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Corporation Finance and Bull Markets: Wall Street Under Oath

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CORPORATION FINANCE AND BULL MARKETS: *WALL STREET UNDER OATH**

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BOOK reviews are never dated. This one is, because I cannot dissociate from my mind the memory that ten years ago today, the newspapers first flashed the news of the crash in securities prices. The public soon realized that the crash was catastrophic. It marked the end of the bull market of 1929, and the beginning of a depression from which we have not emerged. But the newspapers are now heralding news of soaring securities prices. Are the bulls coming out of their Wall Street lairs? Will they deliver us from the depression? Who knows? But history has its tales to tell.

I.

In January, 1935, Governor Lehman appointed Ferdinand Pecora Justice of the Supreme Court of New York. In the fall of that year, he was overwhelmingly elected to continue in his judicial post for a term of fourteen years. A grateful electorate thus gave recognition to the superlative achievements of the former counsel to the United States Senate Committee on Banking and Currency. He has now taken time out to write the absorbing story spread over the 12,000-page printed record of the testimony taken by the Senate Committee in 1933–1934.

The Senate Committee functioned as an investigatory body. Its primary concern was to diagnose the causes of the financial debacle, and to formulate a curative and preventive program. Persons occupying positions of highest importance and responsibility in financial institutions were called to give testimony.

* WALL STREET UNDER OATH. By Ferdinand Pecora. New York: Simon & Schuster, 1939, pp. xi, 311.

EDITOR'S NOTE: This article was originally submitted as a book review, but because of the timeliness of the book and subject it has been printed as a leading article.

II.

J. P. Morgan was among the first to testify. Concededly, his was the greatest private banking firm. Under its articles of copartnership, the firm consisted of twenty partners. Differences or disputes among them were subject to Morgan's final decisions. He could dissolve the partnership at any time. His valuation of a partner's interest was conclusive. At the end of each year, half of the profits was credited to the individual accounts of the partners; the other half remained as undivided profits, subject to distribution at Morgan's discretion. Closely affiliated with J. P. Morgan and Company were three other banking houses: Drexel & Company of Philadelphia, Morgan Grenfell & Company of London, and Morgan et Cie. of Paris. These affiliates facilitated the national and international business of the parent company.

The latter conducted a bank deposit and an investment banking business. Its depositors were carefully selected. Individual depositors held positions of trust as officers and directors of well-known banks, and the Company accommodated them with personal loans. Corporate depositors included the giant railroad, communication, utility, oil and motor corporations. At the end of 1927, deposits exceeded half a billion dollars, and even at the end of 1932 (a depression year), deposits exceeded 340 million dollars. Deposits were subject wholly to the disposition of the partners of the firm, who, as private bankers, were free from governmental regulation, examination or supervision.[1]

Its investment business was very extensive. Between January 1, 1919 and May, 1933, the Company, generally in association with other bankers, offered to the public more than six billion dollars of new securities.[2] Until 1929, the Company operated on conservative lines, but in that year, it entered the promotional field, and launched the United Corporation (a utility holding corporation), the Alleghany Corporation (a railroad holding corporation), and Standard Brands, Inc. (a merger of large food corporations).[3] The

[1] *Id.* at 15.
[2] *Id.* at 18.
[3] "The process of concentrating wealth, of creating greater and greater corporations, of combining into new and gigantic units organizations already

Morgan Company acquired option warrants at a dollar each, convertible into United Corporation shares at $27.50. Not long thereafter, the shares rose to a high of $70, and the option warrants rose to $47.[4] Morgan tradition precluded a public offering of the common shares of the corporations which the Company had launched. Such tradition, however, did not preclude a private offering of the shares to a select list of purchasers. "Preferred lists" included ex-President Coolidge, General Pershing, Colonel Lindbergh, Senator McAdoo (a member of the Senate Investigating Committee), William Woodin (Secretary of the Treasury at the time of the investigation), and other persons of influence.

The Morgan Company could see nothing improper in such practices. The Morgan letter sent to persons on the preferred lists contained an offer to sell them shares, at cost to the Morgan Company, although the market price of the shares was almost double the offering price. The Morgan Company nevertheless refused to concede that it had favored such persons.[5] J. P. Morgan had a profound belief "in the invincible

very large in their own right, was proceeding at a fast pace, and J. P. Morgan and Company was leading the procession." *Id.* at 26.

[4] *Id.* at 24.

[5] George Whitney, a Morgan partner, speaking of persons on the preferred lists, testified: "They take a risk of profit; they take a risk of loss."

See letter addressed to William Woodin, later Secretary of Treasury:

"J. P. Morgan and Company,
"February 1, 1929

"My dear Mr. Woodin:

"You may have seen in the paper that we recently made a public offering of $35,000,000 Alleghany Corporation 15-year collateral trust convertible 5 per cent bonds, which went very well.

"In this connection the Guaranty Company . . . also sold privately, some of the common stock at $24 a share.

"We have kept for our own investment some of the common stock at a cost of $20 a share, and although we are making no offering of this stock, as it is not the class of security we wish to offer publicly, we are asking some of our close friends if they would like some of this stock at the same price it is costing us, namely, $20 a share.

"I believe that the stock is selling in the market around $35 to $37 a share, which means very little, except that people wish to speculate.

"We are reserving for you 1,000 shares at $20 a share, if you would like to have it.

"There are no strings tied to this stock, so you can sell it whenever you wish * * * We just want you to know that we were thinking of you in this connection and thought you might like to have a little of the stock at the same price we are paying for it * * *.

"Hoping you are having a pleasant trip, and with best regards,

"Sincerely yours,

William Ewing."

Id. at 29.

rectitude of his own regime". He "was the undisputed and absolute, though benevolent, monarch of his realm." [6]

III.

The blackest days of the depression came late in February and early in March of 1933. Moratorium legislation and "bank holidays" were the emergency palliatives of those days. A defeated President made a sad and quiet exit from the White House. His successor summoned the nation to battle against the depression. President Roosevelt's first "war measure" was the compulsory closing of every bank whose doors were still open. No bank was to reopen until it established its liquidity.

The National City Bank, founded in 1812, was one of the largest banks in the world. Only a few days before it closed pursuant to presidential proclamation, Charles E. Mitchell, Chairman of its Board of Directors, testified before the Senate Committee. "He was an impressive figure, forceful, self-confident and persuasive. He was then about fifty-six years old, a self-made man in the American tradition, raised to the financial heights by his innate capacity and will, and a dominant and attractive personality." [7] He had joined the National City organization in 1916, and had risen rapidly to a position of leadership. Until the crash of 1929, his slogan had been "expansion to the limit," and a public, avid to invest,[8] had hung on his every word. A chastened public now heard the story of the ramified growth of his organization.

For a century, the National City Bank had carried on the business usual and customary for commercial banks. But in 1911, it conceived the idea of forming a banking affiliate, and caused the incorporation of the National City Company in New York.[9] The Company's charter authorized every vari-

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[6] *Id.* at 6, 7.

[7] *Id.* at 71.

[8] "The public * * * were determined that every piece of paper would be worth tomorrow twice what it was today." Testimony of Otto H. Kahn, of Kuhn, Loeb & Company. *Id.* at 52.

[9] Frederick W. Lehmann, then United States Solicitor General, recognized immediately that the formation of the National City Company was an attempt to circumvent the National Banking Act, and to avoid its regulations and restrictions. Notwithstanding his expression of this view in an opinion rendered

ety of business activity except banking and railroading. The Bank and the Company, while legally distinct and separate corporations, were factually integral and practically identical. The Company's capital of $10,000,000 came from a 40% Bank dividend, which the shareholders had consented to transfer to the Company. Pursuant to a voting trust agreement, the shares of the Company were issued to three voting trustees,[10] and the Bank's shareholders became the owners of Company trust certificates. A shareholder could not, however, sell his Bank shares without at the same time selling his Company trust certificates. The two instruments, printed on both sides of the same sheet of paper, were legally and physically inseparable. The management of the Bank and of the Company was practically identical. In 1929, Mitchell was Board Chairman of the Bank and of the Company. The Bank had seventy-five branches in Greater New York, and many branches all over the world. The Company had sixty-nine branch offices in at least fifty-eight cities. Under Mitchell's direction, the National City organization sold yearly a minimum of a billion dollars of securities, and sometimes as much as two billions. For the ten years preceding the Senate investigation, the sales aggregated at least twenty billion dollars. The National City organization "manufactured" these securities (Mitchell's phrase), or participated in their manufacture. Under his leadership, "the National City grew to be not merely a bank in the old-fashioned sense, but essentially a factory for the manufacture of stocks and bonds, a wholesaler and retailer for their sale, and a stock speculator and gambler participating in some of the most notorious pools of 'the wild bull markets of 1929.'"[11] Before the Senate Committee, Mr. Mitchell assumed a lofty moral tone, even though the transactions in respect to which he testified were subject to severe criticism. I select a few examples for consideration.

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by Lehmann to the Department of Justice, the National City Company and similar banking affiliates went unmolested. *Id.* at 80.

[10] James Stillman, Sr., then Chairman of the National City Bank; Frank A. Vanderlip, then President of the Bank; and Stephen S. Palmer, then a director of the Bank.

[11] *Id.* at 76.

Edgar D. Brown.

In 1927, Edgar D. Brown, a resident of Pottsville, Pennsylvania, owned $100,000—$75,000 in cash, and $25,000 in United States government bonds. His health was not good, and he was planning a trip to the coast. When he testified before the Senate Committee in 1933, his wealth was gone, his health was broken, and he was earning a pittance as clerk of Pottsville's Poor Board. The change had come about in the following way: In 1927, he read a magazine advertisement suggesting that if the reader was planning a lengthy trip, it would pay him to get in touch with the National City Bank, which would closely guide him in his investments. The advertisement was signed by the National City Bank. He answered the advertisement, and a representative of the National City Company soon called to see him. He had implicit confidence in its representative, because he believed that he was dealing with the largest and soundest bank in the country. He imposed the single condition that his funds be invested in bonds, with fixed interest returns. The Company's expert advised him that his investment in the United States government bonds was "all wrong". Soon, these bonds were sold, and instead, the Company invested his funds in Viennese, German, Greek, Peruvian, Chilean, Rhenish, Hungarian, and Irish government bonds, as well as in bonds of private American corporations. High-pressure salesmanship was then applied, and he was inveigled into borrowing $150,000 in order to have his bond investments total a quarter of a million dollars. Later, when the value of these bonds declined, Brown complained to the National City Company, only to be told that the fault was his, because he had insisted upon investment in bonds. The Company now suggested that he buy stocks. His confidence in National City was still undiminished, and he authorized the suggested substitution, without specifying the nature or character of the shares to be purchased. Violent trading in stocks on his account ensued, and Brown was steadily losing money. He complained again, and his portfolio was changed to shares of the National City Bank and Anaconda Copper, in both of which the Company was then trading heavily. The value of his shares continued to decline. On October 4, 1929, he went to the Los Angeles branch of the National City Bank, and "asked them to sell out everything." What ensued is best told in the words of the record:

"Mr. Brown: I was placed in the category of the man who seeks to put his own mother out of his house. I was surrounded at once by all the salesmen in the place, and made to know that that was a very, very foolish thing to do.

"Mr. Pecora: That is, to sell your stocks?

"Mr. Brown: Especially to sell the National City Bank stocks. * * * I then received an unsolicited wire from their agent in the East * * * (*reading*) 'National City Bank now 525. Sit tight.' "

The crash came a few weeks later. Brown was sold out, and most of his capital was impaired. He tried to borrow money from the bank in which he had had implicit faith, but he was told that a loan was impossible unless he had "assured earning power and could pay off the loan within six months." He had no such earning power. He was forty years old, tubercular, almost totally deaf, with a wife and family dependent upon him for support.[12] He had been "wiped out". Mr. Mitchell expressed "retroactive distaste" for such practices.

Minas Geraes Bonds.

Mitchell testified that the Company had made every effort to find "safe and proper" securities issues. The Company's marketing of Minas Geraes bonds in 1928 and 1929 failed to substantiate his claim. Hardly anyone knew what or where Minas Geraes was. But the National City Company knew. It knew that prior to 1928, Minas Geraes, one of the states of the Republic of Brazil, had obtained French loans, that it had defaulted in payment, and that a suit by the bondholders had been brought against it. The Company had in its files a report from its expert on South American finances sent in 1927 to the Company's vice-president in charge of its foreign bond department, declaring that "the laxness of the State authorities (of Minas Geraes) bordered on the fantastic. * * * It would be hard to find anywhere a sadder confession of inefficiency and ineptitude than that displayed

[12] *Id.* at 84.

by the various State officials on the several occasions." [13] Notwithstanding this report, the Company introduced into United States markets an issue of $8,500,000 Minas Geraes bonds in 1928, and an additional issue of $8,000,000 in 1929. The report of the expert was no obstacle in the preparation of a prospectus for the bonds. In fact, the same expert prepared the prospectus, and in it he advised the investor that "Prudent and careful administration of the States' finances has been axiomatic with the successive administrations in Minas Geraes." [14] These bonds were sold by the Company at $97.50 and $87. At the time of the Senate investigation they had fallen to about $21. Bankers and selling houses had made a profit of approximately $600,000. Investors had lost approximately $13,000,000.

National City Bank Stock.

For many years, the shares of the National City Bank were listed on the New York Stock Exchange. But in January, 1928, the officers of the Bank professed to have discovered manipulative practices in the trading of the stock on the Exchange. They considered these practices "distinctly disadvantageous and probably at times * * * even * * * dangerous", and they caused the stock to be stricken from the Exchange. The shares were then selling at $785 per share, with a par value of $100. Salesmen of the Company, stimulated by special premiums, were then put to work. Some days, they sold as many as 40,000 shares; they even sold shares short, and the Company borrowed 30,000 shares from Mitchell's private holdings to cover the short sales.[15] In June, 1928, the shares sold at $940; in January, 1929, at $1,450; a few months later, after a five-to-one split-up, at $585 ($2,925 on the pre-split-up basis). After the crash, the shares fell from $585 to $21. In the three-and-a-half-year

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[13] *Id.* at 97.

[14] *Id.* at 98. A person connected with the National City organization questioned the above-quoted language of the prospectus as possibly "subject to criticism." The Company conceded (?) the validity of the criticism, and changed the word "axiomatic" to "characteristic"!

[15] "Greed and irresponsible banking could go no further." Pecora's comment. *Id.* at 112.

period ending December 31, 1930, the Company sold almost 2,000,000 shares.

A penitent Mitchell declared before the Senate Committee: "I would not do it again." [16]

IV.

In 1930, the Chase National Bank effected a merger with the Equitable Trust Company, and became the largest bank in the world. For many years, Albert H. Wiggin had been its president and chairman of its Board of Directors. He had joined the Bank in 1904, and had achieved the reputation of being the most popular banker in Wall Street. But in consequence of the merger in 1930, control of the Bank passed to the Rockefellers, and Winthrop W. Aldridge, brother-in-law of John D. Rockefeller, Jr., became its president. Wiggin remained its active head, with the title of Chairman of the Governing Board, until his resignation in December, 1932. He testified before the Senate Committee late in 1933. His answers were "terse, succinct and directly to the point, with seldom an unnecessary word". He was "calm, shrewd and cynical" and "most decidedly a die-hard." [17] His testimony quickly deflated his popularity.

While the National City Bank had its National City Company, the Chase Bank had its five affiliates, chief among them being the Chase Securities Corporation, organized in 1917. In addition, Wiggin had his six private corporations, controlled by his immediate family; three of them were Canadian corporations, organized to reduce or avoid income taxes.

During the depression years, Wiggin, in reporting to the shareholders of the Bank, denounced high wages, and declared that American business "may reasonably ask labor to accept a moderate reduction in wages." Wiggin, however, did not always practice what he preached. As head of the Chase National Bank, his salary in 1928 was $175,000; in 1929, an equal amount; in 1930, $218,750; in 1931, $250,000. But in 1932 he did accept "a moderate reduction in wages". He received only $220,300; less than the 1931 "wage", but

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[16] *Ibid.*
[17] *Id.* at 136.

more than the 1928, 1929 and 1930 "wage"! These figures represent Wiggin's *regular salary* as head of the Bank; he also received large sums as bonus. The presidency of the Bank was just a part-time job for Wiggin. In addition, he held fifty-nine directorships, and was a member of finance and executive committees of many corporations. For such services, he received, for example, from the Brooklyn-Manhattan Transit Corporation a salary of $20,000; from Armour and Company, $40,000; from the American Express Company, $30,000; from Western Union, $2,000. Many of these corporations procured loans from the Chase National Bank, but Wiggin denied that decisions on loan applications were in any way influenced by his associations with the corporations. In 1928, when his salary as head of the Bank was $175,000, and his bonus was $100,000 (a total of $275,000), his real income, added to that of the private corporations which he controlled, was more than $6,800,000, on which federal income taxes of approximately $962,000 were paid.

Between September, 1927 and July, 1931, the Chase Securities Corporation, directly or indirectly, participated in and financed pools in bank stock. During the five-year period 1928–1932, trading in bank stock brought the Bank's investment affiliate a profit of $159,000. During substantially the same period, trading in the same stock brought Wiggin and his private corporations a cash profit of more than $10,425,000. Over $4,000,000 of this profit was realized between September 19, 1929 and December 11, 1929. During that period, he was a member of the "Bankers' Consortium", formed to stabilize the market as far as possible. The Bank, through its affiliates, was participating in a pool to stabilize the market. But Wiggin was selling Chase Bank stock short. Five thousand of the shares which he sold short were sold directly to the pool. To finance these transactions, Wiggin and his corporations borrowed more than $8,000,000 from the Bank.

Upon his resignation as chairman of the Governing Board of the Bank in December, 1932, Wiggin was granted a pension of $100,000 annually. After his deflation by the Senate Committee in 1933, public disapproval become so overwhelming as to impel Wiggin to renounce his pension. "In the entire investigation," says Justice Pecora, "it is doubtful if there was another instance of a corporate executive who so thoroughly and successfully used his official and fiduciary position for private profit." [18]

V.

The New York Stock Exchange was a "scarlet thread" ever winding its way through the Senate investigation. An unincorporated association of 1,375 members, it operated very much as a club, subject only to self-discipline, and to no external regulation. To its president, Richard E. Whitney, it was a "perfect institution".[19] To Wiggin, it was "a God-given market".[20]

When questioned before the Senate Committee, Wall Street financiers affected a naïve innocence of familiarity with Exchange practices. Mitchell and Wiggin were wholly unfamiliar with pools. Arthur W. Cutten, famous in speculative finance, could not define a "wash sale". Buttenweiser, of Kuhn, Loeb and Company, knew of "pegging" only from hearsay.[21] But the Senate Committee found that in 1929, pools, syndicates, joint accounts and the like, were operating in 105 stocks listed on the Exchange. "The public who bought these stocks at dizzily mounting prices did not do so merely because of impersonal economic forces; they were the victims of a determined, organized group of market-wise operators, armed with special information and special facilities, and backed generously with banker's credits".[22]

VI.

The testimony before the Senate Committee "had brought to light a shocking corruption in our banking system, a widespread repudiation of old-fashioned standards of honesty and fair dealing in the creation and sale of securities, and a merciless exploitation of the vicious possibilities of intricate

[18] *Id.* at 161.
[19] *Id.* at 259.
[20] *Id.* at 262.
[21] *Id.* at 261.
[22] *Id.* at 263.

corporate chicanery." [23] Enormous sums of money had been lost by unwary investors who had purchased worthless securities.[24] State regulation had proved ineffective. The Senate Committee set about to prepare a program of federal legislative reform which culminated in the enactment of four statutes.

The Banking Act of 1933 required the separation of the commercial banks from their security affiliates.[25] A director or officer of a bank was forbidden to serve as officer of an investment house. Private bankers, such as J. P. Morgan & Co., were required to choose between their bank deposit and underwriting business.

Then the Securities Act of 1933,[26] the Securities Exchange Act of 1934,[27] and the Public Utility Act of 1935 [28] were enacted. I have analyzed these Acts elsewhere,[29] and I shall therefore consider them here very briefly. The primary purpose of the Securities Act of 1933, popularly known as the Truth in Securities Act, is to provide for a full and fair disclosure of the facts concerning securities issued for sale by means of interstate instrumentalities or the mails. Disclosure is effected by a registration statement filed with the Securities and Exchange Commission, and a similarly registered prospectus delivered to the purchaser.

The essential purposes of the Securities Exchange Act of 1934 are (1) to regulate securities exchanges and markets, (2) to control credit, (3) to prevent unfair practices and (4) to regulate corporations with listed securities by requiring periodical reports, controlling proxies, and also, to a limited extent, directors, officers and principal shareholders.

The Public Utility Act of 1935 provides for the elimination of unnecessary public utility holding companies, and for

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[23] *Id.* at 283.

[24] The losses sustained by the investing public through the sale of fraudulent securities in the United States was estimated in 1933 to have been twenty-five billion dollars for the ten years preceding. Legis. (1933) 33 COL. L. REV. 1220.

[25] 48 STAT. 184 (1933), 12 U. S. C. §24-7 (1934).

[26] 48 STAT. 74 (1933), 15 U. S. C. § 77a (1934).

[27] 48 STAT. 881, 15 U. S. C. § 78a (1934).

[28] 49 STAT. 838 (1935), 15 U. S. C. A. § 79 (Supp. 1938).

[29] PRASHKER, CASES AND MATERIALS ON PRIVATE CORPORATIONS (1937) 611, 619, 1198.

the regulation by the Securities and Exchange Commission of the remaining companies.

Before and after the enactment of these statutes, dire prophecies were made of their probable consequences. On the whole, these prophecies have proved false. It is true that immediately after the enactment of the Securities Act of 1933, the flotation of new securities declined, but this was due to the fear of promoters and underwriters to risk the truth. The investing public had become less gullible.

VII.

Gone from the seats of the mighty are the old titans of Wall Street. J. P. Morgan still rules, but thanks to the Banking Act of 1933, only half of a partitioned kingdom. Mitchell, the super-banker and stock salesman, was displaced. Wiggin, the most popular banker in Wall Street, has withdrawn. Richard E. Whitney, the Stock Exchange moralist and spokesman, was convicted on his own confession for misapplying clients' and Stock Exchange funds. History has its tales to tell.

Twenty-five years ago, James Harvey Robinson developed the thesis that we study the past in order to understand the present, and that present conditions and opinions can be understood only by following carefully the processes which produced them.[30] The people of the United States should never forget the processes which produced the current federal securities legislation. So long as they remember and understand, they will firmly resolve not to permit it to be effaced or emasculated. Such resolve will be an enduring tribute to the work of Justice Pecora, who has now made available in book form, *Counsel's Summation of the Testimony.*

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[30] ROBINSON, THE NEW HISTORY (1913) 24.