

SENATOR WAGNER INTRODUCES INVESTMENT TRUST LEGISLATION

Senator Robert F. Wagner of New York today (Thursday, March 14, 1940) introduced in the Senate comprehensive legislation to regulate investment companies and investment advisors, and issued the following statement concerning its purposes and provisions:

NATIONAL PUBLIC INTEREST IN INVESTMENT TRUSTS AND INVESTMENT COMPANIES

"Investment trusts and investment companies constitute one of the important media for the investment of savings of the American public and an important factor in our national economy. At the present time, these organizations have total assets of approximately \$4,000,000,000. In addition, they control or exercise a significant influence in a great variety of industrial enterprises, public utilities, insurance companies, banks, etc., with aggregate resources of approximately \$30,000,000,000.

"During the past ten years there have been approximately 4,500,000 holders of certificates or shares of investment trusts and investment companies located in every State. American investors have sustained losses exceeding \$3,000,000,000, out of a total investment in such companies aggregating about \$7,000,000,000. During the period between the early 1920's--when the investment companies first made their appearance in this country--and the present, approximately 1300 investment enterprises of all types were created. However, only about 650 trusts and companies are still in existence, the remainder having disappeared either through mergers, receivership, dissolution or bankruptcy. In addition, numerous companies controlled or influenced by investment companies went bankrupt or sustained substantial losses. A large portion of these losses is directly attributable to those managements which refused to recognize their fiduciary obligations to their shareholders and subordinated the interest of the investor to their own pecuniary advantage.

"The problems with respect to investment trusts and investment companies are still acute, for new organizations of this type are still being formed in large numbers and are raising substantial funds. From the middle of 1933 up to the end of 1939, approximately \$2,400,000,000 of securities of investment trusts and companies have been registered with the Commission. Although not all of these securities have been distributed, approximately \$400,000,000 of investment company securities were sold during 1936 and 1937 alone, or approximately one-sixth of all nonrefunding corporate issues sold during those years. During the last few years, sales campaigns have been vigorously conducted and investment trust certificates are being sold upon the installment plan to individuals in the lowest economic and income strata of our population -- individuals who are particularly susceptible to devious high-pressure selling methods and who have been subject to unconscionable penalties and forfeitures in all-too-many instances.

SECURITIES AND EXCHANGE COMMISSION INVESTIGATIONS

"The abuses and deficiencies of investment trusts and companies which occasioned these losses to the American public are not academic, and not merely attributable to the financial and economic ethics which prevailed during the 1920's. Some of the most flagrant abuses and grossest violations of fiduciary duty to investors were perpetrated during the very time that the Securities and Exchange Commission was conducting its comprehensive study of investment trusts and investment companies pursuant to Section 30 of the Public Utility Holding Company Act of 1935. That study conclusively demonstrates that, unless these organizations are subject to supervision and regulation, the interest of many of almost 2,000,000 American investors in these institutions will be substantially threatened.

GENERAL PURPOSES OF THE LEGISLATION

"This bill provides for the registration and regulation of investment trusts and investment companies and for the registration of investment counselors and other investment advisory services. The underlying purpose of the legislation is not merely to insure to investors a full and fair disclosure of the nature and activities of the investment trusts and investment companies in which they are interested but to eliminate and prevent those deficiencies and abuses in these organizations which have contributed to the tremendous losses sustained by their security holders.

INVESTMENT TRUSTS NOW LARGELY UNREGULATED

"Investment trusts and investment companies, like banks, insurance companies and similar financial institutions, represent large pools of liquid funds of the public entrusted to individuals for management and investment. Yet unlike these other financial institutions, investment trusts and investment companies, although their field of activity is unlimited, have been subject to virtually no regulation and

supervision by any governmental agency, Federal or State. This absence of regulation is one of the fundamental causes of the abuses which have been altogether too frequent.

#### FINANCIAL ABUSES

"Because of this absence of safeguards, promoters and managers of investment companies have been able to determine every aspect of their affairs in an atmosphere of self-dealing and conflicting interests devoid of arms-length bargaining. Independent scrutiny, in behalf of public stockholders, of the transactions and activities of promoters and controlling groups in the organization and operation of investment companies has been and is virtually non-existent. Too often, the organization of investment trusts and companies was motivated not by a desire of their sponsors to engage in the business of furnishing investment management to the small investor but rather to accumulate large pools of wealth which would provide a variety of sources of profit and emoluments to their sponsors and controlling persons:

"Only a small amount of capital is required to form investment trusts and companies. As a consequence, these organizations are still experiencing an unsound mushroom growth; and various individuals, regardless of their background, have been able to promote or acquire control of these organizations, with their large pools of liquid assets, with a minimum of investment. In many instances, control of these institutions has been made impregnable by devices such as management voting stock; voting trusts; the common law or business trust form of organization in which security holders have no vote; long-term management contracts which also assured substantial compensation irrespective of the company's performance; option warrants to purchase the company's stock which have the potentiality of substantially diluting the value of the public stockholder's interest; and finally, domination of the proxy machinery for the solicitation of authority to vote the shares held by public stockholders.

"In many instances, the pecuniary interest of the promoters, distributors and managers have dominated almost every phase of the organization and operation of investment companies to the detriment of investors. Capital structures, which are often confusing and incomprehensible to investors, have been created with the ulterior motive of vesting in the controlling groups complete control of the public stockholders' funds and a disproportionate share of the companies' profits. The capitalization of investment companies was in many instances determined solely by the amount of securities the public would absorb. As a consequence, unsound capital structures have been created--structures which fostered and perpetuated sharp conflicts of interests between the holders of senior securities and junior securities. These conflicts have often been resolved to the detriment of the public senior security holders and to the advantage of the common stock held by insiders. The holders of junior securities have retained control of the funds, although in essence the assets belonged to senior security holders; and have transferred, for substantial payments for their stocks without asset value, control of these funds without the consent or knowledge of senior security holders. Many senior securities had no protective feature, or inadequate features which were circumvented and nullified by the controlling common stockholders; and the public investors were powerless to prevent unfair and injurious practices. These companies with senior securities have been, in essence, margin accounts--margin accounts not subject to further margin calls--for trading in common stocks for the benefit of the inside common stockholders. Unwarranted speculative activities have resulted.

"In addition, these capital structures with more than one class of security have accentuated the problem of payment of dividends in investment companies; for the controlling common stockholders have caused the payment of dividends and other distributions on their common stock to the pecuniary injury of the senior security holders. Capital gains have been drained off by the common stockholders in periods of rising prices, and dividends paid, although the senior securities had inadequate asset coverage.

"Investment trusts and investment companies have suffered many abuses which are peculiar to that type of organization. Investment companies are permitted to be organized with the broadest powers, and in essence, constitute 'blind pools' of public funds. As a result, sponsors, promoters and controlling groups in many instances have directed the investment of the public's funds in a variety of activities without the consent of the stockholders and irrespective of the announced investment policies which induced the public to invest in the enterprise. In addition, the assets of investment trusts and investment companies consist of cash or marketable securities readily reducible to cash, which could be used to acquire any type of security, property or business. As a consequence, officers, directors, managers and other insiders have often unloaded valueless or dubious securities and other property on investment companies at extravagant prices; have borrowed the funds of their investment companies; and have caused such companies to make loans to enterprises in which these insiders were interested. Substantial amounts of these loans have never been repaid. Investment companies in many instances have been exploited by investment banker sponsors and managers to enhance their banking and brokerage business. The investment companies were caused to participate in underwritings; to stabilize

the market in securities underwritten by such managing groups; and to purchase substantial blocks of stocks in industrial companies, railroads, banks and insurance companies in order to expand the banking and brokerage business and build up the financial empires of these insiders.

"To augment and intensify all of these opportunities for control and personal profits at the expense of public stockholders, insiders have often fostered excessive pyramiding of investment companies into complicated corporate systems. Funds, securities and other property were shifted by the dominant persons among the various investment companies in the system and their controlled industrial and other enterprises, in order to promote their own personal pecuniary interests, to create misleading values and fictitious profits for the purpose of deceiving stockholders, and to centralize and perpetuate their control. In many instances, the pyramiding of investment companies involved a complete renunciation of the policies the stockholders had been led to believe their companies would pursue; management costs have been inequitably allocated among the various pyramided companies, and expenses have needlessly been duplicated.

"Wholesale trafficking in, and bartering of control of the management of investment companies without the knowledge or consent of the investor has also been a frequent abuse in the history of investment companies. Stockholders have suffered large losses as a result of undisclosed overnight transfers of control of their funds to new interests who have either been incompetent or dishonest. Under existing conditions, investors are powerless to protect themselves against the consequences of such shifts in control.

"Managements have also used their control of the applicable corporate and statutory machinery to subject stockholders to inequitable readjustments of the rights, privileges, preferences and values of their securities, by judicial reorganizations, recapitalization plans, mergers, consolidations, dissolutions and sales of the corporate assets to other companies. Existing remedies for the protection of stockholders against inequitable plans of readjustment are inadequate, cumbersome and impractical. The financial resources of the average stockholder are usually insufficient to meet the burden of complicated and long-drawn-out judicial and other proceedings which may be necessary to oppose successfully unfair management-prepared plans.

"Another fundamental abuse has been that many promoters and managers of investment companies have a greater interest in the profits which they can realize from the distribution of investment company securities than in compensation for the avowed function of furnishing expert, disinterested investment service to investors. As a consequence, management may be subordinated to distribution. Unsound investment trusts and companies may be organized in an effort to create securities or merchandise with sales appeal; and the investments of the companies may be made, not on basis of their soundness, but on the basis of their effect on sales of the companies' shares. Selling charges are often fixed to yield a maximum of fees to distributors and frequently include many "hidden" fees exacted from the purchasing public. The profits to be derived in the merchandising of investment company securities has also prompted the rapid formation of investment trusts and companies by the same sponsors in order to "switch" investors from old companies into new companies, each switch being accompanied by exaction of a new selling "load" from the security holders.

"In the case of those investment trusts and companies which continuously sell their shares to the public, practices have often been countenanced which have resulted in substantial dilution of the investors' equity in the fund. Such dilutions have taken place as recently as last Autumn. The small investor, purchasing investment trust shares or contracts on the installment payment plan, has often been subjected to excessive sales loads and onerous penalties and forfeitures.

"Implementing the perpetuation of all these abuses is the management's domination of the accounting practices and the scope and content of the financial reports transmitted to the stockholders. The absence of uniform accounting principles has facilitated the transmission to stockholders of annual reports which are often misleading and incomplete.

"This is not a complete catalogue of the deficiencies and abuses which have existed in the investment company industry. Of course, these abuses do not exist in equal degree in all classes of investment companies or in companies within each classification. Some abuses are peculiar to certain types of companies only. In addition, some managements have taken steps to eradicate some of the defects and malpractices prevailing in the industry. However, considering the investment company industry as a whole, fundamental deficiencies and abuses actually or potentially exist in all classes of investment companies, and in the absence of legislative regulation, will continue or recur. The problem of the protection of the investor

and the national economy is too vital to permit of haphazard voluntary solutions.

"Investment trusts and investment companies have furnished but comparatively little capital to industry. For the most part, these organizations have invested their funds in securities which have been outstanding for some time. On the other hand investment trusts and investment companies could be capable of performing important functions in the national economy and of becoming one of the important institutions in this country for the investment of savings, along with banks and insurance companies. As media for investment in securities, particularly equity securities, investment companies may be able to offer more diversification and more competent management than the ordinary individual himself can provide, if the major present temptations to management, unrestrained by effective compulsory standards of fair conduct, are removed. Certain types of investment companies could be particularly useful to the national economy in supplying the needs of new industrial enterprises, through equity financing and loans, thereby making available to these enterprises sources of capital funds which would otherwise be beyond their reach. Finally, investment companies, if made into real representatives of the participating investors and not of other interests, could become more effective advocates of the great body of investors in our industrial system than the now inarticulate small stockholder.

#### INVESTMENT COUNSEL AND ADVISORS

"The activities of investment counsel and other investment advisory persons in many respects offer the same opportunity for abuse of trust reposed in them by investors as exists in the case of managements of investment companies. The extent of their influence is only partially indicated by the fact that the portion of these advisers studied by the Securities and Exchange Commission managed or gave advice with respect to over \$4,000,000,000 of funds. The bill does not attempt to deal comprehensively with the problem of investment advisers, but is intended only to eliminate the more obvious basic abuses relating to the type of individual who may register as an investment adviser, profit sharing compensation, unloadings and perpetration of frauds upon clients, and assignment of clients' contracts.