Exchange Commission to cause all investment advisers to register, which is simply the step before regulation.

We have been asked would we mind a simple registration. Yesterday it was mentioned that the nurses and the dentists had registered and were required to pass certain examination. I feel certain that in both cases there was a demand and need established prior to the legislation requiring them to register. I do not believe, in this case, the demand has as yet been established.

One further thought, gentlemen, before I leave—Yesterday Mr. Rose in his testimony seemed to indicate that a standard of qualification could be set up for this industry. Experience has proven that some sort of standard was needed in the case of the dentists and the nurses, prior to the time they were required to register and by which they could be individually judged. The distinctions between those groups and ourselves are, first, that we ourselves have not as yet been able to define a reasonable standard of qualification for investment counsel; and, second, that the investment counsel profession has taken steps, wholeheartedly from their early beginning to establish a high standard of practice governing their own actions.

One more word. I think the simple matter of the whole thing is this: There has not been demonstrated, so far as any of the investment counsel firms that are here assembled are concerned, any definite outline of the need for legislation. Now, as I say——

Senator WAGNER (interposing). Are you limiting yourself to investment counsel or speaking generally?

Mr. LOOMIS. To investment counsel.

Senator WAGNER. All right.

Mr. LOOMIS. I might also include "the fringe." I have not heard any argument about them. I have merely been told that there is such a thing. I think it would have to be proved that there was a fringe, what such a fringe constituted, and all about it, before there was a demonstrated need.

Senator WAGNER. I misunderstood you. I thought you said so far as the entire field of investment trust was concerned.

Mr. LOOMIS. Oh, no.

Senator WAGNER. Because we have had some testimony on that as you know.

Mr. LOOMIS. Surely.

Senator WAGNER. All right.

Mr. LOOMIS. Since there has been no establishment of a need for this legislation, I cannot see any basis for it. I question a lot whether the Congress wants to begin to legislate in a matter for which there has been no need therefor demonstrated.

One more word. If the Congress and this committee, in spite of what we have said, believe that some sort of bill should be enacted into law, even though there has been no basis for its enactment, I will say this: That the profession, my concern among them, will stand very ready, anxious in fact, to cooperate with the Congress and with the Securities and Exchange Commission to make just as good a bill as we possibly can, for the good of the profession, for the public interest, and for ourselves.

I thank you.

Senator WAGNER (chairman of the subcommittee). I thank you.

(Thereupon Mr. Loomis left the committee table.)

Senator WAGNER (chairman of the subcommittee). Professor Dodd.

STATEMENT OF PROF. E. MERRICK DODD, JR., HARVARD LAW SCHOOL, CAMBRIDGE, MASS.

Senator WAGNER. Professor Dodd, we will be delighted to hear from you. You ought to know about this.

Mr. DODD. Mr. Chairman and Senators: I came down here to talk about that portion of the bill that deals with investment trusts. I would, however, like before I deal with that, to say just a word about the investment-counsel aspect of the bill which we just heard discussed by other witnesses.

I have been somewhat astonished as I have been listening to the testimony today and read the testimony of yesterday, at the suggestion that because investment advisers, investment counsel, properly enough regard themselves as members of a profession, that that is the reason why they should not be regulated.

It seems to me quite obvious that just the opposite is the case, that it is our normal practice under our laws, both State and Federal, to regulate professions; that when people hold themselves out as competent to render professional services to the public, we do regulate them. We regulate the professions to keep undesirable people out. We regulate the legal profession, we regulate the medical profession, we regulate the accounting profession, and we regulate all of the major professions. With my own profession, the legal profession, we regulate not only who can get in but who can stay in. As a member of the bar I am subject at all times to disciplinary measures on the part of those two courts of whose bars I am a member, the Federal and the State courts. I can be disciplined, and I can be disbarred.

Furthermore, in their relatively minor——

Senator WAGNER (interposing). I take it that is done for the public welfare.

Mr. DODD. Of course it is done for the public welfare; and I am not one of those who regards a public official as a totally different sort of human being because we label him a "judge" or label him an "administrator." It would not alarm me in the least if I was, as a lawyer, subject to discipline by the Securities and Exchange Commission instead of being subject to discipline by the Supreme Judicial Court of Massachusetts.

Moreover, it is not accurate to state, as Mr. Loomis stated, that lawyers are exempt from that provision of the bill. They are only exempt insofar as they give advice about investments incidental to conducting their ordinary professional duties as lawyers. What that means it seems to me is obvious: If I, as a lawyer, have a client who is accustomed to come to me for legal advice, and in that connection I have become thoroughly familiar with the financial affairs of that client, who is very likely to be a woman or other person not perhaps very cognizant of investments, and if he or she asks me a question about whether a certain investment he or she proposes is a good risk, the bill allows me to answer the question to the best of my ability, without saying: I cannot give you any advice about that because I am not a registered counsel.

But that does not mean that because I am a laywer I can hold myself out as giving good investment advice to all comers. I am not exempt from the provisions of the bill because I am a lawyer, but only exempt in the narrow field where I can give investment advice as incidental to my ordinary duties to my regular legal clients.

Well, so much for that. Let me turn to what I came down here to speak about, that portion of the bill that deals with investment trusts.

I have been teaching corporation law at the Harvard Law School for 12 years, and I taught at other law schools for some years before that, and prior to that I practiced law, including a good deal of corporation law.

As I have been teaching corporation law I have become more and more interested in the investment trust situation, primarily for two reasons: First, because it is clear to me that if investment trusts are properly managed they can perform an enormously important service for the investor, particularly the small investor. The large investor can get competent investment advice, can employ investment counsel; and if he is a large investor he can have his own investment adviser. The small investor cannot do that. Investment counsel serve only large investors. The small investor cannot get diversity because he has not enough money to try to invest directly in stocks, say common stocks, himself.

The primary function of the investment trust is to give the small investor those two services, (1) expert selection, and (2) diversity.

In addition to that, I feel that the investment trust, if properly managed and if it regains its popularity with investors, which it has to a considerable extent lost, can perform a very important service to industry, because it can furnish to industry institutional buyers of common stock.

We have great institutional buyers of bonds. We do not have any substantial number of institutional buyers of common stocks, and that is one of our primary difficulties in marketing corporate equities.

So that the investment trust has long interested me as something that could perform a very important service, both to the investor and to American business.

I have long been very much bothered about what seems to me clear—the fact that while there are some excellent investment trusts, that the industry as a whole has not adequately been performing that service. As a student of State corporation laws I have long been well aware of the fact that under State laws, notably under the laws of Delaware, under which laws most of these trusts incorporate, this enterprise is wholly unregulated, so that there are ample opportunities for managements to engage in activities detrimental to the investor.

There are not only ample opportunities for the employment of improper practices, but there is no question that those opportunities have been used to a very large extent. Some 2 years ago the Securities and Exchange Commission made a very illuminating study of one group of investment trusts, Equity Corporation and its subsidiaries. Now they have made a similar study on a much broader scale, and that study, which I have carefully examined, is very revealing. It reveals not only outright looting—and if that were all that it revealed I should not be tremendously worried, perhaps, because, while there has been a good deal of it, that has not been a widespread practice so far as I can make out, although there has been a distrubing amount of it—but it reveals other things which are very dangerous to the investor even though one might not label them as outright looting.

In the first place, it is clear that for a very large part of the investment trust industry we do not have any substantial publicity. When an investment trust is issuing new securities it comes under the Securities Act. If securities are registered on the Stock Exchange they come under the Securities Exchange Act; but many of the investment trusts come under neither of those acts.

Quite apart from that the major evils in the investment trust field as I see them will not be cured by publicity. Those major evils which will not be cured by publicity as I see them, are primarily two, although there are some others.

In the first, place, there are evils which result from self-dealing; from the fact that so many of our investment trusts are managed by persons who are in the business of selling securities, or are brokers of securities, or are connected with corporations that want to find a market for their securities, so that opportunity for a dangerous kind of self-dealing is peculiarly prevalent in this industry.

Now, a man may be on both sides of a bargain and still be honest, but a man cannot be on both sides of a bargain without having his judgment affected by that fact.

Furthermore, self-dealing is particularly dangerous in this kind of enterprise because of the nature of the enterprise. For instance, if the management of a large steel company were composed of people who owned a lot of worthless land in the dust bowl, it would be nevertheless impossible for them to sell out to the steel plant, to substitute their desert land in the dust bowl. On the other hand, it is not only possible but very easy and is not at all infrequent for the managers of an investment trust, with an excellent portfolio, to dispose of all or a large part of such portfolio and substitute less desirable securities therefor.

The liquidity of the investment trust makes the danger of self-dealing far greater than that possible in the case of industrial plants and public utilities.

Now, this bill deals with that problem in two ways: It deals with it in part in section 17, which prohibits certain transactions of that kind. It deals with it in part in section 10, by making certain persons ineligible after 1 year as officers or directors of investment trusts.

Well, now it may be asked, and I think it has been asked by people who have appeared before you: Why that double-barreled protection? If you have a provision against self-dealing, why not stop there?

Well, as I see it, for two reasons: In the first place, it is one thing to prohibit self-dealing, and another thing to make that prohibition genuinely effective.

We have had prohibitions against self-dealing in corporation laws for generations, and self-dealing has gone on. It is very hard to stop it. It is very hard to stop it because it is very easy to conceal. A man may sell his own securities to a corporation through a straw man, so that self-dealing is not easily discovered.

It is only partially effective to say that people shall not sell their own securities to their trusts. They will still do so to a considerable extent. We will not succeed in stopping them.

In the second place, there are dangers that do lurk in a certain type of interlocking directorates that are not self-dealing. We will say that an investment trust buys a large block of securities of some corporation. It becomes pretty obvious that it is in the interest of the trust that those securities should be sold. But to throw those securities on the market will depress the market for that particular type of stock. Corporate managements do not like to have that happen to their securities.

Let us suppose, therefore, that we have a very influential common director of the investment trust, a person who is a director of an investment trust on the one hand, and on the other hand a director of the corporation whose securities it owns. He is not in a position to look at that matter solely from the standpoint of the interest of the investment trust. As a director of the other corporation he does not want sales which will seriously affect the market for that corporation's securities. Now, self-dealing does not prevent that because there is no dealing there where there ought to be action.

So for those two reasons I feel it is clear that a mere prohibition of self-dealing, though thoroughly desirable, thoroughly necessary, is not enough; that it is important to go further, as this bill goes, and to provide that certain persons shall be ineligible after an adequate period for readjustment, as members of boards of directors.

Section 10 of the bill makes certain persons ineligible but the class of persons who are made ineligible represent a relatively small number. There will still remain eligible plenty of experienced financial experts if that section is enacted into law.

It is of course no novelty for the Congress to limit the availability of certain persons for membership on boards of directors. We have done that with the railroads, making interlocking directorates between railroads and certain other corporations, or between other railroads, unlawful, except with the consent of the Interstate Commerce Commission under the Interstate Commerce Act. We have limited the eligibility of certain persons as directors of banks under the Banking Act. Various classes of persons cannot be directors of banks without the approval of the Federal Reserve Board. We have done the same thing with the public utilities in the Holding Company Act, under which a large class of persons are ineligible as directors without the consent of the Securities and Exchange Commission. The Clayton Act makes it illegal for persons to be directors of certain types of competing corporations. So it is no new thing for Congress to say that the dangers involved in certain kinds of interlocking directorates are such that that type of directorate should be forbidden by law.

Next, as to capital structure, which is in my opinion one of the most important features of the bill. As you know, while the bill does not affect the capital structure of existing trusts, it does provide that future investment trusts shall have only one type of security—common stock. Why should we do that with investment trusts if we do not do it with other corporations?

Well, as I see it, we should do it with investment trusts because there is a very substantial difference between the issue of senior securities by investment trusts and the issue of senior securities by industrial companies. Generally, the portfolio of an investment trust is almost entirely composed of common stock; and frequently the portfolio of an investment trust is to a large extent composed of the common stock of companies that themselves have senior issues of securities. The result is that debentures of an investment trust or preferred shares of an investment trust are an interest in common stock, at one stage and often several stages removed from the operating enterprise.

As I see it, there are two objections to that. In the first place, it tends to deceive or mislead the type of investor who is not very sophisticated about financial affairs; and that is very important, in view of the fact that so many of the investors in investment trusts are small investors, and in view of the fact that the primary social function of these trusts and their primary public usefulness is to serve the small investor. The small investor is often—although not always, of course—a rather unsophisticated investor; and the danger is that he will buy preferred bonds or shares without realizing that what he is getting is merely a limited interest in common stock. That is a very real danger.

What is perhaps more serious than that is the fact that even if he does realize what he is doing, he is running risks which even the fairly sophisticated investor does not appreciate.

What is the effect of issuing preferred stock in an investment trust? You are promising the preferred stockholder that you are going to give him priority in dividends, up to usually something like 6 percent. How are you going to do that? You must earn your operating expenses, in addition. You can do that only by averaging 6½ or 7 percent on your money. It is a rather difficult thing to do; it is an almost impossible thing to do at certain periods of the business cycle, except by speculation. Therefore, you are tempted into speculation.

Moreover, the effect of the business cycle is this: In the first place, preferred shares of investment trusts are rarely issued except in booms. Experience indicates that they are very difficult to sell except in booms. People will not buy preferred shares in this sort of enterprise except at a time when they feel that stocks are going up and that, therefore, preferred shares in a fluctuating pool of common stocks are fairly safe. So they are sold in booms. That means they are sold when common stock prices are rather high.

Well, unhappily, booms—so far as we know—are always succeeded by slumps. Then what happens? What happens then is that your asset values fall off and that your common stock becomes nearly wiped out or wholly wiped out, so far as asset values are concerned; but its voting power is rarely wiped out. It generally retains control, although it has a very limited asset value.

Another thing happens under these circumstances—and has happened—and that is that your preferred dividends pile up. The figures compiled by the S. E. C. are these: That of 58 companies with preferred stock issues, the issues of 35 of those companies went in arrears. Out of preferred stock issues at the end of 1939, the total arrearages aggregated nearly $80,000,000.

Well, what happens then? You have got a lot of arrears piled up on your preferred stock issues. Generally, you still have control in the common shares. You have got control in the people whose hope of dividends is very remote because of these preferred arrearages ahead of them.

What are they tempted to do? Well, they are not only tempted to do, but it has been shown that to a very large extent they do do one of three things—perhaps more, but three things particularly: One thing is to engage in speculation. They are speculating now with preferred stockholders' money. They have very little hope of a come-back for the common stock unless they do speculate and take long chances. They have got practically nothing to lose, because they are speculating with other fellow's money and not with their own. So they are tempted to speculate, and they very frequently do speculate.

Another thing that they are tempted to do and which they have often done is, as the S. E. C.'s study shows, to sell out to somebody who wants to buy control for sinister purposes. Control may be in the hands of a perfectly honest man; but there are men who, as owners of common stock, are discouraged in their own ability to get much out of this enterprise, because of the preferred stock ahead of them. Somebody comes to them—somebody who sees an opportunity, by having control, to use that control for purposes of looting the trust—and offers a substantial price for what is otherwise worthless common stock, merely in order that he may get control. Because the common stock is worthless, except for control purposes, the temptation to sell out without inquiring very carefully into the kind of fellow to whom you are selling out is a very real temptation—a temptation that I should hate to be confronted with, myself. That temptation has been yielded to over and over again.

However, they may do neither of those two things. In many cases what they will do will be a third thing. What they will do will be to put pressure of one sort or another on the preferred stockholders to consent to a recapitalization—to a recapitalization which will reduce or radically change the rights of the preferred stockholders, so that the common stock may get back into the picture.

Now, Mr. Chairman and Senators, it is unfortunate that our State laws make that process an almost wholly unregulated process and a very dangerous one for the preferred stockholders. Take the law of Delaware—and I mention Delaware because something like half of our investment trusts are incorporated there: Under a law of Delaware it is possible—as the recent *Havender case* in Delaware indicates—to make radical changes in the capital structure of a Delaware corporation as incidental to a merger between a parent and a wholly-owned subsidiary. I should not say "incidental"; because what you do is that you make the merger for the sole purpose of changing the capital structure. In Delaware you can change the capital structure not only under the amendment section of the statute but under the merger section of the statute. If you proceed under the merger section of the statute, there is no provision for a separate vote by the preferred stockholders. Accordingly, you can put in a merger that radically affects preferred stockholders' rights, that gets rid of their accrued dividends entirely, for example—as that case decided—without even getting rid of the common stockholders, providing the common stock has control.

However, suppose the preferred stockholders do have a right to vote: Even there, the dangers are very great. The management is normally in the hands of people elected by the common stockholders, whose interests are allied to theirs. They are the people who put out the literature that comes to a stockholder with his proxy, indicating to him why he should vote for this. It is as though we had a political campaign where all the campaign literature came from one side and none of it came from the other side and where the other side was unorganized.

The directors elected by the common stockholders control the dividend policy of the corporation. It has very frequently happened that preferred stockholders have been put into a mood to consent to radical changes in their rights by starving them for a while from dividends, even though dividends could legally have been paid, and then intimating to them that if they would only "play ball" with the management and put through the kind of amendment that the management is seeking, then in some mysterious way the corporation's ability to pay them dividends would suddenly be increased.

Then, again, as in the *International Paper case*, there are situations where it is in the interest of both groups, preferred and common, that some change be made, such as a wiping-out of deficit by reducing capital stock; but the common stockholders, with the aid of the management, will take the position, "We will not vote for this change, even though it is in the interest of both parties, unless you, the preferred stockholders, will grant us a large concession and will in effect bribe us to vote in the way that it is in our own interests to vote, anyway."

For years I have watched litigation in the State courts with regard to recapitalizations; and, frankly, it frightens me. The State courts have felt that the legislatures have granted these broad powers, that the courts should not interfere with the exercise of those broad powers unless they are used not merely unfairly but outrageously. Generally, they can be upset only for fraud; and what the Delaware court calls "fraud" has to be something very, very raw, I can assure you.

The same is true of many other of our courts. They have felt that since the State legislature did not give them control over these reorganizations, and since it left it to the stockholders' hands, therefore the court should interfere only in rare cases.

We have there something totally different, gentlemen, from what we have with regard to reorganizations where creditors are involved. There the Congress has wisely provided a statute under which we have very careful judicial supervision of such things.

Senator WAGNER. Senator Hughes, will you preside for just a few moments? I will be back almost at once. I did not want to miss hearing any of it.

(At this point Senator Wagner (chairman of the subcommittee) left the hearing room.)

Senator HUGHES (presiding). All right, Professor Dodd; please continue.

Mr. DODD. Where creditors' rights, including bondholders' rights, are involved, we not only have a statute calling for court intervention and in some cases S. E. C. advisory opinions, but we now have an opinion of the Supreme Court, in the *Los Angeles Lumber Products Company case*, which makes it the duty of the court to reject any reorganization plan which does not thoroughly protect the priority claim of bondholders.

They have nothing of the sort where we are merely changing the capital structure of a corporation; and such changes may be of a sort greatly to reduce the priorities of the preferred stock, and yet be unassailable under our State laws.

No doubt it is possible to deal with this matter to some extent by putting special protective provisions in the preferred-stock contract; but as I see it, there are very serious difficulties in the way of that.

In the first place, even if you provide that in certain cases voting rights will go over to the preferred stockholders, actually it is generally impossible for the preferred stockholders to oust the management put in by the common-stock holders, even where they would like to do so; because there is no way of organizing them. You cannot beat somebody with nobody, as has often been said in politics; and it is equally true in the management of American corporations. The existing board of directors is in. They will send out proxies urging the preferred stockholders, if they now have obtained the voting control, to reelect them. If you are not going to reelect them, you have to get a rival slate, and somebody has got to organize the opposition. The preferred stock is usually held in small lots by small investors. Usually there is nobody there to organize the opposition.

Furthermore, I feel sure that if you somehow succeed in making preferred-stock provisions really protective, preferred stock would not be issued, anyway. The reason it is issued is because it does enable holders of the common stock, even if the corporation gets into difficulties, still to run the show; and if you could really effectively give the preferred-stock holders power to run the show, if you could give them power to liquidate the enterprise, for example, if it was in their interest to liquidate, those rights of the preferred stockholders would then be regarded by the common-stock holders as so dangerous that preferred stock would not be issued.

(Senator Wagner then reentered the hearing room and took a seat at the committee table.)

Mr. Dodd. I simply do not believe that you can put into your preferred stock issues provisions that are really protective to the preferred stock; I doubt if you can do it at all. If you can do it, I am sure that you would thereby produce a situation where promoters, who generally expect to be common stockholders, would not want to issue any preferred stock.

This bill proposes to prevent new issues of preferred stock and new issues of bonds. The bond situation is very similar, except that a so-called bond—which is nothing but an interest in a pool of fluctuating common stock—is an even more anomalous investment than preferred stock in such an enterprise.

As I say, the bill proposes to prevent such issues in the future. They are not being issued today; they will not be issued unless there is a boom, and that is the very time when it is dangerous to issue them, because it is the time when this pool of assets will be way up and when the danger of shrinkage will be peculiarly great. However, there are a large number of such issues on the market at the present time; and, therefore, the bill goes on to endeavor to furnish some protection to those who now hold preferred stock in these enterprises.

In many cases that stock is issued on terms which give them very little protection. The bill endeavors to give protection to them in a number of ways. One is by giving the S. E. C. power over recapitalization plans. The reason why I am thoroughly convinced that our State laws are inadequate on that and that regulation of recapitalization plans is necessary, I have already tries to indicate. They are not regulated by courts. They are proposed by managements, ordinarily by managements identified in interest with the common stock. The cases in which they have gone through in one way or another, despite the fact that they were plainly unfair to the preferred holders, have