Commission. In many respects the proposals are substantially the same as the provisions in the present bill, but it is important to note that although we had many of the proposals in a general way, we never saw the language contained in the proposed bill, and the importance of this can be seen when you come to consider the many complicated provisions of the bill, such as section 10, which I expect to take up this morning.

It is one thing to discuss the general objectives of section 10, and it is quite another thing to analyze the complicated provisions in the actual draft of the section, and then discuss the provisions in the actual light of that language.

The same thing is true of the most of the other provisions of the bill. They are complex and demand the most careful study and consideration in order to understand their meaning, and especially their implications.

We are not complaining. We had no right to be heard more fully by the Commission. We do not question that the Commission may have had reasons which seemed valid to them for the course which was followed. That was a matter within the discretion of the Commission. But it is important that the Senate committee does not receive the impression that the bill now being considered was worked out in collaboration or agreement with the industry. That is just not so. We stood ready to work out a bill with the Securities and Exchange Commission, but were not given that opportunity.

Now, as to the matters which I would like to present today: On Friday I had the privilege of presenting to your committee the principles which some of my associates and I in the closed-end investment company field believe to constitute a proper basis for legislation aimed at regulating investment companies. Mr. Quinn has given you our general views regarding the bill which is now before your committee and has discussed in some detail the provisions delegating what we consider far too broad power to the S. E. C., and also certain specific provisions of the bill which we do not consider either appropriate or necessary.

Today I should like to lay before you my views as to the effect which the bill as now written will have upon the whole question of the management of investment companies. As I told you last Friday, I consider the question of competence of management to be of paramount importance in the successful operation of investment companies, only exceeded, perhaps, by the obviously necessary requirement that any management to be successful must be honest. As I said to you on Friday, for some reason the valuable and voluminous study of our industry by the S. E. C. has not concerned itself with the constructive side of this management problem. It is true that the S. E. C. report was, in essence, an indictment of those managements which had proved themselves to be incompetent or worse, but there was nowhere apparent an adequate evaluation of the enormously important role that competence plays in the actual operation of investment companies. And I think that as a result the S. E. C. has prepared a bill which goes far to disrupt competence in its effort to root out malpractice. Competence certainly cannot be created by legislation of any kind, but it can easily be destroyed by legislation which is ill conceived. Those of us who are in this business are daily reminded of the practical side of management and the frequently insurmountable difficulty of providing

first-class workmen to do the job. My plea is that this already difficult problem shall not be unnecessarily made more difficult.

Now the bill throughout directly and indirectly affects the management problem. Indeed, the whole bill looked at from one viewpoint is simply an effort to restrain and restrict management, presumably in the interest of investors and of the public. With this objective in view, the bill undertakes to say who and who may not manage investment companies.

I have given a great deal of thought to the proper manner of presenting to you the effect of this bill on the whole question of the future management of investment companies and as a result should like, with your permission, to approach the matter by telling you directly and in nontechnical language the practical effect that the pertinent provisions of the bill will in fact have. In this way I believe that I can demonstrate to you the problem with the greatest possible clarity. I may say here that the sections of the bill to which I refer are primarily the rather complicated ones of section 10 and parts of other sections which have an indirect bearing thereon. Therefore, if you will assume for the moment that the statements I shall make are correct, I shall later point out the specific provisions of the bill on which they are based.

It is my considered opinion that the present bill must in its cumulative effect eliminate from the affairs of investment companies—and by the affairs I mean from service as directors or officers of such companies—all persons who fall into the following categories: (*a*) directors and officers of the 1,500 leading corporations in the United States, and (*b*) all members of important investment banking firms and brokerage houses.

I should like to indicate to you just what these eliminations mean. According to the S. E. C. report there are on the average 1,500 securities held at one time in the aggregate portfolios of American investment companies. The coverage indicated by this statement is best realized by recalling that there are only approximately 1,100 companies whose securities are listed on the New York Stock Exchange. It seems to me fair to say, therefore, that the 1,500 securities held by all investment trusts comprise in a general way all companies of any importance listed on any American exchange, as well as a number of unlisted though worthwhile companies.

Generalizing further, it is not an exaggeration to characterize any such list as comprehensive of what would popularly be known as the leading American companies. Now the boards of directors of these companies would probably range between 7 and 25 directors each, say 15 on the average. This would mean that perhaps 22,500 would be a fair guess at the total number of directorships on all these boards. Allowing for duplications, of which of course there are many, I should think that 15,000 would be a reasonable enough estimate of the number of different individuals who are members of the boards of these 1,500 leading companies.

By any realistic standard, these 15,000 people should be regarded as embodying the best industrial and commercial ability in America, and one should not forget to add to them the unknown number of officers who are not members of their companies' boards but who would likewise be excluded from investment company affairs.

Now I should like to recall to you at this point the fact that investment companies invest primarily in equity securities of American industry. I think the directors and officers of these industrial companies must be regarded as experts in equity securities, as the values of these securities are, after all, simply reflections of the earning power of the companies that these men manage. So the exclusion from investment company affairs of the whole of these top industrial and commercial classes of the country is a removal of professional assistance from these companies comparable to prohibition by law in connection with legal problems of the use of the leading 15,000 lawyers of the country, or in engineering work the leading 15,000 engineers. In any of these situations this would be regarded as a tremendous degree of exclusion.

Further, in addition to these top industrial, commercial, and merchandising people, the present bill would exclude investment bankers and the more important brokers. I am only too well aware that neither of these classes has been outstandingly popular during recent years, but one cannot overlook the fact that they constitute the groups most skilled and experienced in the handling of equity securities—far more so in this special field than are the commercial bankers, savings bankers, or insurance company managers of the country.

Now, these people are to be excluded from the investment company business. And what is the investment company business? It is of course, the business of investing and conserving the funds of other people. Naturally it is not the only business or activity that has these characteristics. There are many other types of institutions which are faced with problems of investment more or less similar to those of the investment company. For example, our colleges and universities, hospitals and various other endowed institutions, museums, insurance companies, commercial banks, and savings banks. All have the common problem. All of these institutions have trustees or directors, one of whose principal duties is the conservation and investment of funds. Who are these trustees and directors as a general rule? The answer is obvious. They are the persons in the community or State, or, if the institution is a national one, in the country, who are best qualified by experience, integrity, and judgment to handle the responsibility entrusted to them. They are, in fact, drawn from the very groups we have just been discussing and which we say have just been excluded. There are no laws (except in the case of investment banking directors of banks) prohibiting their association with investment activities, and the penalty would be great if such laws came into existence.

Nor is the individual under any such restriction as to his private needs. Indeed, it is certainly the normal procedure of an individual wishing advice about investments, to go to some person who is familiar with investments. If he wants advice about any other phase of business, he would certainly seek out someone of his acquaintance in that business—the more successful and eminent the better.

But this bill says that alone among all the people in the United States needing or seeking advice or assistance as to the investment of their money, the stockholders of investment trusts are to be uniquely isolated from these principal normal sources of financial advice. I can't believe that there is any problem inherent in the investment company that requires that it, of all American institutions,

be singled out for complete deprivation of the benefit of the counsel of those persons who are best qualified to give it.

Whatever views one may entertain with respect to the permanent operating personnel, it would seem to me that the problem of the board of directors is easily distinguished from that of the operating group. In my opinion, one of the main functions of a board of directors is to bring to the professional managerial class the varied viewpoints of the world outside the walls of the particular business—to give the management a broad background of enlightenment and advice. The necessity for this infusion of outside wisdom is recognized in every great industrial company of the country, and nowhere is it more essential than in our industry.

Now, I am fully aware that nowhere in the bill is there a categorical prohibition of the continued association of these classes with the direction and management of investment companies. However, I shall now show how the proposed bill inevitably would operate to bring about this result.

Before considering those provisions which deal directly in prohibiting directorships it is appropriate to examine section 9 (a), as this section in my opinion would deter many individuals from accepting positions on the boards of investment companies. Section 9 (a) requires that all directors register. This provision has in view some very worthy objectives. For example, the Commission will deny the right to register—which means the right to serve in any capacity with an investment company—to any applicant who within 10 years has been convicted of a felony in connection with a financial transaction, or who has been enjoined by the order of a court from acting generally in any financial capacity. These restrictions are certainly sound and might well be incorporated in the statute in some other way. There is no necessity of requiring affiliated persons to register with the S. E. C. in order to accomplish this objective. The bill further provides that the application of a director for registration—

> shall contain such information and documents, in such form and such detail, as to such person * * * as the Commission may by rules and regulations prescribe as necessary or appropriate to effectuate the purposes of this title.

Now it seems to me quite possible that the Commission might decide that it is wise to have each individual reveal his personal financial condition, a list of all of his security holdings and debts and other matters which have been universally regarded heretofore as completely private. It might well be regarded as pertinent to make the registrant reveal the financial condition of all of his partners. Certainly, most men of affairs would think twice before they would subject themselves to these possibilities.

Now as to the direct prohibitions of section 10. The subsection that gets to the heart of the directorship problem is 10 (e). It says in effect that anyone who is a director of any company, any of whose securities are owned by the investment company, cannot be a member of the board of the investment company unless the investment company owns 5 percent or more of the stock of such company. I do not believe that this latter exception would cover many situations. Out of one-hundred-odd securities in my own corporation, only two or three would be exempted thereby. Under the proposed bill, wherein the diversified company one is largely kept down to investment of 5 percent I am sure the exemptions would be negligible.

In short, I think without stretching the point at all that section 10 (e) can be regarded as all-inclusive in keeping practically the whole top class of industrialists, merchants, and so forth, from being on the boards of investment companies. I have told you how large and important a class this is.

Indeed, if there had been any doubt in my mind as to the meaning and intention of this section 10 (e) (1), it was removed during the hearings on April 8, when Senator Taft asked Mr. Schenker:

> The result is * * * no investment company could have as a director or officer any director or officer of a stock listed on the New York Stock Exchange?

To this Mr. Schenker replied: "That is correct, sir."

The second part of this subsection provides that one cannot be a director of an investment company and of a portfolio company if he, or any of his partners, is an investment banker or broker. For the partner of a prominent banking house this provision is almost enough to rule him off the board of any investment company, because he or his partners collectively are represented as a rule on the board of a fairly large number of companies. It would, in this instance, be impossible to suggest either that the investment company should be denied the right of investing in such a broad group of leading stocks, or, on the other hand, that all of the partners would resign individually their positions on these other boards. But even if the banking house could meet this condition, it seems to me it would have to retire from the board by virtue of subsection (f) which provides that no investment banker, broker, or partner of such firms can be on the board of an investment company if they serve as principal underwriter for any company whose stock is owned by the investment company to the extent of the uninfluential amount of one-half of 1 percent. Clearly the investment banker in the face of these provisions has but two alternatives, namely, to give up his investment company affiliations or to get out of the investment banking business. It is probably unnecessary to labor this point further by making it clear that if the investment banker remains on the board of a substantial diversified investment company, he would, for practical purposes, eliminate his banking firm from affiliation with subsequent underwritings of the leading American companies.

Now the net effect to these direct prohibitions upon individuals from being directors of investment companies will naturally remove from the present boards of investment companies a large number of directors. A very real problem, indeed, will be that of trying to find adequate replacements.

In addition to these direct provisions against individual directorships are a number of other provisions dealing with the problem in a different way, namely, by prohibiting that majorities of boards shall be composed of certain classes of peoples. The prohibitions occur in subsections 10 (a) (1) and (2). For the moment it is enough to remark that they forbid that the majority of an investment company board shall consist of members of a banking firm, or brokerage partnership, or those who act as managers, investment advisers, or principal underwriters. This apparently is to be true whether or not the particular groups so prohibited happen to be the largest stock owners or not; or, in other words, happen to be that group who normally and usually would be represented on the board of a company in a control position.

Then there are further prohibitions under subsection 10 (c) against the banker and broker, to the effect that they cannot, or any of their partners cannot, be directors of more than one investment company except under that special situation of the so-called investment company system. Then again, the bankers and the brokers have further prohibitions under subsection 10 (d) (3) which says, in effect, that any person who regularly acts as broker (who is, of course, the investment banker or broker) cannot be the manager of an investment company.

Now, we of the industry are aware that the question of segregating investment bankers and brokers from the management of investment companies has been debated for a long period of time by members of the Commission. Judge Healy said before this committee 2 weeks ago, regarding this matter of segregation, the following:

> Nor does the bill require the segregation of investment bankers, brokers, and distributors from the management of investment companies, a step which various officials of investment companies advocated in the hearings before the Commission. However, to prevent the evils which may result from the divided loyalties, certain specific restrictions are imposed on affiliations involving conflicts of interest.

I appreciate the fact that the authors of the bill have attempted to avoid segregation, but I consider their attempt unsuccessful. For I believe that this bill not only provides for segregation of the investment company from the banker and broker, but I am forced to believe that the segregation is almost complete from that whole leading class of industrialists and merchants as well. In my opinion, this bill is the essence of segregation. It has avoided nothing but the word.

As a young man I was interested in magic and was a great disciple of Houdini who was then, and probably has remained, the greatest magician of our age. His great escape act used to be that they would handcuff him and rope him and finally nail him in a packing case, and in a minute he would come out smiling before the audience.

This bill has provided handcuffs and ropes for the industrialist. For the banker, it has taken the handcuffs and ropes and bound him and nailed him in the packing case. I do not think the banker can get out. In fact, I do not think he can ever get in. I deplore the separation of these useful people from their useful place in the operation of this business.

One more word about the director problem, because there are still some more provisions that would bother him. I think it is fair to say that, in general, the function of the directors is to keep the company in contact with the outside world and to be responsible in the determination of general policy. In the matter of the investment company, this would mean that they would be responsible for such major questions as to the general program of acquisition or disposition of securities, and in a general way, for the determination of fields of investment.

But this is a very different thing from asking them to pass upon every minute purchase and sale, to examine every report and recommendation made by the operating staff, and to consider every daily investment opportunity which may arise. I am sure you will agree that these distinctions between the operating staff and the directorship staff are fair distinctions.

Section 30 (e) makes life very difficult for any director who does not follow every detail of daily operations. This section has a very worthy purpose, which is to keep any affiliated person from trading

against the operations of his company. It seeks to accomplish this by making every director the subject of censure by his board of directors, possibly also by the S. E. C. and by the public. It does it this way. It requires that every person registered under section 9 must within 30 days after the close of each quarter of the fiscal year, submit a statement to the board of directors showing the amounts and dates of every purchase or sale made for his account of any securities of a company, the securities of which were purchased or sold by the investment company during such quarter.

But under section 30 (c) the Commission would have the power to require an investment company to transmit this report of such transactions to the stockholders of the company. Under section 30 (a) its filing with the S. E. C. may be required—which in the normal case means newspaper publicity.

The only point I am trying to establish is that there may well be, and surely will be in many instances, innocent transactions in the same securities by the director of a company as there were by the company. As the provisions now read, I do not believe they will deter the dishonest individual from operating, but I do believe they might inadvertently destroy the reputation of an innocent and honest man. I should personally not agree to subject myself to these provisions if I were an independent, nonoperating director and therefore one in no position to maintain information on every security transaction every day.

I have attempted to take the complicated and sometimes puzzling provisions of section 10 and its related sections and subsections and to point out their actual results in operation, and how and why these results are inevitable. I have tried to show not only the cumulative effect of these provisions on the problem of putting together managements for investment companies in the future, but the effect on existing management relationships as well. And this latter subject is a particularly important one because the bill, if it should pass in its present form, is going to upset, if not destroy, numerous management organizations which have been laboriously built up over the past generation, and will ruthlessly abrogate contractual rights which flow from contracts freely entered into and satisfactorily maintained for many years.

I say this with all deference to the remarks made by Judge Healy in his opening statement at these hearings when he said: "The bill's provisions have been scrupulously adapted to the existing diversities of investment company organizations and functions." I am sure that the judge was sincere in the general proposition which he advanced, but I should like to show you just what the management restrictions in the bill would do to one large investment company.

I do not like to refer so continually to my own company but these particular provisions of the bill happen to strike us with especial severity and I think it would interest you to see what the practical effect of the proposed bill would be in the case of an actual company which has thus far operated successfully.

The Lehman Corporation was established by the firm of Lehman Bros. in 1929. In its articles of incorporation and in the prospectus under which it was issued to the public it was made abundantlyy clear that the corporation would be managed under a management contract by the investment banking firm of Lehman Bros. and that its board

of directors and officers would be entirely composed of the partners, employees, and direct nominees of Lehman Bros. The Lehman Corporation has had a successful record; in fact, I believe it ranks among the first, second, or third of all investment trusts in existence. During its whole history our records do not disclose that any stockholder has demanded or suggested the change of our management, or the exclusion of any individual or class of individuals from the board of directors or management. The directors of the corporation have been reelected annually by a majority of the stockholders without opposition. Original stockholders and persons who have subsequently become stockholders are presumably fully aware of the relationship of the Lehman Corporation to the firm of Lehman Bros.

What will happen to the Lehman Corporation if section 10 of this bill stands? First, it will be absolutely necessary to turn over a majority and probably all of the board of directors to persons not affiliated with the firm of Lehman Bros. and not affiliated with any of the 100 companies represented in the portfolio of the company; second, the firm of Lehman Bros. will have to decide whether it wishes to remain as principal broker of the corporation, or as manager. A decision to remain as manager would entail retirement of the firm from the investment banking business in which it has engaged for 90 years, which is, of course, entirely unthinkable.

The following paradoxical situation would thus be created: Elsewhere in the bill it is provided, and properly provided, that managements cannot be changed without the consent of stockholders. But here the operation of section 10 would require a legally elected management, presumably entirely satisfactory to the stockholders, to turn over the affairs of the corporation to a new group unknown to the stockholders. True, the mechanics of this abdication would be in accordance with legal procedure. Presumably, a new slate of directors would be offered for election by the stockholders at the next meeting. Under existing corporate procedure, it is probable that they would be elected. Who they would be, and whence an almost completely new board could be drawn that the present management would wish to endorse, by inference (the whole field of American industry being closed in this choice), is a problem that I am not prepared to solve now. We have indicated before that we think it would be fraught with the most serious practical difficulty, but—following along the procedure—this new board of directors, totally independent of Lehman Bros., would then be required to find substitute officers and make new management arrangements to replace the Lehman Bros. personnel which is now active in the management of the corporation.

Thus the net effect would be that the present stockholder who has exercised his own judgment, and for better or worse, and however wisely or unwisely, has decided that he wants to own shares in a company managed by the firm of Lehman Bros., will by law be told that he can no longer employ their services, but has two alternatives; one, to accept the services of a group quite unknown to himself who will in future manage his money; or, if he does not wish to go along with this solution, he may sell his stock.

Frankly, we have no specific idea as to what the average stockholder may do in these circumstances, but it is reasonable to suppose that at least a fair number of stockholders will decide that they would prefer

to sell. If this decision should be made by any large number of stockholders, it would clearly have a most unfavorable effect on the market value of the investment of the remaining body of stockholders.

And there is in this case the final irony that the firm of Lehman Bros., for its own and family accounts, owns more than any other single interest in this stock, and has always maintained a very large investment in it—a very realistic guaranty that the managers of the corporation would always find their interests and those of the stockholders in general agreement.

I have cited this illustration because I happen to be familiar with it, and not as necessarily typical of every case of management and control of an investment trust by an investment banking firm. It does seem to me, however, that the consequences of the present bill in the case of the Lehman Corporation would constitute a reductio ad absurdum and should serve to justify serious reconsideration being given to the blanket proposal for the practical segregation of bankers and industrialists from the investment trust industry.

Now of course I do not approve of any legislation (such as this bill) which would cause such a violent and, to my mind, unjustified disruption of contract rights and business relationships which have operated to at least the general satisfaction of all concerned, even during the past 10 troubled years. I am sure that any reasonable man would agree with my point of view, unless it could be shown that there were such serious and inherent dangers in the relationships against which the law was directed that they could only be adequately guarded against by the particular provisions proposed.

Now what are these dangers? In general, they are the various conflicts of interest which quite obviously exist when persons occupy dual relationships. In the complexities of modern business life these dual relationships are inevitable and the choice of appropriate means for protecting against them is always a question of degree. In the history of investment companies, the S. E. C. has shown you a list of abuses which arose out of conflicts of financial interest between managements and stockholders of these companies in which managers enriched themselves by the improper use of the stockholders' funds. This was true of managers who were investment bankers and those who were not. In the case of investment bankers, it was perceived by the S. E. C. that there were additional conflicts of interest between them as managers and directors of investment companies, over and above those conflicts which might be inherent in the case of other types of managers or brokers. The S. E. C.'s answer to the very real problem raised by the revealed abuses, and by the latent possibility of the recurrence of such abuses, has been the complicated provisions of section 10 which we have shown you to have the practical effect of segregation.

Now I recognize the dangers which exist, but I think there is another answer to them and one which permits the continuation of many desirable existing relationships while giving adequate practical protection to stockholders. Therefore, I should like to discuss this problem in the light of the six principles which I stated on Friday as appropriate for the regulation of the industry, particularly one of them, namely, the prohibition on self-dealing between affiliated persons and investment companies. If you will consider this prohibition, which exists in the proposed bill and which I think is not only appro-