commission's work in which he is interested. The Commission has made an exhaustive check of its mailing lists to eliminate those no longer desiring specified material.

The announcements issued during the past fiscal year included 173 releases under the Securities Act of 1933; 131 under the Securities Exchange Act of 1934; 837 under the Public Utility Holding Company Act of 1935; 151 under the Investment Company Act of 1940; and 2 under the Investment Advisers Act of 1940. In addition, three releases were issued concerning the Commission's

activities in corporate reorganizations and seven releases were issued under the Trust Indenture Act of 1939.

The Commission also continued the daily publication of its Registration Record, which presents a brief description of the data filed under the Securities Act of 1933 and the Trust Indenture Act of 1939.

The following is a partial classification by subject matter for the past fiscal year:

Opinions and orders: 921
Reports on court actions: 98
Statistical data: 10
Survey series: 6
Accounting series: 2

Other Publications, 1935-44

The principal publications issued by the Commission during the 10-year period include the following:

Decisions and Reports of the Commission, volumes 1 to 10, July 2, 1934, to February 28, 1942

Annual Reports of the Commission, Nos. 1 to 9, 1935 to 1943, inclusive.

Judicial Decisions, volume 1 (comprising all court decisions, reported and unreported, in civil and criminal cases involving statutes administered by the Securities and Exchange Commission to December 31, 1939.

Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees:

Part 1. Strategy and Techniques of Protective and Reorganization Committees, 1937.

Part II. Committees and Conflicts of Interest, 1937.

Part III. Committees for the Holders of Real Estate bonds, 1936.

Part IV. Committees for the Holders of Municipal and Quasi-Municipal Obligations, 1936.

Protective Committees and Agencies for Holders of Defaulted Governmental Bonds, 1937.

Trustees under Indentures, Management Plans Without Aid of Committees, 1938.

Part VIII. A Summary of the Law Pertaining to Equity and Bankruptcy Reorganizations and of the Commission's Conclusions and Recommendations, 1940.

Report on the Study of Investment Trusts and Investment Companies:

Part I. The Nature, Classifications, and Origins of Investment Trusts and Investment Companies, 1938.

Part II. Statistical Survey of Investment Trusts and Investment Companies, 1939.

Part III. Abuses and Deficiencies in the Organization and Operation of Investment Trusts and investment Companies:

Chapters 1 and 2, 1939.
Chapters 3, 4, and 5, 1939.
Chapter 6, 1940.
Chapter 7, 1941.

Part IV. Control and Influence Over Industry and Economic Significance of Investment Companies: Chapters 1 and 2, 1941.

Part V. Conclusions and Recommendations 1941.

Supplemental reports:

Investment Trusts in Great Britain, 1939.

Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services, 1939.

Commingled or Common Trust Funds Administered by Banks and Trust Companies, 1939.

Fixed and Semifixed Investment Trusts, 1940.

Companies Sponsoring Installment Investment Plans, 1939.

Companies Issuing Face Amount Installment Certificates, 1940.

Investigation in the Matter of Richard Whitney et al.:
Volume 1. Report of the Commission, 1938.
Volume 2. Transcript of Hearing, 1938.
Volume 3. Exhibits, 1938.

Investigation in the Matter of McKesson & Robbins, Inc.:
Testimony of Expert Witnesses, 1939.
Report on Investigation, 1940.

Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, 1941.

Report on Trading in Unlisted Securities Upon Exchanges Pursuant to Section 12 (f) of the Securities Exchange Act of 1934, 1936.

Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, 1936.

Report on the Problem of Multiple Trading on Securities Exchanges, 1940.

Cost of Flotation for Small Issues, 1925-29 and 1935-38, 1940.

Cost of Flotation of Registered Securities, 1938-39 and 1940.

Selected Statistics on Securities and Exchange Markets, 1939.

List of Securities Traded on Exchanges Under the Securities Exchange Act of 1934, 1944.

Report on Floor Trading -- January 15, 1945.

Over-the-Counter Brokers and Dealers Registered With the Commission, July 31, 1942.

Official Summary of Security Transactions and Holdings by Directors, Officers, and Principal Security-holders; Issued monthly.

Official Summary of Security Holdings of Officers, Directors, and Principal Stockholders as of December 31, 1935.

Dividend Status of Preferred Stocks of Registered Public Utility Holding Companies and Other Electric and Gas Utility Subsidiaries as of December 31, 1938.

Charts Showing Location of Operating Electric and/or Gas Subsidiaries of Registered Public Utility Holding Companies, 1939.

The Problem of Maintaining Arm's Length Bargaining and Competitive Conditions in the Sale and Distribution of Securities of Registered Public Utility Holding Companies and Other Subsidiaries, 1940.

Depreciation and Dividend Statistics of Electric and Gas Subsidiaries of Registered holding Companies, 1930-40.

Security Issues of Electric and Gas Utilities, 1935-44.

Financial Statistics for Electric and Gas Subsidiaries of Registered Public Utility Holding Companies, 1943.

Registered Public Utility Holding Company Systems, October 15, 1944.

Uniform System of Accounts for Public Utility Holding Companies.

Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies.

Survey of American Listed Corporations:

Reports 1 to 66, inclusive, covers 66 industry groups, 1934-37.

Volumes 1 to 5, inclusive, covers 42 industry groups, 1934-38.

Volumes 6 to 7 covers 10 industry groups, 1934-39.

Supplements 1 to 42, inclusive, supplements the 42-industry groups contained in volumes 1 to 5, inclusive, 1939.

Statistics of American Listed Corporations, Part 1, 1937.

Statistics of American Listed Corporations, Part II, 1935-39.

Subsidiaries of 2,052 Registrants covers parents and subsidiaries of approximately 1.5,000 companies, 1937-38

Reports 1 to 27, inclusive, covers 52 industry groups, 1939-40.

Reports 1 to 10, inclusive, covers 13 industry groups, 1940-41.

Return on Invested Capital covers 58 industry groups, 1936-41.

Parents and Subsidiaries 1942, covers approximately 14,000 corporations, 1942.

Data on Profits and Operations, parts I, II, III , IV, covers 1,120 corporations. 1936-42.

Data On Profits and Operations, parts I, II, III, IV, V, covers 1,530 corporations, 1942-43.

Balance Sheet Data, parts I, II, III, covers 1,530 corporations.

INSPECTION OF REGISTERED INFORMATION BY THE PUBLIC

Copies of all public information on file with the Commission, appearing in registration statements, applications, reports, declarations, and other public documents, are available for inspection in the public reference room of the Commission at Philadelphia, Pa. During the past fiscal year more than 5,222 members of the public visited this public reference room seeking such information, and thousands of letters and telephone calls were received requesting registered information. (This is exclusive of requests for copies of releases, forms, publications, etc.) The Commission, through the facilities provided for the sale of public registered information, filled more than 1,824 orders for photocopies of material, involving 144,841 pages.

Insofar as practicable, the Commission has sought to make some of the public registered information filed with it available in its regional offices. In the New York regional office at 120 Broadway facilities are provided for the inspection of certain public information on file with the Commission. This includes copies of (1) such applications for permanent registration of securities on all national securities exchanges, except the New York Stock Exchange and the New York Curb Exchange, as have received final examination in the Commission, together with copies of supplemental reports and amendments thereto, (2) annual reports filed pursuant to the provisions of Section 15 (d) of the Securities Exchange Act of 1934, as amended by issuers that have securities registered under the Securities Act of 1933, as amended. During the past fiscal year 7,969 members of the public visited the New York office public reference room, and more than 3,789 made telephone calls to this office, seeking registered public information, forms, releases, and other material.

In the Chicago regional office, which is located at 105 West Adams Street, there are available for public inspection copies of applications for permanent registration of securities on the New York Stock Exchange and the New York

Curb Exchange which have received final examination in the Commission, together with copies of all supplemental reports and amendments thereto. During the fiscal year ended June 30, 1944, more than 2,801 members of the public visited the Chicago public reference room, and approximately 674 telephone calls were received there and 2,340 requests were made for registered information, forms, releases, and other material.

In each of the Commission's regional offices there are available for inspection copies of prospectuses used in public offerings of securities effectively registered under the Securities Act of 1933, as amended. Duplicate copies of applications for registration of brokers or dealers transacting business on over-the-counter markets, together with supplemental statements thereto, filed under the Securities Exchange Act of 1934, are also available for public inspection in the regional office having jurisdiction over the zone in which the principal office of the broker or dealer is located. Also, inasmuch as letters of notification under Regulation A exempting small issues of securities from the registration requirements of the Securities Act of 1933, as amended, may be filed with the regional office of the Commission for the region in which the issuer's principal place of business is located, copies of such material are available for inspection at the particular regional office where it is filed.

During the past fiscal year duplicate copies of applications for registration of investment advisers, together with supplemental statements thereto filed under the Investment Advisers Act of 1940, have been made available for public inspection in the regional offices having jurisdiction over the zone in which the principal office of the investment adviser is located.

There are available for inspection in the Commission's San Francisco and Cleveland regional offices, in which arc provided complete facilities for such registration and qualification, copies of registration statements and applications for qualification of Indentures filed at those regional offices. Copies of all applications for permanent registration of securities on national securities exchanges are available for public inspection at the respective exchange upon which the securities are registered.

CONFIDENTIAL TREATMENT OF APPLICATIONS, REPORTS, OR DOCUMENTS

Among the Acts administered by the Commission, the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Investment Company Act of 1940, and the Investment Advisors Act of 1940 provide for the confidential treatment, upon application by registrants, of information contained in reports, applications, or documents which they are

required to file. The Securities Act of 1933 empowers the Commission to hold confidential only material contracts, or portions thereof, if it is determined by the Commission that disclosure will impair the value of the contracts and is not necessary for the protection of investors. The other four statutes referred to are, in general, without specific restriction in this respect and empower the Commission to hold confidential under certain conditions any information contained in any reports required to be flied under those statutes. Disclosure of information confidentially filed under the latter statutes is made only when the Commission determines that disclosure is in the public interest.

The Commission has in force additional wartime rules which provide for the omission or confidential treatment, either on the Commission's own motion or upon application, of information contained in such documents when it is inconsistent with the standards of the Code of Wartime Practices promulgated by the United States Office of Censorship. Since often copies of these documents must be filed also with the securities exchanges, the Commission has enlisted the cooperation of the exchanges in temporarily withholding their copies until they are cleared by the Commission for public inspection, or such information as is specifically authorized or directed by the Commission has been deleted therefrom. The staff of the Commission renders every possible assistance to registrants in advance in the preparation of documents in accordance with the objectives sought by these additional wartime rules.

[statistical tables omitted]