THE MEANING OF "CONTROL" IN THE PROTECTION OF INVESTORS

The stock market crash of 1929 exposed a catalogue of corporate practices employed to deceive and discriminate against the small investor. These practices were largely instrumental in bringing on mass financial ruin.¹ For years corporations had floated large quantities of unsound stocks without telling investors about the true state of their assets and earning power, or the identity of their promoters, managers, and chief stockholders.² Corporate insiders, capitalizing on secret information about impending corporate action, had themselves extracted huge profits from ordinary investors by selling their own stock to the public in advance of expected price declines.³ Organizers of holding and investment companies, by obtaining unfair contracts or excessive payments from their operating subsidiaries, had siphoned off vast sums of subsidiary profits.⁴ In reorganizations,⁵ security conversions,⁶ and dividend declarations,⁷ the interests of small investors were often sacrificed to those of large stockholders.

In 1933, Congress, determined to undercut these practices and thereby make another 1929 impossible, embarked upon an ambitious program. The

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¹ Losses suffered by investors in the few years following the 1929 crash would finance a few months of a modern war. Between 1920 and 1933, 50 billion dollars worth of securities were sold in the United States. By 1933, 50% of these were worthless. Stock and bond losses over the 1929–32 period reached the staggering figure of 93 billion dollars. *Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 2408, 81st Cong., 2d Sess.* 10 (1950).

² “Alluring promises of easy wealth were freely made with little or no attempt to bring to investors’ attention those facts essential to an estimation of the worth of any security. Whatever may have been the full catalogue of forces that brought to pass the present depression, not least among them has been this wanton misdirection of the capital resources of the nation.” *H. R. REP. No. 85, 73rd Cong., 1st Sess.* 2–3 (1933).

³ Prior to 1933, speculation by management and chief stockholders in the stock of their own corporation was an accepted practice. For particularly flagrant examples of insider trading, see *Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 2408, 81st Cong., 2d Sess.* 25–6 (1950); *Hearings before the Senate Committee on Banking and Currency on S. 84, S. Res. 56, and S. Res. 97, 72d Cong., 2d Sess. and 73rd Cong., 1st and 2d Sess.* (1933–34); SEC, *REPORT ON THE STUDY AND INVESTIGATION OF WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES*, pt. II, 315–51 (1937) (hereinafter cited as *PROTECTIVE COMMITTEES*).


⁶ “The power to convert a security . . . connotes the probability that the power will be exercised when such conversion is most favorable to the 'control'." *BERLE AND MEANS, MODERN CORPORATION AND PRIVATE PROPERTY* 187 (1932).

⁷ The unchallenged discretion of directors to declare dividends at their option gives them the power, by withholding earnings, to deprive one group of shareholders of their share in these earnings and hand it over to another class. *Id* at 193.
initial legislation was built on the premise that full and fair disclosure would enable investors to protect their own interests. The Securities Act of 1933 required issuers in primary public distributions to disclose to every investor all relevant information about corporate affairs and personalities. The SEC, established in 1934 to enforce the provisions of the act, demanded specific disclosure of the identities of "controlling persons." Under the Securities Act, complete disclosure was also made a prerequisite to secondary public distributions, but such disclosure was limited to distributions by "controlling persons" involving the use of an underwriter.

Congress next directed its attention to the abuses of holding and investment companies. This time, however, affirmative regulation rather than mere disclosure was deemed necessary. Holding company abuses were most flagrant in the public utility industry—an industry boasting the largest


10. Securities Act §§ 5 and 4(1) make registration mandatory only for public distributions by the issuer or distributions made by an underwriter or dealer. "Underwriter" is defined in § 2(11) as a person participating in the distribution of securities on behalf of an "issuer." But "issuer" is defined for purposes of 2(11) to include anyone "directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." Other exemptions applicable to certain types of securities and security transactions are contained in §§ 3 and 4 of the Act.

There are other "control" provisions in the Securities Act. The SEC may demand consolidated balance sheets from issuers and their "controlling" persons under § 19. Section 15 imposes joint and several liability upon persons who "control" violators of civil liability provisions of the Act where the "controlling" persons know of or have reasonable grounds to believe in the existence of the violation. On the surface, this provision appears to make at least majority stockholders automatically liable for deficiencies in the registration statement, but no suit under § 15 seems yet to have been brought against any "controlling" person. But see Petersen Engine Co., 2 S.E.C. 893, 904 (1937) (that the facts "might well be construed by the courts to impose liability upon the registrant as a 'controlling person' "). The dearth of litigation under § 15 may be ascribed to the prosperity of the security market in the period since the passage of the act during which none of the civil liability provisions in the act have been extensively used. See Comment, Civil Liability under the Federal Securities Act, 50 Yale L.J. 90 (1940).

number of investors in the country. Here Congress struck first. Under the Public Utility Holding Company Act of 1935, gas and electric holding companies which exercised a “controlling influence” over operating subsidiaries were brought under SEC supervision. The act was made broad enough to cover any company in a position to exploit its subsidiaries—from the fully integrated holding company to the company which existed only to invest in its subsidiaries.

Investment companies exercising a “controlling influence” over their operating subsidiaries were placed under SEC supervision by the Investment Company Act of 1940. Here, however, Congress was unwilling to interfere with integrated industrial empires. It therefore defined an investment company as a company whose primary function is to invest in its subsidiaries. Holding companies employed primarily to operate subsidiaries over which they have a “controlling influence” were exempt from the Act. This exemption was phrased ambiguously enough, however, to leave to the SEC a choice of restricting the exemption to integrated holding companies or extending it to companies exercising a “controlling influence” short of actual directive power over their subsidiaries.

The third phase of investor legislation focussed on bondholders. Congress struck at a long-established practice whereby issuers and underwriters appointed bond indenture trustees whom they “controlled” and whose cooperation was assured in subsequent bond defaults and reorganizations. The Trust Indenture Act of 1939 automatically disqualified any bond trustee in a “control” relationship with either issuer or underwriter.

All four statutes had one thing in common. Vital to their success was the proper interpretation and application of the terms “control” and “controlling influence.” The responsibility of giving meaning to these words was delegated in all four instances to the SEC. After almost seventeen years of administration it is possible to evaluate the SEC's performance, and to assess the adequacy of the statutes’ “control” provisions as instruments of investor protection.

**THE SECURITIES ACT**

*Unmasking Control*

Before 1933, investors had no way of finding out who was in “control” of an issuer. It might be a fraudulent promotor with a flagrant record of...
criminal indictments and civil suits, or a professional promotor whose previous selling ventures had been notorious failures. On the other hand, the investor often had as much to fear from "control" groups which were super-respectable. Giant corporations often sold securities in subsidiaries which they planned to run for their own benefit. Financial wizards, like Gianninns of the Bank of America, financed ostensibly independent brokerage firms and then used them to carry on large-scale market operations in the stock of other corporations which they dominated. Without knowledge of who these "controlling" persons were, the investor was a pawn in their hands. One of the best ways to judge the prospects of a new issue is to evaluate the honesty and ability of the men who will run the corporation. Investors, left in the dark, were deprived of this opportunity. They were, moreover, unlikely to recognize the hand of "controlling" persons in later corporate action which might discriminate against their interests.

supplying investors with needed information about the issuer. See Hearings before House Committee on Interstate and Foreign Commerce on H.R. 4314, 73rd Cong., 1st Sess. 95-1-1 (1933).

16. "I recall, for instance, one case . . . in which a promoter in New York, living in a building having four different entrances, one on 5th Avenue, one on Forty-second Street, one on Forty-Third Street, and a back alley entrance, promoted a great many companies and used the different addresses. . . . He got away with a great deal of money on several promotions and was finally picked up . . . after he had collected from widows and orphans about $100,000." Testimony of John Hill, id. at 153; Charles E. Rogers, 3 S. E. C. 597 (1938) (license revocation proceeding under Securities Exchange Act in which "controlling" person had been previously convicted on a mail fraud charge); Light, Wofsey & Benesch Inc. Exchange Act Rel. No. 4052(1948) (license application denied where "controlling" person had been guilty of violating Securities Act in predecessor firm.); 15 SEC ANN. REP. 19 (1949) (failure to disclose previous cease and desist orders issued against the registrant's sale of mining securities.); Sweet's Steel Company, 4 S. E. C. 589 (1939) (previous sponsorship of another small and unsuccessful steel issue motive for concealing underwriting arrangement with and "control" over present steel issuer).

17. See, e.g., 15 SEC ANN. REP. 17-18 (1949) (exchange of subsidiary's old preferred for new preferred resulting in special benefit to parent corporation undisclosed to other investors); BERLE, STUDIES IN CORPORATE FINANCE 154 (1928) (". . . A subsidiary corporation will float an issue of securities, using the proceeds to support other ventures in which the subsidiary itself is not directly interested.").

The problem of the subsidiary investor is a numerically significant one. Sixty of the 200 largest non-financial corporations studied by the SEC in 1940 were under the "control" of other corporations. GOLDSMITH & PARMEELE, DISTRIBUTION OF OWNERSHIP IN 200 LARGEST NON-FINANCIAL CORPORATIONS 109-10 (TNEC Monograph 29, 1940).


19. SEC registration forms have given the investor a good start toward recognizing "control" abuses of the most familiar kind. The following must be disclosed in the registration statement: names of purchasers to whom securities were sold at a discount during the six months before filing or would be sold in the future; the names of vendors and purchase prices of property sold within past five years not in the ordinary course of business and the relationship of all such vendors to the issuers; material corporate loans to affiliates or controlling persons, material contracts providing for the issuer's management; names of all owners of 10% equity in corporations; servicing contracts with any of the issuer's affiliates;
To supply the needed information, the Securities Act of 1933 required all issuers of new securities to file registration statements with the SEC and to distribute prospectuses to the public. The exact contents of these statements were left to the SEC. Early in its administration the Commission ruled that all prospectuses and registration statements must identify the "controlling" persons in the issuing corporation.

But granted the wisdom of disclosing "control," the real problem was defining it. Expressly repudiating judicial criteria of "control" which inclined toward a 50% stock ownership figure, the Commission defined "control" as "the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a corporation through the ownership of voting securities, by contract, or otherwise." With the abandonment of a near-50% figure of stock ownership as a requisite of "control," the ranks of "controlling" persons grew. A chief stockholder owning less than a majority of stock, but consistently holding a sufficient number of proxies to elect a majority of directors, was held by the Commission to "control." His "control" was self-perpetuating: he the interests of any affiliate in property bought or sold by the corporation not in the ordinary course of business. Securities and Exchange Act—Form S-1. Such disclosure has obviously deterred control and insider abuses. See 12 SEC ANN. REP. 10 (1947) (issuer cancelled proposed arrangement to sell all goods through officer-controlled companies); 13 id. 20 (1948) (issuer forced to disclose that agreed purchase of stock of controlling affiliate's subsidiary resulted in 2 million dollar profit to the controlling affiliate).

But in spite of all these leads, the investor still needs to be told outright who "controls" the corporation. See Doris Ruby Mining Co., 4 S.E.C. 427, 430 (1939).

22. See note 9 supra. Failure to disclose the name of the "controlling" person in the registration statement constituted a material omission. Investment Corp. of North America, 5 S.E.C. 287, 292 (1939). This omission warranted a stop order proceeding against the issuer under section 8(d) of the Act. Until the issuer made full disclosure of those in "control," he could not lawfully market his securities publicly. SEC Rule 410 allows the issuer to disclaim "control" in cases of doubt, but it requires him to state all the material facts about any questionable "control" relationships in the registration statement. 17 CODE FED. REGS. § 230.410 (1949).
23. See, e.g., United States v. Union Pac. R.R., 226 U.S. 61 (1912) (46%); Northern Securities Co. v. United States, 193 U.S. 197 (1904) (75%). But see Hyams v. Calumet & Heckla Mining Co., 221 Fed. 529, 541 (6th Cir. 1915) ("a control purposely gained and exercised by a minority stockholder with the aid of the proxies of other stockholders may have the same effect as control by an actual stock majority"). The "doctrine of the dominant shareholder" usually imposed the fiduciary duty of a management official upon majority stockholders only. See, e.g., Southern Pacific Co. v. Bogert, 250 U.S. 483 (1919). The ambiguous legal status of pre-1933 non-majority "control groups" is discussed in BERLE & MEANS, op. cit. supra note 6, at 233-45.
Since 1933, however, courts have adopted the more flexible "control" criteria introduced by administrative agencies. See, e.g., Rochester Telephone Co. v. FCC, 307 U.S. 125 (1939); Timberg, Corporate Fictions, 46 COL. L. REV. 533, 561 (1946).
24. SEC Rule 405.
25. See, e.g., Thompson Ross Securities Co., 6 S.E.C. 1111, 1120 (1940) (shareholder owned 18% stock but held proxies for over 50%).
could rely on the directors whom he elected for access to the proxy machinery in the next election. Only a rival stockholder willing to engage in a proxy fight, or a rebellious management denying him access to the proxy machinery, could unseat him. Similarly, several minority stockholders who voted their stock together over a period of time, elected a slate of harmonious directors, and frequently consulted together on corporate policy were usually deemed to be in joint “control” of the corporation.26

The Commission found, moreover, that “control” can be wielded in more subtle ways. In a corporation where the board of directors does little more than rubber stamp executive committee decisions the man who chooses the executive committee is the real “controlling” person.27 In other corporations, the underwriter who demands the undated resignations of a majority of directors as the price of his underwriting contract is in “control.”28 Even a major creditor who shares in profits and losses and maintains an option to exchange his “loan” for equity in the firm may be a “controlling” person.29 In no case does the Commission look to actual use of

Berle and Means call this “minority control” and discuss it at length in MODERN CORPORATION AND PRIVATE PROPERTY 80–4 (1932). The SEC found that about half of the 200 largest non-financial corporations in the United States were “minority controlled.” GOLDSMITH & PARMELEE, op. cit. supra note 17, at 103–4.

26. The SEC made people in joint control register as “controlling persons.” Investment Company of North America, 5 S. E. C. 287 (1939) (2 shareholders had voting control together; effectuated capital and basic financial changes in corporation jointly); Sweet’s Steel Co., 4 S. E. C. 589 (1939) (5 banks together owned almost a majority of shares; managed the steel company jointly).

The courts agreed with the SEC. Landay v. United States, 108 F.2d 698 (6th Cir. 1939), cert. denied, 309 U.S. 681 (1940) (defendants voted holdings in a bloc to control the corporation; held jointly liable for violating Securities Act). The SEC found in its study of 200 corporations that “The dominant position in a large corporation is but rarely embodied in a single block of stock owned directly by one individual or one corporation. As a rule there exist a number of separate holdings which are more or less connected and which actually vote and act in unison. . . . When such a community of interest is based on joint dependence on each other’s stock holdings as a means of maintaining a dominant position, a substantial degree of stability results.” GOLDSMITH & PARMELEE, op. cit. supra note 17, at 101.

27. See, e.g., International Resources Corp., 7 S.E.C. 689, 716 (1940). Boards of directors, in general, are unavoidably dependent upon corporate officers for information. As a result, in three quarters of the cases studied by the TNEC the board did little more than ratify decisions of management. Legally, however, the board is still universally recognized as the ultimate governing body of the corporation. DIMOE & HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS 24 (TNEC Monograph 11, 1940). See, generally, Douglas, Directors Who Do Not Direct, 47 HARV. L. REV. 1305 (1934); Comment, The Executive Committee in Corporate Organisation, 42 MICH. L. REV. 133 (1943).


29. Sweet’s Steel Co., 4 S. E. C. 589 (1939) (“controlling” person held a majority of shares on which he exercised voting and dividend rights as collateral for a loan); Walston & Co., 7 S. E. C. 937 (1940) (“controlling” person contributed about 90% firm’s capital and chief source of business, shared in profits and losses, and maintained an option to acquire legal title to any portion of firm he desired). Other legal devices such as the holding company or the voting trust are familiar levers
the power to direct corporate policy. By definition, power alone suffices. 30

The Commission's broad definition, however, has not been applied to all types of "control" which it might reasonably cover. In large corporations, for example, management may itself "control" where no shareholder is large enough to compel access to the corporation's proxy machinery. 31

While such "control" is often difficult to discover, it is obvious enough in corporations with a perpetual management group and no shareholder owning more than a small proportion of the voting stock. Disclosure of such "control," where possible, would be of utmost benefit to investors. On guard against management, they would be more likely to discern dishonest or notoriously inefficient managers and refuse to invest. Or, having invested, they might make diligent use of their proxy votes in choosing management officials. They might also give serious consideration to matters requiring

of control to the SEC. See Equity Corporation, 2 S. E. C. 675, 680-84 (1937), for an amazingly complicated system of control employing both devices. Commissioner Healy, concurring, was provoked to say: "... I cannot resist commenting upon the bewildering maze

of corporations involved in the transactions described and upon the labyrinthic course of the transactions themselves among these artificial beings, these corporate slaves, called into existence by those who move them about and control them more completely than ever a master ordered the lives and acts of human slaves. The most remarkable aspect of all is that through our legislatures' "liberalizing" of corporation laws and changing by statute the common law rules against intercorporate holdings, it is we ourselves who have made it possible." Id. at 689.

30. See Canusa Gold Mines Ltd., 2 S. E. C. 548, 555 (1937). ("The Item [calling for disclosure of controlling persons] is directed solely to the existence of the power." ) (Emphasis added.) Compare the SEC's emphasis on the existence rather than the exercise of control with the judicial notion that a chief shareholder cannot be held responsible for the acts of his corporate alter ego unless he has somehow exercised his controlling power in such a way as to disregard the corporate entity. See Horowitz, Disregarding the Entity of Private Corporations, 14 WASH. L. REV. 285 (1939) and 15 WASH. L. REV. 1 (1940); Berle & Means, op. cit. supra note 6, at 237. ("The only conclusion which could be drawn [from judicial treatment of control groups] was that where an individual or group had in fact exercised the powers of management, they must be governed by the same standards of conduct as those applied to the formal management. ... ") (Emphasis added.)

31. See Goldsmith, op. cit. supra note 17, at 103, who estimates that 60 out of 200 corporations surveyed by the SEC were probably controlled by management relying on the power of the proxy machinery. Yet management holdings in these corporations averaged only 5% of the total stock holdings. Id. at 56. Famous examples of giant management-controlled corporations are: American Telephone and Telegraph (where the largest shareholder owns less than 1% of the voting stock), Bethlehem Steel, Eastman Kodak, General Electric, Montgomery Ward, Paramount Pictures, etc. There are cases, however, of stockholders with as little as 15% voting stock being able to commandeer a majority of proxies to oust a rebellious or uncooperative management in command of the corporation's proxy machinery. See Berle & Means, op. cit. supra note 6, at 82-4.

Berle and Means see management control as the inevitable result of the continued growth of corporations to a point where no shareholder can hope to amass enough stock or proxies to control management. If this should occur, any distinction between the "control" group and management would become an academic question, since they would be the same. Id. at 84-9.
shareholder approval. Where management control defies discovery, however, the SEC is in most cases powerless. For in such circumstances, investor protection can be achieved only through the type of rigorous government surveillance over management which prevails in the closely-regulated public utility and investment company fields.

A second type of control which may not be revealed in the registration statement is that stemming from monopoly. In a monopolistic industry, the leaders may "control" price, production, and sales policies of their "competitors" or even their "customers." Disclosure of such "control," however, would do little good. Unless the investor refrains from investing in a diseased industry altogether, he cannot avoid the effects of monopoly control. Investor protection in this field lies beyond the scope of security legislation. Only enforced competition can provide the investor with the autonomy which he is supposed to have.

The underwriting business may be a special example of monopoly control. The trade practice is for one underwriter to handle all the financial business of a particular issuer. Ordinarily no other underwriter will solicit that firm's business. As a result, it has been charged that underwriters can generally dictate the nature, timing, and price of their "customers'"

32. For a discussion of SEC proxy rules, which make such alternatives possible for the shareholder, their limited application, and general worth see Emerson & Latcham, SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation, 59 Yale L. J. 635 (1950).

The SEC, on occasion, has found a corporate officer to be "controlling" in connection with investment company regulation. See note 95 infra. His "control" stemmed from his influence with the major stockholders rather than from his official position. Transit Investment Co., Inv. Co. Rel. 927 (1946).

33. Former SEC Chairman, now Supreme Court Justice Douglas criticized the Securities Act in 1934 for doing nothing which "controls the powers of self-perpetuating management." He supported a "control which would combine regulation by industry with supervision by the government." He admitted, however, that such supervision might engage the government in "activity a thousand fold more complex than the analogous activity of the Interstate Commerce Commission. . . ." Douglas, Protecting the Investor, 23 Yale Rev. (NS) 521, 528, 532 (1934).

34. See Laidler, Concentration of Control in American Industry, 410 (1931); Berle & Means, op. cit. supra note 6, at 69–70, 120–1.

35. "Market sharing normally characterizes the investment banking field. . . . They do not compete for corporate stocks and bonds. Each investment house has its territory where others do not intrude. Houses do not solicit business from a corporation that is dealing with another firm. They do not bid on securities that have been offered to others. . . . Issuers of securities, in effect, are allocated among the members of the trade. . . ." Wilcox, Competition and Monopoly in American Industry 176–7 (TNEC Monograph 21, 1941). For the effect of investment banking monopoly on the issuer's financial policies, see Weston, The Economics of Competitive Bidding in the Sale of Securities, 16 U. Chi. L. Rev. 1, 18 (1943).

Formerly, investment banker domination over issuer's financial policies was insured by the maintenance of a representative of the investment banker on the issuer's board. Owens, Business Organization and Combination 355–67 (1934). But regulatory legislation in the banking, trust indenture, public utility, and investment company field have attacked such a practice. See, e.g., Holding Company Act § 17(c).
security issues. Investor protection, sorely needed, could not be gained by disclosure. For this reason, perhaps, the SEC has not insisted upon disclosure of monopoly control between issuer and underwriter. More extreme measures are needed. Antitrust regulation of the underwriting business, for example, might insure arm's-length bargaining between issuers and underwriters. Short of this, the SEC might be empowered to prescribe competitive bidding among underwriters for the business of all corporate issuers. The Commission already possesses this power over public utility issues, and an extension to all issues might well free corporate financial policy from underwriter "control."

Secondary Distributions by "Controlling Persons"

The Securities Act's registration and prospectus requirements for new

36. Investors suffer when underwriters dictate floating of excessive security issues primarily to collect the fees involved. The Congressional Report on the Securities Act in 1933 stressed the fact that "... investment bankers with no regard for the efficient functioning of industry forced corporations to accept new capital for expansion purposes in order that new securities might be issued for public consumption." H.R. REP. No. 85, 73rd Cong., 2d Sess. 2 (1933). Moreover, the fees charged by monopolistic underwriters may be excessive, resulting in higher prices for the investor.

37. While the SEC presently requires that the issuer disclose any underwriter with whom it is in a "control" relationship, Registration Form S–1, Item 12, this requirement results in disclosure of only those rare cases in which the underwriter actually "controls" or is under "common control with" the issuer's management in all corporate matters. See, e.g., Southeastern Industrial Loan Co., 10 S. E. C. 617 (1941) (underwriter and registrant were both "controlled" corporations of same parent); Reiter-Foster Oil Corp., 6 S. E. C. 1028, 1043 (1940) (underwriter had "control" of issuer's board). A second reason might be the difficulty of discovering such "control." The SEC's experience with administering Utility Rule U–12F–2 which denied underwriting fees to anyone in such a relationship with the issuer "that there is liable to be ... an absence of arms-length-bargaining" indicates that the exact degree of influence in the issuer-underwriter area is often too difficult to determine. See SEC, 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 8–9 (1940); Morgan Stanley & Co. v. SEC, 126 F.2d 325 (2d Cir. 1942), affirming Dayton Power and Light Co., 8 S. E. C. 950 (1941); Blair & Co., 12 S. E. C. 661 (1943). Indeed, the SEC abandoned its attempt to administer this provision in 1941 and adopted instead a rule of compulsory bidding for all utility securities. SEC Rule U–50. Holding Co. Rel. 2676 (1941).


39. The controversial issue of competitive bidding for all corporate issuers has been discussed heatedly for almost 10 years, especially since the adoption in 1941 of Rule U–50 providing for compulsory bidding for public utility securities. At present the SEC has no power to prescribe competitive bidding for other types of issuers. See Holding Co. Rel. No. 2676 (1941), expressly disclaiming any such power. For the arguments pro and con compulsory bidding see Weston, op. cit. supra note 35 (conservative approval); McClintock, Competitive Bidding for New Issues of Securities (1939) (indignant disapproval); Emblen, Competitive Bidding for Corporate Securities (1944) (argument analyses).
issues apply only to public distributions by the issuer. Corporations may and do place many issues privately with a select number of corporate "insiders." Such issues are exempt from the Act's disclosure requirements because at the time of issue they in no way affect the small investor. But should these "insiders" later decide to sell their holdings to the public, the need for disclosure would then be as imperative as in original public distributions. Indeed, where an "insider" offers his unregistered stock to the public, an additional need for disclosure exists. Without it, the "insider" alone has access to vital information about the corporation's affairs, and is therefore in a position to extract secret profits from his unwary purchasers.

40. Securities Act § 4(1) exempts from regulation "transactions by an issuer not involving any public offering." For a discussion of the numerous factors, besides number of offerees, which are considered by the SEC in determining whether or not an offering is "public", see, McCORMICK, UNDERSTANDING THE SECURITIES ACT AND THE SEC 101-5 (1948); Sec. Act Rel. 285 and 603 (1935).

Sections 3 and 4 contain other exemptions for particular types of securities and transactions, even when publicly distributed. The applicability of these exemptions to secondary distributions by "controlling" persons is discussed in Heineman, Secondary Distributions and Continuing Exemptions under the Securities Act, 34 ILL. L. REV. 812 (1940).

41. Private placements have accelerated since the passage of the Securities Act. Institutional investors, i.e., insurance companies, constitute one of the most important classes of security purchasers and take almost all of their holdings through private placement. In 1938, the 26 largest life insurance companies owned 10% of our total industrial debt, 17.4% of all railroad debt, and 18.2% of all utility debt. TNEC Hearings, 76th Cong., 3rd Sess., pt. 10-A (1940).

Institutional investors, of course, present much less of a danger to investors when they later sell their holdings than ordinary corporate insiders. For one thing, their skilled investment analysts will prevent them from buying unsound stock. Secondly they are not so likely to sell out for profit on advance information of price declines, since they are not interested in speculative profits. Presumably they will refrain from interference in the corporate management. In fact, the welfare of the institutional investor has attracted more attention than the welfare of the investors to whom he sells. In 1941, a proposed amendment to the Securities Act would have required issuers who sold private placed securities to institutional investors to register them so that the institution would have the benefit of required disclosures. SEC, REPORT ON PROPOSALS FOR AMENDMENTS TO SECURITIES ACT, etc., 1, 18-19 (1941).

In 1949, the SEC estimated that $2,657,000,000 in securities were privately placed as compared with a total of $3,443,000,000 distributed publicly in the same year. 15 SEC ANN. REP. 7 (1949).

For a discussion of private placements and their effect upon the investment banking field in general, see McCORMICK, op. cit. supra note 40, at 294-5; McClintock, op. cit. supra note 39, at 25-69; Weston, op. cit. supra note 35, at 42-3.

42. See Throop & Lane, Some Problems of Exemption under the Securities Act, 4 LAw & CONTEMP. PROB. 89, 117 (1937): "To the small investor it is relatively immaterial whether his securities derive from the issuer directly or from some large holder who has undertaken a liquidation of his holdings. The need for basic information as to the factual background of the security may be as great in one case as the other." See also SEC, REPORT ON SECONDARY DISTRIBUTION OF EXCHANGE STOCKS 5, 8 (1942) (hereinafter cited as SECONDARY DISTRIBUTIONS).

43. "In the Commission's experience, abuse of inside information has been particularly prevalent in the case of securities which are not the subject of reporting. . . ." PURCELL,
But Congress, in regulating secondary distributions, paid insufficient heed to the need for disclosure. The Securities Act demands of the corporation a registration statement and prospectus in secondary distributions only when made through an underwriter by a person "controlling, controlled by or under common control with the corporation." Congress gave two reasons for drawing the line at "controlling" persons: only one in "control" can compel the corporation's management to undertake the burden of registering; and of those with access to inside information, "controlling" shareholders are most likely to distribute a sufficient quantity of stock to warrant investor protection against exploitation.

In assuming that only a "controlling" person can compel registration, Congress placed the SEC in a dilemma. The Commission applied the same tests of "control" in requiring registration of secondary distributions which it had established in compelling disclosure in all registrations.

A large proportion of secondary distributions in listed securities is made by corporate insiders. In 1945, $193,870,000 of securities involved in secondary distributions were registered for cash sale. A "controlling" shareholder may still distribute his unregistered holdings personally or through a broker on the floor of the exchange as long as no solicitation is involved. In neither of these cases does he employ an underwriter. He is therefore exempt from disclosure requirements under § 2(11). In actual practice, however, it is practically impossible to distribute much stock by such methods. See McCORMICK, op. cit. supra note 40, at 68-9.

45. See H.R. Rep. 85, 73rd Cong., 1st Sess. 13-4 (1933): "All the outstanding stock of a particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Whenever such a distribution reaches significant proportions, the distributor would be in a position to control the issuer, and thus be able to furnish the information demanded by the bill. This being so, the distributor is treated as an equivalent to the original issuer, and if he seeks to dispose of the issue through a public offering, he becomes subject to the Act."

46. E.g., Thompson Ross Sec. Co., 6 S. E. C. 1111 (1940) (president owned 18% of stock but "controlled" through proxy votes); Resources Corp. International, 7 S. E. C. 689 (1940) (stockholder owned 27% of stock but "controlled" through domination of officers and executive committee). See pages 315-16 and notes 25-30 supra.

See McCORMICK, op. cit. supra note 40, at 69: "In determining whether a person may be deemed an issuer within . . . 2(11) . . . the Commission has taken the position that control means that degree of influence over the management and policies of the issuing cor-
though a shareholder met these tests and was therefore presumed to be able to compel registration, he often contended that he could not do so. If such a contention were untrue and the Commission swallowed it, collusion between "controlling" persons and corporations to avoid disclosure would be encouraged.\footnote{See Testimony of Rush S. Dickson, \textit{Hearings before House Committee on Interstate and Foreign Commerce on H.R. 4344}, 77th Cong., 1st Sess. 617 (1941). In the case cited, a stockholder in a family corporation claimed that he could not get the cooperation of the management for registration although it was urgent that he dispose of his holdings immediately. Although it is possible that other members of his family with whom he may have enjoyed cordial business relations in the corporation would refuse him this favor, the possibilities for collusion in such a situation are obvious.} If, on the other hand, the shareholder's plea, though actually true, were denied by the Commission, the net effect would be an unjustified destruction of the liquidity of his capital.\footnote{See note 47 supra. In that case the SEC insisted on registration and apparently forced the stock to be distributed intrastate. Such a restriction causes great inconvenience and financial loss to the stockholder. Curtailment of a shareholder's right to convert his securities into liquid cash is perhaps the most serious consequence of a finding of "control" in any of the five Acts, particularly where the shareholder's major assets are tied up in the stock and he needs the cash quickly. The consequences of "control" under the other Acts, labeling of the shareholder as "controlling" in the registration statement, imposition of certain affirmative duties upon him, or even prohibition of his right to act in certain fiduciary capacities are not potentially as disastrous.} Congress might have spared the Commission such embarrassment by empowering it to requisition statements from management, at the shareholder's expense, whenever it determined that a shareholder was "controlling."\footnote{See Holding Company Act \S 18 for an example of comprehensive information—getting powers already accorded the SEC. Issuers might legitimately fear the potential civil liability which the Act would impose for deficiencies in registration statements or prospectuses filed pursuant to such contracts for secondary distributions. An amendment requiring "controlling" persons to sign the registration statement in secondary distributions for their benefit might allay the issuer's fears. For the defrauded investor could then sue the "controlling" person directly as a signer of the registration statement without the necessity of proving his "control" over the management or other signers of the statement. See SEC, PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT, etc. 24 (1941).} Or Congress might have required issuers placing their securities privately to incorporate into their contracts of sale a provision promising cooperation with shareholders in any future registration deemed necessary by the SEC.\footnote{Either provision, however, could still result in needless expense for the shareholder if he were erroneously deemed "controlling" by the SEC. On the inevitable margin for error in such determinations of "control" see Blair-Smith, \textit{Forms of Administrative Interpretation Under the Securities Laws}, 26 Iowa L. Rev. 241, 252–4 (1941). The average cost of registration is estimated by the SEC at $1 per $1,000 publicly raised. Opponents of extended registration requirements estimate that registration of a $100,000 issue costs $5,000. See \textit{Hearings before House Committee on Interstate and Foreign Commerce on H.R. 4344}, 77th Cong., 1st Sess. 582, 617 (1941).}
But even if the obstacle to registration were thus hurdled, the act would still fall short of protecting investors against insider sell-outs of unregistered securities. The principal fallacy of the statute lies in Congress' second basic assumption that the only insiders to be feared are those in control. Underlying this assumption was an unwillingness to subject small distributions unlikely to affect more than a few investors to disclosure requirements. But the truly small distribution is already protected by Section 3(b) of the Securities Act. Under this section, the SEC has exempted from registration all secondary distributions under $100,000. An insider distributing securities in excess of that amount should be compelled to register. Whether he is controlling or not, he has access to vital information with which to exploit uninformed investors. Section 16(b) of the Securities Exchange Act of 1934, which strips insiders of short-term trading profits, is applicable to any director, officer, or holder of 10% of the corporate equity. Congress should adopt similar standards as a prima facie test for determining whether a shareholder selling his stock is likely to hold an advantage over the public by virtue of his inside information.

THE HOLDING COMPANY IN CONTROL

The affirmative regulatory phase of Congress' program opened with an attack upon holding companies. "Control" over several operating sub-

51. Securities Act, Regulation A. The floor for primary distributions is presently $300,000. Sec. Act Rel. 3066 (1945).

Secondary distributions of listed securities studied by SEC ranged in value from $25,000 to several million dollars. The average number of shares involved in secondary distributions is often several times larger than the number of those shares traded on an exchange in several weeks. SECONDARY DISTRIBUTIONS, op. cit. supra note 42, at 2, 31 (1942).


53. The adoption of an inflexible test for insiders based upon a stock ownership figure like the 10% one contained in 16b would not be advisable. Rather the Holding Company Act technique of a presumption of "inside information" based upon a stock ownership figure would give the SEC greater leeway in regulating distributions by people who are insiders by dint of factors other than stock ownership. Perhaps a compromise might be worked. Ten percent equity ownership might conclusively render its owner an insider in the corporation. Lack of 10% ownership, on the other hand, would not conclusively preclude a stockholder from being adjudged an insider.
sidiaries was often concentrated in the hands of a few people by a small investment in holding company stock. These people were then in a position to drain off subsidiary earnings through interlocking directorates or officerships and through intercompany transactions.4

Public utility holding companies were notorious examples. Sixteen giant holding company systems dominated 90% of the electric utility industry in the early thirties.5 Each system consisted of tiers of holding companies with the men in "control" of the top holding company running millions of dollars worth of utility assets though at times furnishing less than 1% of the total investment.6 The remainder came chiefly from the public holders of bonds, hybrid securities, and non-voting stock.7 In good times, the holding companies creamed off the utility's operating profits in the form of dividends on their own stock.8 In bad times, the holding companies drained off subsidiary funds through excessively priced contracts,9 upstream loans from

54. On the holding company as a legal device for acquiring "control," see generally Bonbright & Means, The Holding Company (1932); Northern Securities Co. v. United States, 193 U.S. 197 (1904).
55. Utility Corporations 159; Comment, 59 Yale L.J. 1088, 1092 (1950). The United Corporation with assets of over 4 billion dollars was the largest of these. Insull, Electric Bond and Share, Cities Service Co., Associated Gas & Electric Co., Standard Gas & Electric Co., North American Co. also were on the list.

Holding company control evolved originally in the industry as a by-product of contractual relationships between independent utilities and utility servicing companies. The utilities often were forced to pay for services in their own securities. The expansion of utility systems brought about by assistance from servicing companies benefited the public. But savings from technical advances and centralization should have been passed on to the consumer instead of being drained off to holding companies.

56. Utility Corporations 169. In the Insull holding company system one dollar invested in the top holding company controlled $2,000 worth of base-line utility property. Eight holding companies intervened between base-line utilities and the top holding company. Id. at 160–1.

Holding companies would often sell overvalued property to a utility for the utility's preferred and common stock. They would then sell the utility's preferred for what the property originally cost them. In this way they could acquire utility common stock free. See 10 SEC ANN. REP. 86 (1945).

57. Public-utility financing in the public markets was done largely with nonvoting securities. Fifty percent of operating utility securities were bonds. Barnes, Economics of Public Utility Regulation 102 (1947). The Niagara Hudson Power Group, for example, capitalized its operating companies with 67 million dollars worth of bonds, 24 million dollars worth of preferred stock, and 8 million dollars worth of voting common. Utility Corporations 99.

58. A pyramided system in which each holding company holds a substantial part of the common stock of the corporation below may produce an enormous profit for top equity securities. The smaller the proportion of the common stock of the utility, the larger will be the holding company's return. The smaller the proportion of the holding company's common stock, the larger will be the return to the common stock owners. Id. at 73–78.

59. Forty percent of the income of Electric Bond and Share came from servicing fees for its subsidiary utilities as compared with 27% in dividends or interest, 13% for sale of investment securities, and 10% for underwriting and financing services. Its subsidiaries were bound to call on it for all managerial, engineering, and security-marketing services.
subsidiary to parent, overpayments to interlocking directors and officers, inadequate depreciation reserves, unwarranted dividends, and sales of electricity and gas from one operating subsidiary to another at a large mark-up.

To protect utility investors and consumers from these abuses, Congress chose positive SEC regulation in preference to disclosure. The Public Utility Holding Company Act of 1935 subjected gas and electric utility holding companies and their subsidiaries to Commission supervision over security issues and acquisitions, proxy and dividend policies, and capital structures. In addition, it required prior SEC approval of all loans and servicing or construction contracts between utilities and servicing affiliates in a holding company system.

These measures, however, would have fallen short of their goal unless enforceable against all gas and electric holding companies in a position to exploit their operating utilities. The Holding Company Act itself took a step in the right direction by defining a holding company as any company which owned at least 10% of the voting stock of a utility or another holding company. But it specifically excluded from regulation any company

Their profit on management and construction contracts was over 100%. Id. at 352-5, 423, 464.

60. Id. at 461. Loans from subsidiary to parent were, of course, at a lower rate of interest than simultaneous loans from parent to subsidiary.

61. Id. at 130-5, 152.

62. Id. at 496, 847 et seq.

63. Id. at 440-8.

64. Id. at 851-4.

65. Utility consumers as well as investors were suffering from holding company abuses. Their profit on management and construction contracts was over 100%. Id. at 352-5, 423, 464.


67. Holding Company Act §§ 6, 7.

68. Holding Company Act §§ 12(c) and 12(e).


70. Holding Company Act §§ 12, 13, 15. Holding companies themselves were forbidden from performing servicing contracts for their utility subsidiaries under § 13(a).

71. Holding Company Act § 2(a)(7)(A). Companies falling under § 2(a)(7)(A) were required to register with the SEC.

Section 2(a)(7)(B) supplied an additional definition applicable to companies which were not required to register under 2(a)(7)(A). A holding company under 2(a)(7)(B) was any person which the SEC, in a hearing, determined to have such "a controlling influence" over the management or policies of a utility or holding company to justify its regulation
meeting the 10% requirement which could prove to the SEC that it did not exercise a “controlling influence” over its immediate subsidiary.\textsuperscript{7}

The Commission announced early that “controlling influence” under the Holding Company Act required a good deal less than “control” under the

“in the public interest or for the protection of investors or consumers.” Similarly §§ 2(a)(8) (A) and 2(a)(8)(B) set out the same standards for determining who is a subsidiary.

Occasionally the SEC has regulated holding companies under this grant in 2(a)(7)(B) or its counterpart 2(a)(8)(B). See Employees Welfare Assoc., 4 S.E.C. 792 (1939) (former parent still controls through common officer and employees despite lack of stock). In general however, the time, energy, and expense involved in investigating and initiating hearings on companies not presumed to be holding companies under the Act preclude extensive use of 2(a)(7)(B) for acquiring jurisdiction over below-10% companies. For an example of possible below-10% utility control situations which the SEC has apparently not touched, see INVESTMENT COMPANIES pt. IV, 20–1 (1942).

If the SEC cannot regulate the applicant as a holding company, it may be able to regulate it as an affiliate. Affiliate is defined for purposes of the Holding Company Act in § 2(a)(11) to include any person owning 5% voting stock in a utility or anyone in such a relation to the utility that there is “liable to be such an absence of arms-length bargaining” between them as to justify regulation in public interest. See Blair & Co., 12 S.E.C. 661 (1943) for an example of companies which could not be regulated as holding companies but only as affiliates, in the absence of a finding of “controlling influence.” See Note, 51 YALE L. J. 1018, 1023 (1940).

Many of the most important regulatory sections of the Act, however, apply only to holding companies and not to affiliates. See, e.g., §§ 6, 7, 11, 12(a)-(d), (h), 13(a). Hence, the need for a liberal definition of “controlling influence” to bring companies under the Act as “holding companies” and not merely as “affiliates.”

72. Utility Act § 2(a)(7)(B) provides: “The Commission, upon application, shall by order declare that a company is not a holding company . . . if the Commission finds that the applicant (i) does not . . . directly or indirectly control a public utility or holding company . . . by any means or device whatsoever, (ii) is not an intermediary company through which such control is exercised, and (iii) does not, directly or indirectly, exercise . . . such a controlling influence over the management or policies of any public utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors and consumers that the applicant be subject to the obligations, duties, and liabilities imposed in this chapter upon holding companies.” Section 2(a)(8)(B) offers subsidiaries the same opportunity to exempt themselves as subsidiaries by proving that they are not controlled or subject to a controlling influence by the holding company.

Of the three showings which an applicant for exemption must make, the lack of “controlling influence” is the most difficult.

In practice, the SEC has denied most exemptions when it has found that “controlling influence” existed between holding company and subsidiary. Occasionally, however, the Commission decides that regulation is not necessary to the public welfare despite the existence of “controlling influence.” See e.g., Matter of Irving Trust, 1 S.E.C. 273 (1936) (assets of holding company being liquidated); Matter of Italian Super Power Corporation, 1 S.E.C. 282 (1936) (utility operating abroad and control shared with a foreign government); Matter of Lehigh Coal v. Navigation Co., 1 S.E.C. 489 (1936) (holding company primarily engaged in a non-utility business).

Where the SEC exempts a company because it has no “controlling influence,” the exemption is usually conditioned on the retention of the status quo in holding-company subsidiary relations. See, e.g., Matter of Allied Chemical & Dye Co., 5 S.E.C. 151, 156 (1939); Blair-Smith, Forms of Administrative Interpretation under the Securities Laws, 26 IOWA L. REV. 241, 252 (1941).
While companies owning neither a majority of subsidiary stock nor access to its proxy machinery might not have been held to "possess the power to direct the management or policies" of a subsidiary under the Securities Act, they could nevertheless possess a "controlling influence" under the Utility Act. If, for example, their only influence over a subsidiary were ownership of a bloc of stock sufficient to veto corporate actions requiring a 2/3 vote, their "controlling influence" would be almost assured. Several holding companies, moreover, could exercise "a controlling influence" over a single utility at the same time. Hence, a holding company might become subject to regulation with respect to a particular subsidiary even though another holding company owned a larger portion of the utility's voting stock or elected a greater share of its directors.

To prove that they exercised no "controlling influence," parents had to demonstrate that their subsidiaries were not "susceptible to their control." "Susceptibility to control" might stem from countless sources. It might result from a few holding company representatives among the utility's directors or officers working harmoniously with the dominant faction in the utility's management. It might stem from large purchases of the utility's energy output by the holding company. It could even emerge from "a long-
"established voluntary practice" of conferring or advising the utility on construction, production, or financial matters.\(^\text{60}\) It could usually be avoided only by showing that the holding company was a virtual outcast in the utility's management, had been denied proportionate representation among its officers and directors, or had been ignominiously defeated on important corporate issues.\(^\text{61}\)

"Controlling influence" was easier to come by than get rid of. Holding companies might create voting trusts to hold their investments in the utilities; but since the trustees were seldom scrupulously independent of any affiliation with the holding company, this device would inevitably fail.\(^\text{52}\) Officers and directors common to holding company and utility might be removed; but "controlling influence" would linger on in the form of friendly relationships, past or present, with the subsidiary's new management.\(^\text{53}\) Holding company proxies might be delegated to the dominant faction in the utility's management; but unless these proxies were indefinite and irrevocable they could not erase the tinge of "controlling influence."\(^\text{54}\) Very often, the holding company could escape regulation only by reducing its investment in a utility to less than 10%, abolishing forever its "latent power to resume control."\(^\text{55}\)

If the rates at which the energy is furnished to the utility are regulated by state utility commissions and the holding company is not the largest shareholder it might escape regulation. Lehigh Power Securities Corp., 5 S.E.C. 143, 144 (1939).

80. Manchester Gas Co., 7 S.E.C. 57, 62 (1940) (no voting control, but tax, accounting, auditing, and engineering consultations. "Controlling influence may spring as readily from advice constantly sought as from command arbitrarily imposed.").

81. Panhandle Eastern Pipe Lines, 9 S.E.C. 370 (1941) (Mokan owned 42% of the stock, but had been refused directors, and had struggled unsuccessfully to break up Columbia's 51% control); Detroit Edison Co., 7 S.E.C. 968, 975 (1940) (refused recognition on utility's board despite attempts to force recognition by breaking a quorum). But cf. Chicago District Electric Generating Company, 2 S.E.C. 10 (1937) (no officers, 2 out of 7 directors, other holding company purchased 95% of utility's output).

82. Byllesby Co., 6 S.E.C. 639 (1940) (trustees are bound to act in interests of former controlling person). "We are doubtful that a voting trust can ever operate effectively to insulate control." Id. at 654.

83. Hartford Gas Co., 8 S.E.C. 758 (1941), aff'd, 129 F.2d 794 (2d Cir. 1942) (utility president formerly affiliated with holding company).


On the other hand, leasing of all the utility's assets accompanied by irrevocable proxies wiped out "controlling influence." Clearfield Bituminous Coal Co., 1 S.E.C. 374 (1936).

85. See Detroit Edison Co. v. SEC. 119 F.2d 730, 739 (6th Cir. 1941); International Paper and Power Co., 4 S.E.C. 873 (1939) (systematic weeding out of interlocking officers and turning over of stock holdings to liquidating trustees); 12 SEC Ann. Rep. 77–8 (1946)
The end result of the SEC's interpretation of "controlling influence" was effective utility regulation. It brought under SEC supervision all companies potentially able to exploit utilities through interlocking directorates and officerships, intercompany transactions, or counselary services. The Commission then took full advantage of its supervisory power to sterilize this potential.

The Investment Company in Control

In 1940 Congress undertook to regulate a second type of specialized company—the investment company. A latecomer on the American financial scene, its prime function was to invest in the securities of diverse industrial companies, and to distribute its earnings on these securities to its own shareholders. Naturally, this scheme appealed to the small, inexperienced investor. It offered him an opportunity to invest his savings wisely through skilled investment analysts, and, for the first time, to spread his investment over the securities of many different firms.

Diversification, however, was too often ignored by investment companies. Their funds were frequently tied up in a few industrial firms which their managers "controlled" or aspired to "control." Concentrated in—

(reduction of holding company voting stock ownership in utility to 5.4%—abolition of holding company management representatives).

Of course, even though the holding company reduced its holdings below the 10% point, the SEC was free to go after them under § 2(a)(7)(B). See note 72 supra.

86. See Comment, 40 Mich. L. Rev. 274 (1941) for an adverse criticism of the SEC's interpretation of "controlling influence." For a more favorable comment see Note, 51 Yale L.J. 1018 (1941). The Commission has, however, always been upheld by the courts. E.g., Public Service Corp. of New Jersey v. SEC, 129 F.2d 899 (3d Cir. 1942), cert. denied, 317 U.S. 691 (1942); 10 SEC Ann. Rep. 115 (1945) and cases listed therein. Up to June, 1944, the SEC had approved 164 out of 565 applications for exemption, denied 52, and 317 had been withdrawn or dismissed. Id. at 114.

87. See notes 66–70 supra.

88. The first investment company in America was organized in 1922. By 1926 the idea was gaining followers rapidly. By 1929, there were well over 600 investment trusts and related companies in existence and they controlled 4 billion dollars worth of capital. Next to utility shareholders, investment company subscribers were the most numerous group of stockholders in the country. See Reis, False Security 113–4 (1937); 10 SEC Ann. Rep. 158 (1945).

Before their introduction into the United States, investment trusts had been popular on the continent, particularly in England and Switzerland. See Investment Trusts in Great Britain, H. Doc. No. 380, 76th Cong., 1st Sess. (1939).

89. See Reis, op. cit. supra note 88, at 113–4. Dr. Leland Rex Robinson, leading authority on investment trusts in the twenties, described the investment company to investors as follows: "an agency by which the combined funds of different participants are placed in securities sharing a distribution of risk such as to introduce 'the law of averages' in protection of the principal; and which aims solely at the safe and reasonably profitable employment of the subscribed investment funds while definitely avoiding any and all of those responsibilities of control, management, finance, direction, or special interest which are sometimes tied in with investment." Id. at 114.


91. Investment companies may concentrate most of their assets in a few companies
vestment endangered the security-holders of both the investment company and its "controlled" companies. Investment company shareholders suffered disproportionately from subsequent failures of these "controlled" companies and from last-ditch attempts on the part of the investment company to save them.92 Investors in the "controlled" companies, like investors in subsidiaries of holding companies, were exploited through forced dividend payments and through transactions with the investment company's affiliates.93

The Investment Company Act of 1940 sought to protect both classes of investors.94 Under the Act, investment companies were given a choice between holding themselves out as diversified or non-diversified companies. If they chose to be called "diversified," they were permitted to invest only 25% of their assets as they pleased. Of the remaining 75%, none could be

for three chief reasons. They may be interested in subsidizing particular companies or industries until these companies get on their feet and their investment can be resold at a profit. This is intermediary banking or industrial finance. They may make a practice of buying up the securities of insolvent companies on the brink of reorganization in order that they may participate in and dominate the reorganization proceedings. The third reason—and the only one with which we are concerned here—is concentration of assets in order to exercise permanent control over corporations in which the investment company's sponsors are already interested, or expect to acquire an interest. INVESTMENT COMPANIES, pt. IV, 1–2.

In its survey, the SEC found 30 such investment holding-companies and at least an equal number of investment companies (only closed end management investment companies are concerned with the control of industry) which controlled some industrial companies as an incidental part of their businesses. The SEC concluded: "Control over industrial enterprise is one of the most important aspects of the investment company movement, particularly from the point of view of the national economy. . . . Investment companies have been used to influence or control other corporations in almost every major type of business enterprise. Their activities have ranged in character from theatre and orchid farms to the development of new mineral discoveries in Africa, and in size from dance halls to billion dollar utility and manufacturing concerns. In all it appears . . . that investment companies have had a close working relationship with industrial, railroad, utility and financial corporations whose assets exceeded $30,000,000,000." id. at 1–2.

For a discussion of legal aids to investment company control over industrial enterprises (lack of charter limitations on investment, waivers, etc.) see id. at 45; and for techniques of obtaining control, see id. at 16–22.

92. On the whole, investment companies which have invested a substantial part of their assets in "special situations" have sustained greater losses than truly diversified investment companies. INVESTMENT COMPANIES, pt. IV, 22–7. For instance, Eastern States Corp., an investment company, which had 92.8% of its assets in the stock of one corporation (24% voting ownership) suffered a paper loss of $14,000,000 on its investment between 1929–1935. Sometimes investment companies with concentrated investments felt impelled to continue investing when their subsidiaries hit bad times. Goldman Sachs lost 11 million dollars on its subsidiary, Frozen Foods Inc., part of which went as unsecured loans to the subsidiary over a two year period of continual deficits. Utility and Industrial Corp. loaned $250,000 to keep its subsidiary alive, and finally had to write down a $724,264 investment to $1, and charge off the loans to capital surplus. Id. at 22–7.

93. Id. at 27 et seq.

94. Investment Company Act §§ 5(b)(1) and (2)
invested in more than 10% of another firm's voting stock. And no more than 5% of the investing company's assets could be invested in one company. The investments of "non-diversified" companies, on the other hand, were left relatively unrestricted. But where a diversified or a non-diversified company "controlled" an operating company, its "control" became subject to SEC supervision. Investment companies had to disclose in registration statements the extent of their existent or intended "control" over operating companies; and transactions between investment company affiliates and "controlled" companies were regulated.95

In the act itself, Congress took a step toward defining "control." Section 2 defined it broadly as the "power to exercise a controlling influence."96 And ownership of 25% of an operating company's voting stock was established as a rebuttable presumption of "control."97 Thus, with its job largely done, the SEC had merely to define "controlling influence" in cases where companies attempted to rebut the act's presumption. In so doing, it was inevitable that the Commission should call upon its experience with the same words under the Holding Company Act. The broad application of "controlling influence" which had proved so successful in hitting at utility holding company abuses was carried over to the regulation of comparable investment company abuses. Where actually applied, it has served with equal effectiveness.98

Before a company could be regulated, however, it had to be brought within the act's definition of an investment company. Here, the SEC ran into trouble. Congress defined an investment company as one whose primary business consisted of investing or trading in securities. Any company engaging in trading or investing at all and having at least 40% of its assets invested in securities was presumed to be an investment company. An applicant for exemption, under Section 3(b), however, could rebut this presumption by showing that it was "primarily engaged in a business other


Affiliates under the Investment Company Act are defined similarly to the Holding Company Act. See note 71 supra.

In addition to these provisions, § 12(d) regulates the investments of "controlled" companies, to prevent "controlling" investment companies from violating prohibitions on their investment policies indirectly through their subsidiaries.

96. Investment Company Act § 2(a)(9).

97. Investment Company Act § 2(a)(9). Investment of less than 25% voting stock created a contrary presumption that "control" did not exist. Yet the SEC survey had found that presumptive "control" by investment companies stemmed from ownership of 10–50% voting stock of a subsidiary. INVESTMENT COMPANIES, pt. IV, 5. In view of this finding, the 25% figure seems unduly low for jurisdictional purposes. Compare the 10% voting stock ownership presumption for holding companies under the Holding Company Act. This 10% figure squares with SEC studies which revealed that utilities were seldom, if ever, "controlled" by less than 10% voting stock. Id. at 37 et seq.

98. See, e.g., Chicago Corp., Inv. Co. Rel. 1203 (1948) (owns 30.6 voting stock, representatives on board directors, veto power on certain corporate issues).
than . . . owning, holding, or trading in securities . . . through controlled companies conducting similar types of businesses." 99 Congress probably intended to exempt only integrated holding companies, i.e., companies primarily concerned with directing actual operations through their subsidiaries.100 But 3(b), as worded, was also subject to a different interpretation. Since the section exempted companies which carried on operations through their "controlled" subsidiaries, and since "control" under the Investment Company Act meant only "controlling influence," the act might reasonably have been held applicable to companies having less than actual directive power over their subsidiaries.101

Unfortunately, the SEC did not rule out such an interpretation altogether. While it took notice of the original incorporating purpose of the company, the proportion of its income stemming from dividends from "controlled" companies as compared with direct payments for services, and the amount of time donated to a subsidiary's businesses,102 it resorted to a search for "controlling influence" where these factors proved inconclusive. And in defining "controlling influence," the SEC adopted substantially the same definition employed under the Utility Act and the regulatory provisions of the Investment Company Act.103 Thus "controlling influence" might mean a mere "susceptibility to domination" by the holding company, stemming from a few interlocking directors or officers or even a

99. Investment Company Act §§ 3(a)(1), 3(a)(3), 3(b)(2). The 40% criterion was established as a result of SEC study of 1800 corporations. See Testimony of David Schenker, Hearings before Subcommittee of Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3rd Sess. 176 (1940).
100. See Hearings before House Committee on Interstate and Foreign Commerce on H.R. 10065, 76th Cong., 3d Sess., 101-2. (1940). The only examples cited in these hearings of holding companies which the drafters wished to protect were pure holding companies like General Motors and U.S. Steel which are integrated holding companies running automobile and steel businesses through their consolidated wholly-owned subsidiaries. The drafters seemed particularly anxious to keep within the law those holding companies whose assets were concentrated in large blocs of stocks in operating companies primarily for investment or other purposes.
101. Thus, a company which spread its investment over several operating subsidiaries in similar lines of business and maintained a "controlling influence" over these firms might run a good chance of escaping regulation as an investment company.
102. See, e.g., Business Property Assoc., 12 S.E.C. 845 (1942) (trustees of alleged investment company actually managed all investment companies of their real estate subsidiaries); M.A. Hanna & Co., 10 S.E.C. 581 (1941) (alleged investment company managed its subsidiaries and did sales and mining exploration for them). On the other hand, the SEC refused to exempt alleged investment companies with their assets concentrated in subsidiaries which were presently inactive. Atlantic Coast Line Co., 11 S.E.C. 661 (1942).
103. Throughout its interpretation of "controlling influence" under the Investment Company Act, the SEC has cited the Holding Company Act cases as precedents. In M.A. Hanna Co., 10 S.E.C. 581 (1941), however, the SEC admitted that "While this phrase as employed in the Holding Company Act must be construed in the context in which it is used and in the light of the general regulatory purposes of that Act, which are not necessarily the same as those of the Investment Company Act, these decisions are nevertheless entitled to weight as significant analogies." Id. at 589-90 n.13.
long-established practice of conferring on financial or engineering problems. As a result, applicants for exemption seldom had trouble proving their "controlling influence" and escaping regulation.

Such mass immunity was hardly what Congress intended. Congress probably wished to exempt only holding companies actually able to coordinate the policies of their subsidiaries. True integration, Congress may have felt, was more important to the country in 1940 than investor protection. But to achieve integration, a holding company needs more than "controlling influence." It needs real "control," as that term is defined under the Securities Act. Public utility experience with "controlling influence" has revealed that influence sufficient to exploit is not always sufficient to insure coordinated management.

Under the act as written, however, the SEC has only limited power to narrow the exemption. It might require proof of a stronger hand in subsidiaries' management to constitute "controlling influence" under 3(b) than it requires under the same words in the regulatory provisions of the act.

104. Bessmer Securities Company, for example, owned 17% stock in one subsidiary, elected 2 out of its 7 directors; owned 7% in another and elected 4 of its 11 directors. Despite the fact that the below-25% investment raised a presumption against "controlling influence" in both cases, Bessmer was held to have a "controlling influence" because of historical associations, counseling, etc. Bessmer Securities Co., 13 S.E.C. 281 (1943); M.A. Hanna Co., 10 S.E.C. 581 (1941) (27% stock, 3 out of 11 directors). "Historical, traditional, or contractual associations of persons with a company or a dominating persuasiveness of one or more persons acting in concert or alone may form the basis of a finding of 'control' in the sense used in the Act." Id. at 589.

105. The SEC itself has declared that the Investment Company Act is the minimum workable regulation of investment companies. Investment Companies, pt. IV, 383 (1942). Commentators go farther and criticize the Act for its liberal exemption policies. "It appears that no investment company is finding it difficult to become exempted from the provisions of the 1940 legislation." Thomas, Investment Company Act of 1940, 9 Geo. Wash. L. Rev. 918, 925 (1941). See, generally, Notes, 88 U. of Pa. L. Rev. 584 (1940); 50 Yale L.J. 440, 443-4 (1941); 41 Col. L. Rev. 269 (1941).

106. The only reference in Congressional hearings on the 3(b) exemption cite Standard Oil, Bethlehem Steel and General Motors as examples of the holding companies which should be exempt, because they are engaged in businesses other than security investment through their subsidiaries. All of these are integrated holding companies. Congress did seem anxious to "distinguish between the company which through a majority owned subsidiary or controlled subsidiary is in the business of manufacturing or operating a company, and a company which invests a substantial portion of its assets in a company merely for investment or holding for other purposes." Hearings before House Committee on Interstate and Foreign Commerce on H.R. 10065, 76th Cong., 3rd Sess. 102 (1940) (emphasis added). The Senate held extended hearings on a bill for investment company regulation which exempted holding companies which conducted a business other than investing or security trading only through wholly-owned or majority owned subsidiaries, making no provision for running such a business through controlled companies at all. At the end of that time, investment companies and the SEC and drafters of the Senate bill got together and drafted a compromise bill which was approved by committee but upon which no printed hearings were held. This new bill included the exemption for conducting a business through controlled companies. Hearings before Subcommittee of Senate Banking and Currency Committee on S. 3380, 76th Cong., 3rd Sess. (1940); S. Rep. No. 1775, 76th Cong., 3rd Sess. 1-2, 12 (1940).
This the Commission has not been willing to do. It remains for Congress, therefore, to implement its intent by insisting upon a finding of real directive power over operating subsidiaries before an applicant is entitled to exemption.

THE BONDHOLDER'S SPECIAL CASE: CONTROLLED TRUSTEES

The bondholder had a special "control" problem. His prime concern was the receipt of his interest when due and his capital upon maturity of the bond. He, together with all other bondholders similarly situated, had an indenture trustee, usually a commercial bank, to enforce these rights. In bad times especially, he depended upon prompt and decisive action by the trustee against a defaulting issuer.

But trustees were not always loyal to the interests of their bondholders. Too often, by reason of affiliation with the issuer or the underwriter, they concealed defaults from bondholders or delayed proceedings to enable management to salvage its reputation. At times they also permitted management to dominate an ensuing reorganization to the financial detriment of the bondholders.¹⁰⁷

The Trust Indenture Act of 1939 guaranteed bondholders an independent trustee. Instead of regulating or requiring the disclosure of "controlled" trustees, it disqualified outright any trustee who "controlled, was controlled by, or under common control with" either the issuer or the underwriter of the bond issue.¹⁰⁸

This disqualification wrought havoc in the underwriting industry. Under the Banking Act of 1933, underwriting departments and security affiliates of large commercial banks had been forced to part company with their founders and begin life anew as "independent" corporations.¹⁰⁹ In most cases, however, they retained their old officers, personnel, and customers. For capital, they relied largely on the management or stockholders of the commercial banks from which they had sprung.¹¹⁰ The Trust Indenture Act § 310(b)(3). On the numerous other grounds for disqualifications, and on the Act in general, see Goodbar, Bond Trustees as Statutory Trustees, 28 B.U.L. REV. 406 (1940). Prior to the act, the SEC could require mere disclosure of trustees' conflicting interests in registration statements. See, e.g., Frye Investment Co., 4 S.E.C. 840 (1939).


¹⁰⁹. First Boston Corporation descends from a security affiliate of the First National Bank of Boston; Harris Hall & Co. from the Harris Trust & Savings Bank of Chicago; Blair & Co. from the Bank of America (pre-1933 split); Central Republic Co. from the Central Republic Bank & Trust Co. Moody's, MANUAL OF INVESTMENTS, BANES, INSURANCE, etc. 1237, 1250, 1313 (1950); Peach, Security Affiliates of National Banks 143–168 (Johns Hopkins University Studies in Historical and Political Science) (1941).
Act therefore raised the following question: could commercial banks act as trustees for issues underwritten by their descendant underwriting firms? 111

J. P. Morgan & Co. provided the test case. In 1934, Morgan Stanley & Co. was incorporated to take over the management, personnel, name, customers, and good will of the old J. P. Morgan & Co. underwriting department. The officers in J. P. Morgan & Co., as preferred stockholders, contributed over 90% of the new firm's capital. These officers, who owned about 65% of the equity in J. P. Morgan & Co., then transferred their stock in Morgan Stanley to members of their families.

After passage of the Trust Indenture Act in 1939, J. P. Morgan & Co. sought approval from the SEC on its eligibility to act as trustee for bond issues underwritten by Morgan Stanley. The SEC found "common control" sufficient to disqualify J. P. Morgan & Co. Although few individuals shared in the ownership of both firms, and neither firm owned equity in the other, the Commission found that the officers controlling J. P. Morgan & Co., the trustee, through 65% equity ownership would be apt to favor their families' financial interest in Morgan Stanley, the underwriter, in times of stress. Morgan Stanley, in turn, was sufficiently "controlled" by the families of these officers through the financial domination inherent in 70% ownership of Morgan Stanley's preferred stock. This "control" was fortified by business and personal friendships and the sharing of customers and good will, i.e., the prestige of the Morgan name.112

Other large underwriting houses took the Morgan case to heart. They ceased doing business on bond issues for which their parent banks acted as trustee, as long as the same group of families owned most of the capital of the underwriter and its parent.113

111. Since both the underwriting and the trust indenture field are dominated by a few metropolitan firms, the chances that prominent New York and Chicago commercial banks might serve as trustees on issues underwritten by their former affiliates were high. Eight New York firms managed the underwriting of 77% of the securities registered during 1934-9. Wlcox, op. cit. supra note 35, at 176. Similarly, 95% of the total dollar amount of all trust indenture work over $1 million is handled by the banks of 9 major cities, and 80.2% of this work is handled by New York and Chicago banks. See Hearings before Subcommittee of House Committee on Interstate and Foreign Commerce on H.R. 2191 and H.R. 5220, 76th Cong., 1st Sess. 98 (1939).

112. J. P. Morgan & Co., 10 S.E.C. 119 (1941). The SEC had already found in Dayton Power & Light Co., 8 S.E.C. 950 (1941), aff'd sub nom, Morgan Stanley Co. v. SEC, 126 F.2d 325 (6th Cir. 1942), that Morgan Stanley was disqualified under Public Utility Rule U-12F-2 from receiving underwriting fees from the Dayton utility because of a likelihood of an absence of arms-length bargaining between the two firms. This stemmed from J. P. Morgan domination of the parent of the Dayton utility and his influence over the underwriting firm.


Some banks, however, still act as trustee for issues underwritten by firms with whose
The Morgan case smacked more of "susceptibility to domination" than "power to direct management or policies." As such, it looked more like a case of "controlling influence" than "control." But whether there was actual "control" or only "controlling influence" meant nothing in terms of bondholder welfare. The Commission's action plugged a gap which might have permitted trustees to escape disqualification through the simple device of distributing their holdings in the underwriter to other members of their families. Investor protection, in this area at least, has triumphed over semantics.

"CONTROL" IN CONTEXT

This study of "control" in five different statutory contexts has shown that in no two of them does it necessarily mean the same thing. This is as it should be. For in each statute the term "control" or "controlling influence" has a quite different function to perform. By and large, the SEC has been quick to realize this. Only under the Investment Company Act has it been doctrinaire in its approach. There, because of its insistence on a uniform definition of "control" in two different sections of the act, the steady rush of exemption seekers has gone unchecked. Apart from this, however, the Commission has wisely interpreted "control" and "controlling influence" so as to implement the overall scheme of corporate regulation laid down in each separate statute.

predecessors they had some connection. Chase National Bank may do work on issues underwritten by First Boston although nearly one half of First Boston's stock was originally distributed to the stockholders of Chase National Bank's former security affiliate, Chase Corp. Moody's, op. cit. supra note 110, at 1288. Communication from Paul C. Beardslee, Chase National Bank of New York, dated Jan. 17, 1950 in Yale Law Library (disclosing continued work on issues underwritten by First Boston). Harris Trust and Savings Bank also does work on issues underwritten by Harris, Hall & Co., descended from an underwriting department of the bank. In this case, however, the underwriter's stock was distributed to several hundred of the bank's stockholders rather than a small family group like the Morgan partners. Communication from F. D. Mann, Harris Trust and Savings Bank of Chicago, dated Jan. 10, 1950 in Yale Law Library.

CORRECTION

In Comment, The Impact of the FCC's Chain Broadcasting Rules, 60 YALE L.J. 78, 109 (1951), it is stated: "In 1941 the Justice Department filed an indictment against NBC and CBS, alleging extensive violations of the Sherman Act. As soon as the Supreme Court upheld the FCC's authority to issue the Rules, however, the Justice Department withdrew its indictment because it considered the question as moot." The term "indictment" should read "complaint." Similarly, in note 152 the term "indictment" should read "complaint."