INVESTMENT TRUSTS

A STUDY IN RELATION
TO PUBLIC ACCOUNTING

HASKINS & SELLS
NEW YORK
1930
Investment Trusts

A RECENT estimate (New York Evening Post, August 31, 1929) places the number of investment trusts operating in this country at 450, employing a total capital in excess of $2,000,000,000.00. New trusts formed in the first two weeks of September would probably result in revising this figure upward to $2,500,000,000.00 with more to come.

This represents a sensational growth, practically all of it since 1921, when one of the important pioneers, the International Securities Trust of America (predecessor of International Securities Corporation of America) was formed. The industry grew very slowly up to 1924. In the succeeding four years it increased rapidly, up to an estimated capital at January 1, 1929, of $1,000,000,000.00, and since that date it has gone forward by leaps and bounds. Records compiled by the Commercial & Financial Chronicle show that of the new corporate issues brought out in the first seven months of 1929, $1,100,000,000.00 were those of investment trust and holding companies. This constituted about one-sixth of all the new financing done during that period. In July the new issues by investment trusts and holding and trading companies totaled $222,000,000.00 and in August investment trust financing in stock issues alone totaled $341,000,000.00.

It has been estimated that 75% of the total funds of our investment trusts are invested in common and preferred stocks,
this proportion representing a considerable increase during the current year owing to the fact that foreign markets have presented less inviting opportunities than heretofore. One survey indicated that about 16% of the total capital was represented by liquid assets. This would indicate that the trusts are carrying at times upward of $300,000,000.00 in cash and loans on call.

By comparison, it is interesting to note that the distribution at July 31, 1929, of an investment fund exceeding $1,000,000,000.00 of one of the great life insurance companies showed about 44% in real estate loans, 15\(\frac{1}{4}\)% in policy loans, 37\(\frac{1}{2}\)% in bonds, 21\(\frac{1}{2}\)% in preferred stocks, 1\(\frac{1}{2}\)% in common stocks, and 1\(\frac{1}{2}\)% in cash. The proportion of preferred stocks will undoubtedly increase as it was only recently that a change in the New York laws permitted life insurance companies to invest in preferred stocks and guaranteed common stocks fulfilling certain requirements.

The oldest and best-known group of American investment trusts is that managed by American Founders Corporation. Published reports show that at November 30, 1928, the portfolio of the three principal supervised companies of this group, excluding intercompany holdings, was about $103,000,000.00, of which 58% was in bonds, 5% in preferred stocks, 23% in common stocks, and 14% in cash and call loans. The management has announced that the total resources of this group in September, 1929, including the management company, exceed $200,000,000.00. Until recently this has been the largest group in the country, but the Goldman Sachs Trading & Financial Corporation, organized in December, 1928, now has a total invested capital of about $244,000,000.00 (see special Investment
Trust Supplement of Standard Statistics Company, dated August 12, 1929). Affiliated with the latter are the two more recently organized investment trusts, viz., Shenandoah Corporation and Blue Ridge Corporation. Still more recent organizations are the Prince & Whitely Trading Corporation and the Lehman Corporation, the latter starting operations with a capital of $100,000,000.00.

In Great Britain, where investment trusts originated and where even before the war they constituted an important factor in finance, it has been estimated that in 1928 there were 150 trusts with invested capital of nearly $1,000,000,000.00 (see page 3 of the very valuable book "American Investment Trusts," by John F. Fowler, Vice-President and Secretary of American Trustees Share Corporation, published 1928 by Harper's). These figures do not include many enterprises which in the United States would be classed as investment trusts.

The term investment trust is something of a misnomer, as most of the institutions covered by the term are not strictly trusts at all. On October 15, 1928, a committee of the Investment Bankers Association of America appointed for the purpose of reporting on the question of State regulation of investment trusts, said, "We are concerned with companies organized to invest and reinvest money and let us therefore represent them at face value and call them investment companies." Despite the logic of this recommendation, it seems impracticable at this time to get away from the popular term "investment trust."

The New York Stock Exchange defines Investment Trusts as "such companies as are engaged primarily in the business of investing and reinvesting in the securities
of other corporations for the purpose of revenue and for profit, and not in general for the purpose of exercising control."

Mr. John F. Fowler defines an investment trust broadly as "an organization for the collective investment of the funds of numerous individuals in numerous securities." He further says: "As defined today, the investment trust has some kinship with holding companies, public utility management companies, savings banks, commercial banks, financing companies, land banks, agricultural credit corporations, building and loan associations, mortgage companies and insurance companies. All these represent a pooling of capital, but they differ from the investment trust in conception. A holding company or public utility management company, like the investment trust, has its assets in the form of securities of other companies, but it differs from the investment trust in that it holds actual or potential managerial control of the companies whose stocks it owns. Especially in the field of public utilities or financial institutions numerous holding companies are in evidence. . . . There is no clear cut dividing line between the holding company or financing company and the investment trust—each may overlap on the province of the other. For general purposes, it may be said that the investment trust purchases securities for the purpose of creating an investment which shall constitute the main source of income, and that such purchases shall be for investment only—not for the acquisition of controlling interests nor primarily for resale. It is argued with good reason that holding company and financing company activities do not mix well with the functions of investment trusts. The main purpose of pure investment may be lost sight of in the managerial view of the com-
panies which control other companies or with the extension of credits to such compa-
ies. The true training of investment trust executives does not embrace manage-
ment of industrial enterprises or the financ-
ing thereof.”

In a survey conducted in 1928 in an effort (since abandoned) to obtain legisla-
tion in New York State for the supervision of investment trusts, Attorney-General
Ottinger defined an investment trust (see page 25 of his Supplemental Survey) as
“any corporation or association formed under the laws of this or any other State
doing business in this State for one or more of the following purposes:

“(1) For the principal purpose, directly or indirectly, of (a) selling, offering for
sale, or otherwise marketing its bonds, debentures or other evidences of indebtedness, or shares of stock of the
said company, and (b) investing and reinvesting the proceeds thereof in
securities.

“(2) For the principal purpose, directly or indirectly, of selling, offering for sale,
or otherwise marketing its trust cer-
tificates or any certificates of interest
of said company or of a trustee, ent-
titling the holder thereof to receive
the income from any designated se-
curities or to receive any designated
securities or the proceeds thereof
deposited with, delivered to or
pledged with a trustee for the benefit
of any such trust certificate or cer-
tificates of indebtedness.

“(3) For the principal purpose, directly or indirectly, of selling, offering for sale,
or otherwise marketing its trust certificates or any certificates of in-
terest of said company or of a trustee,
and for directly or indirectly investing and reinvesting principal or surplus of any trust fund, the ownership or partial interest in which is evidenced by trust certificates other than stock certificates."

The usual classification of investment trusts by form divides them into two main groups. The first group, called statutory, also called British type or Scottish type, corresponds to the definition appearing under (1) above. The second group called contractual or trust type proper embraces the definitions appearing under (2) and (3) above.

Under the statutory group a new security is created "by setting up the investment trust as an intermediary between the investing public and the securities acquired as an investment." These capital securities, issued in varying proportions of bonds, debentures, and preferred and common stocks, are sold like any other corporate obligation.

The contractual group embraces trusts proper, under which the principle of joint ownership is applied and certificates of participation are issued to the subscribers. "The contractual trust," says Mr. Fowler, "while it usually is formed by a corporation, is itself not a corporation, but a creature of contract. Generally, the contractual trust comes under the legal definition of a common law trust—'a right of property held by one for the benefit of another or others.' The person who holds the right of property—legal title—is the trustee and the beneficiaries are those for whose advantage the trust is created. It is possible for a contractual trust to be so framed as to vest legal (as distinguished from equitable) title to an investment fund in the certificate holders. The organi-
tion then created is not a common law trust, but is evidenced merely by a 'deposit agreement.' Thus, the indenture for Diversified Trustee Shares, series 'B' (American Trustees Share Corporation) specifically affirms that '(legal) title to the deposited stocks and securities shall vest in the respective certificate holders in proportion to their holdings of certificates.'

Under the contractual form an investment fund is deposited with a trustee and certificates of interest are sold to investors at a price based on the value of the securities in the fund plus a differential representing the cost of raising capital and other expenses, such as trustees' fees paid in connection with the deposit and custodianship of property in the investment fund. These differentials vary from 1% to 10% or more on the value of the principal.

Two general classes of contractual trusts may be recognized, namely, the general fund type and the unit share type, the latter sometimes known as "bankers' share," "collateral share," "stock conversion," or "trustees' share." The broad distinction between these two types of contractual trusts is that certificates of the general fund type are issued against a fund (or one of a series of funds) of considerable size, say $1,000,000.00, which has been accumulated according to no rigid scheme and frequently under an indenture permitting substitutions, while the certificates of the unit share trust are issued against one of several or many relatively small (say $20,000.00) identical blocks or units of investment securities, each unit being in itself virtually a small trust, which is in many or most cases of a rigid type not permitting substitutions. The unit trust participations are divided into shares,
representing a proportionate ownership, say 1/1000 part, in one of the units.

As an example of the unit share type, each Diversified Trustee Share, series “B” (issued by American Trustee Share Corporation), represents a 1/1000 interest in a unit of 134 shares of specified common stocks comprising 30 shares of seven railroad stocks, 28 shares of seven public utilities stocks and 76 shares of sixteen industrial stocks.

“To be valid the instrument by which a contractual trust is created must not violate the well-known rule against perpetuities or against restraints on alienations. . . . Certificate holders may redeem their certificates for cash or convert them directly into the deposited securities . . . Redemption, in the case of unit share trusts, is usually accomplished through a provision for convertibility of certificates. The holder of shares aggregating a full interest in a unit on surrender of his certificates, received a unit of the deposited securities; no redemption fee is charged.” (Fowler.)

Most American investment trusts are of the statutory or British type; out of 199 investment trusts classified by Mr. Fowler as of July 1, 1928, 146 were statutory type, 21 were contractual—general fund type, and 32 were contractual—unit share type. These were further classified according to restrictions on the composition of portfolio and general discretion in its management, as follows:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Con-</th>
<th>Statutory</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>General trusts, commonly known as general management type, investing in bonds and stocks of various descriptions</td>
<td>105</td>
<td>7</td>
<td>112</td>
</tr>
<tr>
<td>Specialized trusts, investing in: Common stocks</td>
<td>7</td>
<td>21</td>
<td>28</td>
</tr>
<tr>
<td>Bonds</td>
<td>1</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Financial stocks (bank or insurance stocks)</td>
<td>19</td>
<td>14</td>
<td>33</td>
</tr>
<tr>
<td>Single industry stocks</td>
<td>14</td>
<td>5</td>
<td>19</td>
</tr>
<tr>
<td>Total</td>
<td>146</td>
<td>53</td>
<td>199</td>
</tr>
</tbody>
</table>
The *New York Evening Post* now publishes quotations, under the head of Investment Trusts, of about 240 issues classified under the four headings “general management,” “specialized management,” “fixed or limited management” and “holding and financial companies” as shown in the first two columns below (the last four columns show the form classification of these trusts per Fowler):

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**Classification per Fowler**

<table>
<thead>
<tr>
<th>Evening Post Classification</th>
<th>Conventional General in 1928</th>
<th>Conventional Fowler Not Listed by</th>
<th>Statutory General</th>
</tr>
</thead>
<tbody>
<tr>
<td>General management</td>
<td>153</td>
<td>93</td>
<td>4</td>
</tr>
<tr>
<td>Specialized management</td>
<td>12</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Fixed or limited management</td>
<td>25</td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>Holding and financial</td>
<td>50</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>companies</td>
<td>50</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>240</td>
<td>100</td>
<td>5</td>
</tr>
</tbody>
</table>

The following trusts, all of them of the statutory type, are among those, as listed by Fowler, in which the management has unlimited discretion regarding investment:

- **Name of Trust**: General American Investors, Inc., Lazard Freres
- **Fiscal Agent**: F. J. Lisman & Company
- **Name of Trust**: Old Colony Investment Trust, Old Colony Corporation
- **Fiscal Agent**: National Shawmut Bank
- **Name of Trust**: Shawmut Bank & Investment Trust
- **Fiscal Agent**: Throckmorton & Co.

On the other hand, the following trusts, all of which are of the contractual-unit share form, are indicated by Fowler as being of the fixed type in which the sponsors have no discretion to change the contents of the portfolio:

- **Name of Trust**: American Basic Business Shares Corporation
- **Fiscal Agent**: F. J. Lisman & Company
- **Name of Trust**: American Trustees Share Corporation
- **Fiscal Agent**: Throckmorton & Co.
In between these extremes are certain trusts like the companies of American Founders group in which the by-laws and resolutions of the Board lay down certain requirements as to diversification of portfolio by industry and country and as to investment caliber of securities acquired. To meet these requirements, the portfolios of three of the group, as shown by published reports at November 30, 1928, were composed as in the table on pages 14-15.

We have Fowler's authority for saying that most discretionary trusts do not specify that their investments shall be marketable. Investment Managers Company, however, goes all the way in assuring that securities in the fund shall have a ready market. Stocks to be purchased must be listed on the New York Stock Exchange and transactions in them must have been recorded within the period of one year; the total outstanding amount of any given stock must be at least $20,000.00. United States Shares Corporation in its common stock trust shares, series “A-1,” provides that each of its securities shall be listed on the New York, Boston or Chicago Stock Exchange. Mutual Investment Company states that not less than 60 per cent. of the investment fund shall be in securities listed on the New York Stock Exchange. International Securities Corporation of America agrees merely that its investments must be “marketable.”

Restrictions regarding the investment caliber of securities purchased, are, in the case of common stock trust shares, series “A-1,” of United States Shares Corpora-
tion, that "no more than 10% shall be in shares rated lower than Ba in Moody's Manual; no stocks shall be acquired if rated lower than B; no more than 50% shall be in stocks rated lower than Baa; not less than 20% must be in stocks rated A or higher." The stocks must also have paid a dividend within six months.

More liberal is the provision of International Securities Corporation of America that securities to be eligible for purchase must be seasoned and the issues must have been established at least four years. North American Investors Corporation stipulates that "only those securities will be purchased about which reliable information and data can be ascertained relative to management, history, assets, earnings, and income of the corporations or other authorities or organizations issuing securities."

Fixed trusts and most management trusts which contemplate the exercise of comparatively little management take the unit share form. The conditions under which substitutions, if any, may be made, are strictly prescribed by the unit share trust in advance. The disposition to be made of stock dividends and subscription rights must be prescribed in fixed trusts and is frequently prescribed in other unit share trusts. Diversified trustee shares, series "B," of American Trustees Share Corporation provide that subscription rights shall be sold and stock dividends other than fractional and odd shares shall be retained in the fund. Bank stock trust shares, series "C-1," "C-2," and "C-3" of United States Shares Corporation provide for retaining all stock dividends. Series "C-1" provides for the sale of rights, series "C-2" for the exercise of rights, and series "C-3" for the exercise or sale of rights at the discretion of managers.

In the case of general management
<table>
<thead>
<tr>
<th>Bonds</th>
<th>Preferred stocks</th>
<th>Cash and call loans</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>66.37</td>
<td>3.75</td>
<td>14.19</td>
<td>15.69</td>
</tr>
<tr>
<td>$42,686</td>
<td>2,410</td>
<td>9,122</td>
<td>10,089</td>
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<table>
<thead>
<tr>
<th>United States of America</th>
<th>British Commonwealth of Nations</th>
<th>Central and South America</th>
<th>Central Europe</th>
<th>Eastern Europe</th>
<th>Western Europe</th>
<th>Japan and other Asiatic Countries</th>
<th>Cash</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.88</td>
<td>4.47</td>
<td>6.29</td>
<td>37.72</td>
<td>4.77</td>
<td>11.14</td>
<td>4.04</td>
<td>15.69</td>
<td>100.00</td>
</tr>
<tr>
<td>$10,212</td>
<td>2,874</td>
<td>4,046</td>
<td>24,257</td>
<td>3,068</td>
<td>7,163</td>
<td>2,598</td>
<td>10,089</td>
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<table>
<thead>
<tr>
<th>Government and Municipal</th>
<th>Transportation</th>
<th>Public Utilities</th>
<th>Industrials</th>
<th>Mortgage banks, banks and trust companies</th>
<th>Investment organizations</th>
<th>Insurance companies</th>
<th>Cash</th>
<th>Total</th>
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</thead>
<tbody>
<tr>
<td>30.59</td>
<td>3.84</td>
<td>12.75</td>
<td>18.88</td>
<td>13.24</td>
<td>4.65</td>
<td>0.36</td>
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<tr>
<td>$19,672</td>
<td>2,469</td>
<td>8,199</td>
<td>12,142</td>
<td>8,514</td>
<td>2,990</td>
<td>232</td>
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<table>
<thead>
<tr>
<th>International Securities Corporation of America</th>
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<tr>
<td>%</td>
</tr>
<tr>
<td>Bonds</td>
</tr>
<tr>
<td>Preferred stocks</td>
</tr>
<tr>
<td>Cash and call loans</td>
</tr>
<tr>
<td>Total</td>
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</table>

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<tbody>
<tr>
<td>%</td>
</tr>
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<td>Central and South America</td>
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<td>Eastern Europe</td>
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<td>Japan and other Asiatic Countries</td>
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<td>Cash</td>
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<tr>
<td>Total</td>
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<tr>
<td>%</td>
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<td>Transportation</td>
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<tr>
<td>Public Utilities</td>
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<tr>
<td>Industrials</td>
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<tr>
<td>Mortgage banks, banks and trust companies</td>
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<tr>
<td>Investment organizations</td>
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<tr>
<td>Insurance companies</td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>Total</td>
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## TYPES OF SECURITIES, THOUSANDS OF DOLLARS

<table>
<thead>
<tr>
<th>Second International Securities Corporation</th>
<th>United States &amp; British International Company, Ltd.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>50.62</td>
<td>$11,210</td>
<td>37.35</td>
</tr>
<tr>
<td>3.29</td>
<td>728</td>
<td>9.68</td>
</tr>
<tr>
<td>37.51</td>
<td>8,307</td>
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<tr>
<td>8.58</td>
<td>1,902</td>
<td>12.65</td>
</tr>
<tr>
<td>100.00</td>
<td>$22,147</td>
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## DISTRIBUTION, THOUSANDS OF DOLLARS

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<tr>
<th></th>
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<th>20.08</th>
<th>$3,294</th>
<th>16.30</th>
<th>$16,768</th>
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<tbody>
<tr>
<td>14.73</td>
<td>2,854</td>
<td>21.91</td>
<td>3,594</td>
<td>9.07</td>
<td>9,322</td>
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<tr>
<td>12.89</td>
<td>589</td>
<td>5.17</td>
<td>521</td>
<td>5.02</td>
<td>5,156</td>
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<tr>
<td>2.66</td>
<td>2,022</td>
<td>23.41</td>
<td>3,841</td>
<td>36.26</td>
<td>37,300</td>
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<tr>
<td>4.28</td>
<td>947</td>
<td>5.30</td>
<td>869</td>
<td>4.74</td>
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<tr>
<td>8.85</td>
<td>1,961</td>
<td>6.85</td>
<td>1,123</td>
<td>9.97</td>
<td>10,247</td>
</tr>
<tr>
<td>6.46</td>
<td>1,430</td>
<td>6.63</td>
<td>1,088</td>
<td>4.97</td>
<td>5,116</td>
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<tr>
<td>8.58</td>
<td>1,902</td>
<td>12.65</td>
<td>2,075</td>
<td>13.67</td>
<td>14,066</td>
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<td>100.00</td>
<td>$22,147</td>
<td>100.00</td>
<td>$16,405</td>
<td>100.00</td>
<td>$102,859</td>
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## TYPES OF INDUSTRY, THOUSANDS OF DOLLARS

<table>
<thead>
<tr>
<th>Second International Securities Corporation</th>
<th>United States &amp; British International Company, Ltd.</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>Amount</td>
<td>%</td>
</tr>
<tr>
<td>25.54</td>
<td>$5,656</td>
<td>15.41</td>
</tr>
<tr>
<td>5.46</td>
<td>1,209</td>
<td>5.83</td>
</tr>
<tr>
<td>7.71</td>
<td>1,707</td>
<td>10.01</td>
</tr>
<tr>
<td>29.79</td>
<td>6,598</td>
<td>22.32</td>
</tr>
<tr>
<td>15.18</td>
<td>3,361</td>
<td>13.46</td>
</tr>
<tr>
<td>7.05</td>
<td>1,561</td>
<td>19.47</td>
</tr>
<tr>
<td>.69</td>
<td>153</td>
<td>.85</td>
</tr>
<tr>
<td>8.38</td>
<td>1,902</td>
<td>12.65</td>
</tr>
<tr>
<td>100.00</td>
<td>$22,147</td>
<td>100.00</td>
</tr>
</tbody>
</table>
trusts, a separate management corporation frequently administers the portfolio for a fee. A usual basis for such a fee is \( \frac{1}{2} \) of 1% annually on the invested capital, which Fowler estimates would be equivalent approximately to 5% of income from the portfolio. This calculation assumes a rate of income from the portfolio (gross income) of 10%, which in Fowler’s observation is a fair assumption. This more or less standard fee of \( \frac{1}{2} \)% per annum on principal is the rate paid to American Founders group by its companies other than International Securities Corporation of America. Some management fees, however, are based on a percentage of income of the portfolio; such fees range from 4% (in the case of International Securities Corporation of America, calculated on gross income including trading profits less taxes) up to 15% or more.

It has been announced that the contract under which the new Lehman Corporation will be managed by the firm of Lehman Brothers establishes an entirely new basis for agreements of this character. The firm is to receive semi-annually for its services 12½% of the net realized profits of the corporation, which compensation the firm agrees to use, upon receipt, for purchase from the corporation of common stock taken at its book value. This compensation will be paid only to the extent that the net realized profits of the semi-annual period then terminated shall exceed a sum equivalent to (1) 6% per annum upon the invested capital (as defined in the agreement) for the period, plus (2) any deficiency in net profits of any prior period below 6% per annum upon the invested capital. The payment of any balance of compensation will be deferred and added to the compensation payable for succeeding periods. Unrealized profits will not
be taken into consideration in determining the above-mentioned compensation or the book value of common stock purchased; but upon the termination of the agreement the firm will receive $12\frac{1}{2}\%$ of the unrealized profits (subject to certain deductions as set forth in the agreement) and, out of the remainder of such unrealized profits, any balance of compensation the payment of which may have been deferred. The firm may, at its option, apply such final compensation to the purchase of common stock on the basis above-mentioned.

In some cases various supplementary forms of compensation accrue to the managers in the form of stock warrants, etc., and the New York Stock Exchange has taken cognizance of this situation by requiring that all applications for listing must set forth full details of the basis of management compensation in any form, whether direct or indirect. The Exchange also requires that only customary and reasonable commissions shall be charged by the management for the purchase and sale of securities for the trust.

The latest trend in the organization of investment trusts seems to be toward the transformation or partial transformation of banking firms and investment houses into corporations which frankly stress the trading rather than the investment feature. Such institutions, being promoted by, and in some instances carrying the names of houses well known in the street, are at present strong market favorites. This appeal to the public lies in the prestige of the names behind them, and as yet little is known as to the composition of their portfolios. Some of the recently organized trusts have acquired considerable blocks of domestic stocks at present levels, though undoubtedly there have also been considerable acquisitions of bonds and of
foreign securities, in which prices are at lower levels.

The New York Stock Exchange requires that all holdings shall be listed in detail in an annual report, except that 10% of the capital and surplus or 10% of the cost of securities held, whichever may be less, may be covered under a heading “Miscellaneous Securities,” provided that such securities have not been held for more than a year. This latter fact shall be certified to by a public accountant, who shall also certify the financial statements and inventories. The provision permitting the showing of “Miscellaneous Securities” as a lump sum was included to protect the companies from the necessity of divulging information of value to competitors during the period of accumulation of new holdings. Aggregate cost and market value of the holdings are also to be shown, with the detail of all prices used for valuation of securities not listed on the New York Stock Exchange or the New York Curb Exchange. Reserves against possible losses shall also be shown.

The capital structure of the trust is a matter of importance to the investor. Normally, in the opinion of Fowler, a conservative ratio would be:

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<tbody>
<tr>
<td>Bonds</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Preferred stock</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Common stock</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Total capital</td>
<td>100%</td>
<td></td>
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</tbody>
</table>

Assuming a capitalization of $100,000.00 with 5% bonds and 6% preferred stock, his calculations show that a trust earning 6% on its portfolio would, on the above structure, earn 8½% on its common stock. A trust, however, whose assets are invested largely in common stocks ought to follow a conservative practice in the issuance of capital securities carrying fixed charges. The Stock Exchange listing requirements provide that no non-voting stocks will be
listed unless substantially preferred as to both dividends and assets, and that non-voting stock shall be accorded the right to vote when one year's preferential dividends are in arrears.

The principal sources of income of investment trusts are, obviously, interest and dividends, and in the case of statutory trusts, profits on sales of securities. Underwriting profits are also a factor in the income accounts of investment trusts and seem likely to become more important. Some of the older trusts prohibit or restrict the amount of underwriting activity. Profits on sales of securities during the past several years have been large. Such profits are not likely to continue on the same scale. But in companies whose operations are world-wide there seems to be much in the contention that there are always promising markets where good securities may be bought cheap and held for appreciation.

Fowler estimates that American investment trusts have been earning 10% from the portfolio annually, including 6% in interest and dividends and 4% on sale of securities, which latter, assuming a turnover of 50% of the portfolio a year means an average profit on sales of 8%. Doctor Robinson, President of Second International Securities Corporation, estimated in 1925 that an average of 7% might be earned in interest and dividends, and 3% on turnover, or a total of 10% from the portfolio. Calculating the cost of raising capital through sale of common shares at 5%, and deducting 1% for administration expenses, the earnings in his opinion should be equivalent to 8½% on the capital subscribed. Assuming that an equal amount of capital would be contributed by bondholders at an annual cost of 6¼%, earnings available for common would be 11%. 
Some companies have done better than this, particularly in 1927, but we have seen no general compilation of statistics on the subject.

Figures compiled by Doctor Robinson show in the year 1924-1925 for 23 leading English trusts an average investment yield of 6.03% and for 21 Scottish companies an average of 6.30%. These earnings represent interest, dividends, and substantial underwriting fees, less a heavy income tax of 4 shillings in the pound. By borrowing money at 4% and after paying expenses averaging less than \( \frac{1}{2} \)%, the yield on common averaged for the English companies 10.83% and for the Scottish companies 14.49%. Profits on turnover are not included. Such profits are credited to investment reserves as a measure of conservatism and also for the reason that if so credited no income tax is payable.

The New York Stock Exchange listing requirements provide that the income account "shall include all revenue, as well as all losses, from whatever source derived. It shall reflect in the aggregate a profit and loss upon each and every completed transaction consummated by a purchase and sale of securities. A technical short sale against a long position must not be used for the purpose of considering any transaction as incomplete. . . . The income account shall include no profits resulting from participation in a syndicate, offering securities to the public, until such syndicate is closed. If the applicant enters into any other operations in account with others, the profit or loss at the date of each published financial statement must be reflected therein."

A further ruling of the Exchange provides that "applicants must agree not to pay any cash or stock dividends on common stock, when such dividends, plus any amount by which the current value of
securities held shall be less than their cost, exceed the earned surplus and undivided profits. For the purpose of the foregoing agreement, stock dividends must be capitalized on what appears to the Committee to be a reasonable basis.”

The various rulings of the Stock Exchange referred to above, relating especially to publication of holdings, management fees, and payment of dividends, together with a ruling on the valuation of stock dividends received, which will be discussed below, are an indication of the importance of some of the problems raised by the emergence of investment trusts in this country.

From an accounting standpoint, the two most important questions relate to the valuation of the investments and to the valuation of stock dividends and rights received. These questions, while not peculiar to investment trusts, arise there with special emphasis, due to the size of their holdings. Most investment trusts—probably with few exceptions—carry their investments at cost. Under Federal income tax regulations, dealers in securities are allowed to compute income on the basis of carrying their “inventories” of securities either at cost or at market (or, as a third alternative, at the lower of cost or market). So far as we are aware, no investment trust has claimed the status of a dealer in securities. The establishment of such a status for tax purposes might conceivably create a presumption in favor of regarding as income for all purposes unrealized profits arising from valuing the portfolio at market, though we would still question the soundness of such a presumption. However, inasmuch as a dealer in securities is defined by the tax regulations as a “merchant of securities,” who hold them “for purposes of resale and not for investment,”
it does not seem probable that an investment trust could qualify as such. Moreover, most investment trusts, having been organized during the appreciating markets of the past several years, have had no occasion to desire to adopt the market basis of valuing their portfolio for any advantage it might have in connection with income tax; and the tax regulations require the continuance of the method first adopted.

Within our observation the adjustment of the investment account to market is not a common practice, even among those clearly to be classed as dealers in securities. Possibly our failure to observe this is because many dealers in securities operate as individuals or partnerships and do not have their accounts audited. In any case, the inclusion of market appreciation in the capital account of an individual or a firm would not raise the same questions as those which would be involved in the case of the surplus account of a corporation. While the availability of unrealized appreciation of assets for the purpose of paying cash dividends is not, in most States, explicitly banned by statute and is in one state (Wisconsin) explicitly permitted by statute, the weight of court decisions and of accounting opinion is against it. Whatever the auditor's personal views on the economic aspects of the subject, his professional safeguard is to insist that unrealized gains from reappraisals be set out separately from earned surplus. With investment trusts, our practice is to include the investments in the balance sheet at cost (less investment reserve, if any) and to show in brackets the market value at closing date.

The valuation of stock dividends received and its effect on income present a more difficult problem. By the term "stock dividends" it is intended to imply
“true stock dividends,” as defined by the New York Stock Exchange, which distinguishes them from stock “split-ups,” in the following terms: “As a matter of definition from the point of view of the Exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not of necessity any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.”

With relation to the receipt of stock dividends, three general practices prevail. One of them follows Federal income tax procedure, under which no income arises on the receipt of a stock dividend unless it is sold. The stock dividend is taken on the books at no value. If other shares of the same issue (or of one of substantially the same character or preference) are carried at a price in investment account, an average cost of the old and new shares results; and if and when the dividend shares are sold only that part of the proceeds which exceeds that average cost is returned as income. If the old shares are not of the same issue as the dividend shares, the tax regulations provide for an allocation of a part of the cost of the old shares to the new shares on the basis of respective market values “at the time the new shares of stock are distributed,” and the profit on sale of the new shares is computed on the basis of such allocated cost. In cases of the last-named variety one of our large clients who otherwise calculates profits in accordance with the tax regulations, does not allocate the cost between old and new stock, but takes in the entire proceeds of sale as income.

A second practice relative to the receipt of stock dividends is to assign a value at market, and to credit that
amount to income. This practice has been followed by one of our important investment trust clients.

The ordinary procedure of this client on selling securities is to take profits on the basis of the average book value of all shares held. If shares received into investment account as stock dividends were sold, the utilization of the average book value basis would result in taking into income not only the market value of the shares at date of receipt, but also a sales profit corresponding to the amount by which the book price of the stock was averaged down from that market value. To avoid this it seems clear that at least in cases where the sale is practically simultaneous with the receipt, average book value basis should not be used. This question has not arisen in practice, however, as our client has been accumulating the shares of the principal issues on which stock dividends have been received and has sold none of these stocks.

A third practice is one which has recently been given prominence by a ruling of the New York Stock Exchange affecting companies desiring listing. This ruling, which was dated September 4, 1929, and is separately reproduced in full herewith (pages 42-46), provides that the recipient may value stock dividends at their stated value as charged to earned surplus by the issuing corporation, and may take that amount into income. The Exchange has not made a general ruling on accounting for stock dividends sold.

Shown graphically, these three general methods of treating dividend shares received (when the dividend shares are substantially identical with the old shares) are as follows:
<table>
<thead>
<tr>
<th>INCOME CREDITS</th>
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<tbody>
<tr>
<td>Dividend Shares</td>
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<tr>
<td>Not Sold</td>
</tr>
<tr>
<td>Tax practice...</td>
</tr>
<tr>
<td>Excess of proceeds over averaged cost (after taking up dividend shares at no price)</td>
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Market value practice... Market value... Entire proceeds.
Stated value practice (as prescribed by New York Stock Exchange) Stated value as charged to earned surplus by issuing corporation...

Stock Exchange has not made a general ruling.

In the case of subscription rights, Federal income tax regulations provide that a part of the cost of the old shares shall be allocated as cost of the rights, on the basis of the respective market values of the shares and the rights. If the rights are exercised, no question of credit to income arises; under tax procedure, the new stock is taken up in investment account at the allocated cost of the rights plus the subscription cost. If the rights are sold, that part of the proceeds which exceeds the allocated cost is returned as income. Alternatively, however, the stockholder may credit to income the entire proceeds of sale of the rights, without assigning any cost to them. This alternative tax procedure creates a presumption that a credit of the entire proceeds to income would be justifiable for all purposes, and some of our clients follow that procedure. In practice, the amounts involved have been relatively small.

The propriety of including in income stock dividends received and not sold and the basis of their valuation are questions which have been revived today in difficult and important forms through a combination of three new factors in American finance: (1) the rapid spread of the practice of paying dividends in stock rather than in cash, (2) the great advance in stock prices, and (3) the concentration in single
investment accounts, resulting from the formation of investment trusts, of large blocks of stock-dividend issues.

The Supreme Court settled that stock dividends are not income for tax purposes to the stockholder. As to whether they are income to the stockholder for other purposes, opinion has been divided. The weight of accounting opinion has probably been against their being so considered. Up to recently, however, no practical cases involving large amounts have arisen, with the result that the question has been a somewhat academic one and has perhaps not received the thorough consideration which it now demands.

The Stock Exchange has been confronted with this question, and in its recent ruling, already cited, it announced that “at the present time it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies, and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the Committee will pass on in connection with each specific instance.”

The phraseology of the paragraph quoted, as well as of the discussion leading up to it, makes it evident that the Exchange has not closed the door to possible future modifications in the direction of permitting income credits on a more
liberal basis. It is a question of such com-
plexity as to make it extraordinarily diffi-
cult to lay down any general rule which
would ignore the facts in individual cases.
For reasons set forth in an attached
memorandum, which we have prepared on
the subject, it appears that there is much
to be said for the practice of taking stock
dividends into income at market value,
and that it would be extremely difficult to
maintain a position of rigid opposition to
the practice. (See Part II below).

Our attached discussion is by no means
adequate. It will probably be some time
before the last word on this complex and
controversial subject will be said. Mean-
while, the problem presses on us as audi-
tors in a highly practical form, and as a
working basis of action the following
tentative solution is offered: that we per-
mit the credit of unrealized stock dividends
to income, provided (1) that the item is
separately set out in the income state-
ment, (2) that the investment account as
a whole including the dividend shares is
conservatively stated, and (3) that any
excess of such credits over the stated value
of the stock dividend as charged to earned
surplus by the issuing corporation not be
used by the receiving corporation for the
payment of cash dividends. It is probable
that the third proviso will in any case be
followed by such corporations as are con-
servatively advised by counsel on the
legal aspects of the subject.

In order to understand the full signi-
ficance of this solution, it is necessary to
realize that a stock dividend has been
defined by the New York Stock Exchange
as "the capitalization, in whole or in part,
of past or current earnings." Obviously,
then, the dividends have been declared
out of earned surplus, but in stock rather
than in cash. To the extent that they
represent earned surplus, stock dividends may be regarded as income, or as an addition to earned surplus of the recipient. If the recipient elects to take stock dividends into his accounts at an amount higher than the stated price at which they were transferred from earned surplus to capital by the issuing company, he should credit to unrealized appreciation the excess of market price over stated price. In the last analysis, however, the matter of importance is to insist that cash dividends not be paid out of any excess of market price over stated price; otherwise a qualified report would be inevitable.

As a broad conclusion to this survey we may well reemphasize the fact that great corporations organized to carry common stocks as their principal body of assets are, in the enormous development of the last few months, practically a new phenomenon. Along with this development, and intimately related to it and to each other in a variety of ways, there have occurred an unprecedented industrial expansion, and unexampled public demand for equity securities and a rapid spread among corporations of a policy of paying stock dividends. This combination presents new problems of such difficulty, or old problems in such difficult new aspects, as may require a searching reconsideration of some of the established maxims of finance and accountancy.

II—Valuation of Stock Dividends Received

The nature of a stock dividend, i.e., whether or not it is income to the recipient, is a question which the Court of Appeals of New York State as recently as December, 1928 (250 N. Y. 1) characterized as an "inveterate controversy." The inclusion in income of a stock dividend
received and not sold is frowned on by numerous authorities. The objections to it are based mainly on the decision and the legal and economic doctrines referred to in the decision of the United States Supreme Court in 1920 (252 U. S. 189) that Congress has no power under the Constitution to tax without apportionment stock dividends as income. This case arose in connection with a stock dividend of 50 per cent of the true type, issued in January, 1916, by Standard Oil Company of California in $100 par value stock and charged to surplus at that value per share.

The decision was by a majority, Justices Brandeis, Clarke, Holmes and Day dissenting. The opinion of the Court rested on (1) what it called the "characteristic and distinguishing attribute of income," namely, that it is "derived from capital . . . not a gain accruing to capital . . . but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital . . . and coming in, being "derived," that is received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from the property" and (2) the fact that "the same fundamental conception is clearly set forth in the Sixteenth Amendment" to the Constitution, namely, that Congress is empowered to tax without apportionment "'incomes, from whatever source derived'."

"The essential and controlling fact," the Court said, "is that the stockholder has received nothing out of the company's assets for his separate use and benefit . . . ." But the Massachusetts Court in 1917 (227 Mass. 522), in a decision holding that a stock dividend was taxable as income under the 44th Amendment to the Constitution of Massachusetts, had pointed
out that "in essence the thing which has been done is to distribute a symbol representing an accumulation of profits, which instead of being paid out in cash is invested in the business, thus augmenting its durable assets. In this aspect of the case, the substance of the transaction is no different from what it would be if a cash dividend had been declared with the privilege of subscription to an equivalent amount of new shares." It is evident that this is so, that the effect of the distribution of a true stock dividend on the books of the corporation and on the cash and investment of the stockholder is precisely the same as if a cash dividend had been distributed and the cash had then been returned as a subscription to new stock. Justice Brandeis saw this clearly when he said, in his dissenting opinion, that "the equivalency of all dividends representing profits, whether paid in cash or in stock, is . . . complete."

The majority of the Supreme Court was able to make no reply to the merits of this conclusive elucidation of the essential character of a true stock dividend as income. The rejoinder of the majority was an irrelevancy, the door for which had been left open by a certain lack of precision of language in the Massachusetts decision, referring as it did to the identity of the two kinds of dividends in substance, whereas their identity in effect was evidently what was meant. The irrelevant answer of the Supreme Court was that a transaction where the stockholder, as in the case of one receiving a stock dividend, had no option regarding the final disposition of the cash, could not be regarded as identical in substance with a transaction where a stockholder, as in the alternative case, had such an option.

Obviously unable to rest its decision on
the essential character of a stock dividend, the Court then proceeded to a point of Constitutional construction, saying that "the Massachusetts Court was not under an obligation, like the one which binds us, of applying a Constitutional amendment in the light of other Constitutional provisions that stand in the way of extending it by construction." It is thus on the following reasoning that the decision implicitly seems to rest: (1) while it cannot be denied that the effect of the distribution of a stock dividend is the same as the distribution of a cash dividend plus a return of the cash as a subscription to new stock, nevertheless the transaction in practice short-cuts this procedure, eliminating the intermediate transfers of cash; (2) as the Constitution forbids the laying of direct taxes without apportionment among the States, a strict construction of the amendment granting power to tax income without apportionment is necessary; (3) strict construction of the language of the amendment permitting taxation, without apportionment, of "income from whatever source derived" makes it impossible to ignore the fact that the intermediate operation of "deriving" the cash has been eliminated.

The decision of the Court thus appears to rest on a question of Constitutional construction and not on the essence of the transaction. This decision by the highest legal authority is of course conclusive as to the absence of legal power residing in Congress to tax stock dividends, but it is scarcely so as to the justification of the stockholder in regarding a stock dividend as income.

It is a favorite argument that there is no income to the stockholder in a stock dividend for the reason that his holdings after the distribution represent no greater
equity in the business than did his original holdings. The total equity remains the same and the equity per share is reduced. This is illustrated by assuming a corporation with a capital account of $100,000.00, representing 10,000 shares and a surplus account of $10,000.00; assuming also the declaration of a 10 per cent stock dividend by charge against surplus at $10.00 per share. The total equity before stock dividend is $110,000.00, or $11.00 a share on 10,000 shares outstanding; after stock dividend the equity is similarly $110,000.00 (all capital, no surplus), or $10.00 a share on 11,000 shares outstanding. The equity per share has been reduced. But this constitutes no argument against defining the stock dividend as income to the stockholder, unless it is to be regarded as equally valid against so defining a cash dividend. For if instead of the stock dividend in the above example a cash dividend of $1.00 a share were declared by charge against surplus, the equity after dividend would be $100,000.00 or $10.00 per share. The equity per share has been reduced precisely as in the case of the stock dividend.

Let us carry this a little further. Assume two corporations, X and Y, identical in structure with the one in the above example. Mr. A holds all the stock of corporation X and Mr. B holds all the stock of corporation Y. Each bought his 10,000 shares of stock at $10.00 a share and carries them on his books at cost, $100,000.00. Corporation X declares a stock dividend as above, and corporation Y a cash dividend as above. On the theory that A has realized no income he would carry 11,000 shares on his books at $9.09 a share or a total of $100,000.00, representing a total equity on the corporation’s books of $110,000.00; B would continue to carry 10,000 shares on his books at $10.00, representing
an equity of $100,000.00. Why should A be required to write his stock down to $9.09, while B is permitted to carry his stock at $10.00? There seems to be no logical reason. Suppose a free market for these stocks to exist, and A to represent the combined stockholders of X, and B to represent the combined stockholders of Y. Suppose the market to be an ideal market in which earnings are capitalized at 10 per cent and stocks go off proportionately at dividend record dates. These stocks are quoted at 10 and on an annual declaration of 10 per cent or $1.00 go off to 9, gradually building up again to 10. The theory that A has realized no income might in this case be bolstered up by insisting that his 11,000 shares are worth at the market only $9.00 a share or thereabouts. But if that is so, what about B? Should we not insist that B write off $1.00 a share against the income credited on receipt of the cash dividend? But we would not insist on that, presumably on the theory that the re-accumulation of a new surplus will gradually restore the price to $10.00. There seems to be, then, no justification for discrimination against A—for insisting that while B through his cash dividend has acquired resources of $10,000.00 available for income purposes, A cannot be allowed to incur operating expenses in a similar amount without being deemed to have impaired his capital.

At least up to this point, i.e., where a stock dividend represents the amount of earnings of the issuing corporation transferred from surplus account to capital account, it seems clear that a stock dividend is income to the recipient, whether or not Congress has the power to tax it as such. And this conclusion, though it has in the past received nothing approaching general acceptance by accountants, has been
strongly buttressed by the ruling of the New York Stock Exchange made in connection with the income accounts of investment trusts.

There is a strongly held opinion, however, that the ruling does not go far enough; that stock dividends received are properly income up to the amount of their market value. The objection to this is based on the idea that the valuation of the dividend shares at market gives rise to unrealized appreciation.

The problem may be brought out by extending and modifying our previous example. Let us suppose that the stock of corporation X is selling at $20.00 a share, which is twice its asset value and is equivalent to capitalizing income at 5 per cent. Suppose that A sells his 1,000 shares of stock dividend to C at market price. C sets up his purchase as an asset at $20,000.00 and conservative certified public accountants certify his financial condition accordingly. The corporation has a net worth of $110,000.00 or $10.00 a share. If A has taken into income the full sale value of $20,000.00, he is still carrying his original 10,000 shares at their asset value of $10.00 a share and C is carrying 1,000 shares at $20.00 a share. Is there any logic in insisting that A is entitled to take into income only a portion of the sale price and must, therefore, by crediting part of the proceeds to his investment account write the latter down to a lower basis than $10.00 a share? It would seem not. But this is a relatively simple and probably not very common case, in that it has been assumed that the cost price on A's books corresponds with the asset value on the books of the issuing corporation.

Suppose we take C with his 1,000 shares bought at $20.00 and carried as an invest-
ment at $20,000.00. He receives a subsequent dividend of 100 shares representing corporation earnings of $1,000.00. The market value is now $30.00 a share, which is three times the asset value and is equivalent to capitalizing earnings at 3 1-3 per cent. C sells the 100 shares to D for $3,000.00, and takes $3,000.00 into income. D takes up the $3,000.00 in investment account and a conservative firm of certified public accountants certifies his financial condition accordingly. C still carries his 1,000 shares at $20,000.00, though their market value is $30,000.00. Can we insist that he write his investment down still more below market by crediting to investment account some of the sale price of the 100 shares, all of which he claims as income? If we do, we are in an illogical position regarding the valuation of the stock at $30.00 a share in D’s balance sheet. Why should we insist that client C provide a reserve against a $20.00 valuation if client D can be considered as not having impaired his capital by buying the stock at $30.00? And on what theory would we require such a reserve? Probably no one would seriously suggest that asset value should be adopted as the criterion. But the only alternative would be to set ourselves up as judges of value on the basis of present or prospective earning power. It may be said that in the case under consideration we could avoid this dilemma by passing the income credit to the full amount of the proceeds of sale on the ground that the sale of the stock dividend constitutes a definite realization through a closed transaction.

But this will not help us greatly. For certain corporations of great financial strength and well-merited reputation for judgment and integrity wish to hold stock dividends received because their judgment
tells them that the retention of these issues strengthens their own position in one way or another, or their special knowledge of the industry which these holdings represent indicates that earnings will catch up to market valuations. They claim the right to take stock dividends into income at market valuation, whether or not sold. Of course, they might sell the dividend shares and simultaneously repurchase them but they do not choose to pay the taxes which would be assessed. They challenge any universal application of the maxim that the closed transaction is a distinguishing characteristic of income. They assert that it has no significance to the determination of income in circumstances where a ready and authentic measure of market value exists, and where, in spite of taking stock dividends on the books at market, the book value of investment account of the receiving corporation is still substantially under the market. The questions that are raised seem fundamentally to be these: Was not the maxim of the closed transaction in its origin a protection against more or less hypothetical estimates of increased values of real estate, where an undoubted opportunity to realize for cash did not and could not exist? Does this maxim apply with equal force and logic to the case of marketable securities as to the case of fixed assets?

Now, whatever our off-hand views or even our settled convictions on this subject, these claims cannot be ignored or brushed aside without serious consideration.

Our interest as accountants is not primarily in either the legal definition of income or in the economic definition. Our primary interest is in the practical effect on the stockholder of the receiving corporation from the standpoint of the protection of his capital investment.
We ought, of course, to have as correct an understanding as possible of the laws of the jurisdiction in which a client corporation is organized and by the aid of such light as can be shed by the legal counsel of our clients we ought to be assured that under the law or any reasonable interpretation of it the corporation is not impairing its capital by utilizing doubtful income credits with which to pay dividends.

But on the subject of closed transactions the law is indecisive. For tax purposes the same Federal law contemplates the payment of income tax by a dealer in securities on gain arising from an unrealized appreciation of securities and by other taxpayers only upon sale. If under Federal law an unrealized gain must be accounted for as income by a dealer in securities who has claimed unrealized losses as deductions, it could hardly be said, in the absence of any express prohibition in the corporation law of a State, that any presumption of illegality runs against accounting for unrealized gains as income for all purposes. In most cases, state laws are silent on the subject. The Wisconsin law, however, permits the payment of either cash or stock dividends out of increase in the value of its property; while the Ohio law (similarly the Indiana law) prohibits the payment of dividends in cash or property out of "unrealized appreciation in value or revaluation of fixed assets," but does not so prohibit the payment of stock dividends. Court decisions, where definite, generally indicate that unrealized profits are not to be regarded as available for dividends, though only one case cited in a recent survey (New York Supreme Court, 1885, 36 Hun 536) dealt with unrealized profit on marketable securities, and in no case is it apparent from the syllabus whether or not the prohibition ran against the payment of stock dividends.
as well as cash dividends out of such unrealized profits.

Nor are economists by any means unanimous on the subject of the closed transaction. Here, as in the legal field, two concepts of income are apparent. Under one concept in great favor with economists income consists of recurrent services rendered by capital and does not include profits on appreciation of capital assets, even though realized. Under the other concept, income broadly is the difference between the net asset value at the beginning and that at the end of the period.

In choosing between these two definitions we may bear in mind that our primary interest in the subject as auditors is not a theoretical one. It is a practical one, looking to the protection of the stockholder of the receiving corporation which is our client. Our interest is in protecting him from a situation where dividends are paid to him out of dubious credits to income, with the result of impairing his capital investment. Where the law sets up a mandatory criterion, whether or not it be an arbitrary one, our course is clear. Where it does not, scrutiny of the asset and reserve accounts is the only means of determining whether or not the capital is intact and protected by a reasonable margin. The only practical measure by which to evaluate a security investment account is by comparison with market value.

If, in a market like the present one (September, 1929), the net result of pricing at market the stock dividends received is still to show a substantial margin in the investment account of market value over book value, it is questionable whether we can reasonably decline to certify accounts in which stock dividends have been taken into income at market value. We can decline, except perhaps in the case of Wis-
consin corporations, to pass credits to income based on a general write-up of securities in portfolio, on the ground that the lower of cost or market is the only safe rule of valuation for the general body of assets or whole stock-in-trade. With respect to shares received as dividends, however, no such argument relating to the conservative statement of the balance sheet is applicable.

Admittedly, a good deal can be said for the proposal to take the stock dividend into income at the value placed on it and charged to earned surplus by the issuing corporation. As a piece of accounting mechanics, it seems at first glance to meet the situation admirably. Let us, however, look at an example, the facts concerning which have been derived from published sources: An investment corporation holds common stock of North American Company (organized in New Jersey) which is on a stock dividend basis of one-fortieth of a share of common quarterly, i.e., at the rate of one-tenth share a year. The stated value of North American common is $10.00 a share. At December 31, 1928, the capital stock account of North American Company (excluding preferred stocks) showed 5,011,960 shares of common valued at $50,119,600.00, consolidated earned surplus of $74,874,413.00 and capital surplus (premium on capital stock) of $23,859,317.00. The earnings of the system for 1928 available for common, after expenses, taxes, and dividends to minority interests and on preferred stocks, were reported as $22,582,721.00 (of which $12,565,805.00 were earnings of the holding company). Stock dividends of one-tenth share were paid, amounting to 480,654.9 shares and charged to earned surplus at $10.00 a share or $4,806,549.00, leaving net increase in earned surplus for the year,
$17,776,172.00. Consolidated earnings applicable to common were $4.51 a share, holding company earnings, $2.51 a share, and the stock dividends as charged to earned surplus amounted to $1.00 a share. The market value of the stock during 1928 ranged from 58 to 97. At the end of the year it was quoted at 95, which was equivalent to capitalizing consolidated earnings at 4.75 per cent. and holding company earnings at 2.63 per cent. Surplus for the year ended March 31, 1929, showed an increase over the calendar year 1928 of $1,300,000.00 and the stock is now selling around 170.

Certain investors of judgment apparently regarded the stock as worth $95.00 a share at December 31, 1928, and some of them took North American stock dividends into income at prices in that vicinity. We may very well, as a measure of conservatism, recommend that dividend shares be taken up at not more than their stated value (in this case $10.00) in pursuance of the ruling of the Stock Exchange. We should be prepared, however, to encounter strong objections to the use of stated value on the part of corporations receiving stock dividends of North American Company and other companies on a stock dividend basis. Some of the reasons for their objections to such a valuation are apparent from the earnings figures and evidences of growth and expansion of the issuing corporations. In the absence of compliance with the Stock Exchange ruling by companies not applicants for listing we shall be obliged to ask ourselves whether it is beyond any reasonable doubt that corporation M will have impaired its capital if it places stock received as dividends on its books at their undoubted cash value and then pays dividends out of the surplus thus created, but that a companion cor-
poration N which purchases for cash at market value securities of the same issue will not thereby have impaired its capital.

Assuming corporation M to be an old company, with its investment account conservatively stated, even after bringing in stock dividends at market value, and assuming corporation N to be a new company with its holdings carried at current market values, the depreciation which will be sustained if prices fall, will be much more seriously felt by corporation N, the present financial condition of which based on the cash cost of security holdings any firm of certified public accountants would certify without hesitation, than by corporation M, against whose policy of pricing at market stock dividends received many accountants would protest. On the other hand, regarding the present condition of corporation N it may, of course, be said that tradition and long-established practice make it unlikely that any public misconception can result from a certification of a balance sheet in which investments are carried at cost. But in this connection, the recent action of the Stock Exchange in requiring publication of holdings is highly significant, and may contain a lesson for us.

A practical solution of this difficult question—one based frankly on a compromise of conflicting arguments and considerations—would seem to be to permit the credit of unrealized stock dividends to income, provided (1) that the item is separately set out in the income statement, (2) that the investment account as a whole is conservatively stated, and (3) that any excess of such credits over the stated value of the stock dividend as charged to earned surplus by the issuing corporation not be used by the receiving corporation for the payment of cash dividends.
Report of the Special Committee on Stock Dividends
New York Stock Exchange

In the requirements for the listing of investment trusts recently promulgated by the Stock Exchange, a provision was incorporated to the effect that investment trusts should not include stock dividends in their income accounts. In recent weeks the wisdom of this ruling has been the subject of discussion between the Stock Exchange and representatives of many companies affected by its operation, and a special committee has been looking into the question of stock dividends from the point of view of the Exchange with a view to clarifying the issues involved.

Based on the report of this committee to the Governing Committee, the following statement of position is made: The interest of the Stock Exchange in the method by which companies account for stock dividends arises out of its consistent policy of attempting to obtain, in connection with corporate returns, such a clear disclosure of the relevant facts as will enable the investor to properly appraise the listed securities in which he is interested.

The stock dividend has, in late years, become an important instrument in the financial policy of American corporations, and there can be little doubt that its use is still in the early stages of development. In particular is it of value to corporations in growing industries requiring the use of large additional amounts of capital, as it permits them in some measure to obtain this capital in the simplest manner from their own stockholders, and, at the same time, permits these stockholders, if they are so inclined, to realize upon their share of current or past earnings so capitalized.

Coincident with the development of the stock dividend, there has taken place the
development of the less than $100 par and of the no par value stock, together with the practice of having large capital or paid in surpluses; and these relatively new conceptions have led with increasing frequency to the corporate practice of partial or complete recapitalization through the form of so-called "split-ups."

As a matter of definition from the point of view of the Exchange, a true stock dividend represents the capitalization, in whole or in part, of past or current earnings; while a split-up has not of necessity any relation to earnings and may mean nothing more than a change in the form in which ownership in an existing situation is expressed.

Accounting practice, in striving to adapt itself soundly to these important developments in corporate procedure, has not yet reached the point where a mere perusal of the year's accounts will suffice to reveal to the average investor in what manner he has been affected by action taken during the year in the matter of stock dividends. On this account, it is felt that the Exchange is justified in seeking to obtain wherever possible for the benefit of the investor such supplementary information as may assist him to a correct understanding of the accounts themselves.

Applications for listing which involve questions relating to stock dividends will be considered in the light of the foregoing. In view of the large and constantly increasing number of listings on the Exchange, either originating in stock dividends or involving questions that have to do with stock dividends, an effort will be made to obtain for the investor such information as may place him in the position to determine in connection with stock dividends received by him, to what extent they constitute true stock dividends rep-
resenting the capitalization of current or past earnings, and to what extent, if at all, they represent merely split-ups involving an expression in a new form of what was already his. In any event, it is felt that the individual investor should make such independent investigations as seem desirable in order to be quite sure that he understands in each instance how he has been affected by the declaration of a stock dividend.

When stock dividends are received by investment trusts, holding companies or other corporations, the manner in which these dividends are accounted for by the receiving company presents a problem somewhat different from that attending the accounting for the payment of stock dividends by the declaring company. Current practice varies all the way from the policy of ignoring stock dividends in their entirety in the income account of receiving companies, to the policy of taking them into the income account whether they have been realized upon or not at the full market value on the date received.

Uniform accounting practice today seems to favor as sound procedure the ignoring of stock dividends in the income account of receiving companies. However, it has been urged on behalf of investment trusts, holding companies and others, with what seems to us to be some measure of justification, that a technical interpretation of the nature of stock dividends may operate to hamper management in the adopting of perfectly reasonable and proper dividend programs of their own, whether in cash or in stock, and may even under certain circumstances force them as recipients, for technical reasons, to realize upon stock dividends which for business reasons they would have preferred to hold.

It may be that accounting practice will
undergo certain modifications in the light of these new tendencies, but it is too early to form an opinion as to the direction that this modification is apt to take. It is possible that a schedule of all stock dividends received will suggest itself as a desirable addition to the annual report of investment trusts, holding companies and others; or, conceivably, a new departure in accounting theory may permit the inclusion of stock dividends in some form or other in the income accounts of receiving companies.

At the present time, it appears as if the Exchange could go no further than to take the position that it will raise no objection to the method by which investment trusts, holding companies and others account for stock dividends received by them and not realized upon, provided there is the fullest disclosure of the procedure adopted, and provided that these are not included in the income accounts of the receiving companies at a greater dollar value per share than that at which they have been charged to income account or earned surplus account by the paying companies. The manner in which receiving companies account for stock dividends received by them and realized upon during the period under review is a matter which the committee will pass on in connection with each specific instance.

RICHARD WHITNEY, FRANK ALTSCHUL, ROLAND L. REDMOND, J. M. B. HOXSEY,

September 4, 1929.

Recommended to the Governing Committee by a joint meeting of the Law Committee and the Committee on Stock List, held September 9th, 1929.

ASHBEL GREEN, SECRETARY.
Adopted by the Governing Committee, September 11, 1929.

ASHBEL GREEN, SECRETARY.

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