

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, JUNE 14, 1940

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE OF THE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE,
Washington, D. C.

The subcommittee met at 10 a. m., in the committee room, pursuant to adjournment, Hon. William P. Cole, Jr., chairman of the subcommittee, presiding.

Mr. COLE. The subcommittee will come to order. Judge Healy.

Mr. HEALY. If the chairman please, I would like to offer a suggestion for your consideration, and it is that since Mr. Schenker and Mr. Hollands have worked on the recommendations for the committee, and Mr. Jaretzki and Mr. Motley for the industry, that if the four of them could sit together before the committee here, it might facilitate a full explanation of the various sections.

Mr. COLE. Very well.

**ROBERT E. HEALY, COMMISSIONER; DAVID SCHENKER, AND
JOHN HOLLANDS, OF THE SECURITIES AND EXCHANGE COM-
MISSION; ALFRED JARETZKI, JR., AND WARREN MOTLEY,
REPRESENTING THE INDUSTRY**

Mr. COLE. The subcommittee will be glad to hear you gentlemen and to have a complete record from this quartet. We will give you all of the time you need.

Give your names for the record.

Mr. SCHENKER. David Schenker, Securities and Exchange Commission.

Mr. HOLLANDS. John Hollands, Securities and Exchange Commission.

Mr. MOTLEY. Warren Motley, of Gaston, Snow, Hunt & Rice, New York.

Mr. JARETZKI. Alfred Jaretzki, Jr., Sullivan & Cromwell, New York.

Mr. Chairman, you asked Mr. Bunker to submit a copy of the memorandum that was circulated among the investment companies. At his request I am submitting that now.

That is a memorandum of agreement in principle. Subsequently the bill before you was drafted. The bill as it was drafted was then also submitted, as Mr. Bunker stated.

Mr. COLE. Very well.

(The memorandum above referred to is as follows:)

MAY 13, 1940.

FRAMEWORK OF PROPOSED INVESTMENT COMPANY BILL (TITLE I)

EMBODYING SUGGESTIONS RESULTING FROM CONFERENCES BETWEEN SECURITIES AND EXCHANGE COMMISSION AND REPRESENTATIVES OF INVESTMENT COMPANIES

1. *Findings and declaration of policy (secs. 1 and 2, present bill).*—These should be revised to accord with the revision of the bill. They should include a declaration of policy against the purchase by an investment company of securities of any issuer for the purpose of obtaining collateral advantages to any person affiliated with such investment company.

The Commission and the industry unite in the earnest suggestion to the Senate committee that it call attention to the tax problem and to the desirability of providing special tax treatment not merely for certain classes of open-end investment companies as under the present law, but for closed-end investment companies as well.

2. *Definition of investment companies (sec. 3, present bill).*—These definitions are in the main satisfactory but careful consideration should be given by counsel (e. g., counsel for the Commission and counsel for the industry) to make certain that there are eliminated those companies whose inclusion under the present bill was neither intended nor desired. As in the present bill, power should be lodged in the Commission upon application to determine that a company is not an investment company, where such is the case, even if it falls within the scope of the technical definition.

3. *Classification of investment companies (sec. 4, present bill).*—The classifications in this section of the present bill are satisfactory.

4. *Subclassification of management investment companies (sec. 5, present bill).*—The division of management investment companies into "open-end" and "closed-end" companies is satisfactory. The further subclassifications of this section should be revised to provide for only two types of companies, perhaps known as diversified companies and nondiversified companies, as follows:

(a) A diversified company should be defined as a company which as to at least 75 percent of its total assets holds no security of any one company in an amount greater than 5 percent of its total assets and not more than 10 percent of the voting securities of any company.

(b) A nondiversified company should constitute any management investment company not falling within the requirements of a diversified investment company.

5. *Exemptions (sec. 6, present bill).*—The present provisions of the bill are satisfactory substantially in their present form, including the powers delegated to the Commission.

6. *Transactions by unregistered investment companies (sec. 7, present bill).*—The provisions of the bill constituting a ban on transactions of unregistered companies are satisfactory in substance as a means of enforcement of the provisions of the bill.

There is doubt as to the desirability of precluding the registration of foreign investment companies, although the difficulty of providing a machinery for enforcing the bill against foreign companies is recognized. If counsel are able to formulate a satisfactory machinery for enforcing provisions of the bill against registered foreign companies, such is to be included in the bill, otherwise the prohibitions against the registration of foreign investment companies will remain.

7. *Registration of investment companies (sec. 8, present bill).*—The formalities for registration are to be worked out by counsel with a view to simplification of requirements and avoidance of unnecessary duplication under other acts.

In addition, the registration statement should contain a declaration of the fundamental policy of the investment company in respect of the following items:

- (a) Classification in which the company proposes to operate;
- (b) Policy as to borrowing;
- (c) Policy as to issuance of senior securities;
- (d) Policy as to underwriting;
- (e) Policy as to concentration of investment in any particular industry or group of industries;

(f) Policy as to purchase of real estate or commodities and as to making loans. This may take the form of a statement that the company reserves freedom of action to purchase real estate and commodities or to make loans.

The registration statement should contain a further declaration in general terms of policy in respect of portfolio turn-over, and shall give the portfolio turn-

over of the company for the last 3 fiscal years. Annually thereafter there shall be filed the turn-over of the company for the preceding fiscal year. This declaration, however, is not binding on the management which is to be free in its discretion to purchase or sell securities whenever in its best judgment such action is desirable.

The registration statement should further contain a list of the officers, directors, managers, and principal underwriters of the company, to be revised periodically, giving in respect of each his affiliations and business experience and such other data as counsel may agree.

The bill is to provide that the registration statement becomes effective automatically upon filing, but the Commission is to have authority after a reasonable time for examination of the registration statement to deregister the company if it finds any false or misleading statements in the registration statement, or if it finds that the registration statement does not contain the required information; provided, of course, that the deficiencies are not met. Such power in the Commission will be subject to court review.

8. *Prohibition on certain persons acting as officers or directors (sec. 9, present bill).*—In lieu of the provision for the registration of officers and directors, there is to be a flat prohibition of any person acting as officer, director, manager, or principal underwriter who has within the past 10 years been convicted of a felony or misdemeanor involving the purchase or sale of any security, or is under injunction by court from acting in certain capacities as specified in the present bill. However, power is to be given to the Commission in its discretion to grant exemptions from this prohibition.

9. *Affiliations of directors (sec. 10, present bill).*—As a complete substitution for the provisions of section 10 of the bill as introduced, the following is to be substituted:

(1) In the event that the board of directors of any investment company shall have a majority of directors who are independent of principal underwriters, regular brokers, investment bankers, all restrictions of the present section 10 are eliminated except "No registered investment company shall purchase any security a principal underwriter of which is a director, officer, or manager of such registered company, unless in acquiring such security such registered company is itself acting as a principal underwriter for the issuer, or unless such security was first offered to the public and the period of the offering syndicate shall have terminated. The Commission is also to have power to grant by general rules and regulations exemptions under certain circumstances to the foregoing prohibition."

(2) In respect of investment companies where no officer or director acts either as principal underwriter, regular broker, investment banker, or manager, the directors, independent of managers or officers, need number only 40 percent.

10. *Recurrent promotion of investment companies (sec. 11, present bill).*—The provisions of section 11 of the present bill are to be eliminated but provision will be made in an appropriate section of the bill for the following:

There is to be a prohibition on formal exchange offers made in respect of securities of open-end investment companies where the exchange involves a premium over liquidating value, unless such offers are approved by the S. E. C., or permitted by its rules or regulations.

11. *Certain prohibitions (sec. 12, present bill).*—Margin purchases and joint trading accounts should be prohibited and also short selling in contravention of rules and regulations of the Commission. Underwriting commitments of diversified investment companies should be limited to a maximum of 25 percent of total assets and should be permitted only to those companies which have in their registration statement declared that they proposed to underwrite. In respect of underwriting, provision should also be made for carrying on underwriting and related activities through subsidiaries or companies to be owned by more than one investment company.

In the future no investment company should be permitted to acquire the stock of another investment company if such acquisition will result in a holding of more than 3 percent of the voting stock of the company whose stock is purchased. Proper exception, however, should be made in connection with transactions designed to simplify existing investment-company systems and in connection with reorganizations, mergers, etc. Further exception should be made to permit the investment of a limited percentage of the assets of an investment company of any class in a jointly organized new venture company. It is understood that there will be a limitation in the maximum size of any such new venture company.

Open-end investment companies are to be prohibited from acting as distributors of their own securities in contravention of rules and regulations of the Commission, language to be agreed to by counsel.

Counsel are to draft suitable provisions in respect of cross and circular ownership.

12. *Changes in investment policy (sec. 13, present bill).*—With classification and investment policy provided for, there should be a prohibition against any change without stockholders' consent in classification or in fundamental investment policy as announced in the registration statement.

13. *Size of investment companies (sec. 14, present bill).*—There is to be no limitation on maximum size of investment companies. The minimum size is to be \$100,000.

The bill will authorize the Commission, if it should believe that further growth of investment companies creates a problem, to make a special study in respect of the size of investment companies and to report to Congress thereon.

14. *Compensation of management; management and underwriting contracts (sec. 15, present bill).*—This provision should contain substantially the same requirements for approval by stockholders and prohibition on transfer of management contracts without consent of shareholders. The Commission recommends, but does not insist, that certain types of profit-sharing contracts be outlawed. Underwriting contracts should also be covered substantially as in the present bill. Existing rights under contracts outstanding March 15, 1940, are to be left undisturbed.

15. *Changes in board of directors (sec. 16, present bill).*—The provisions of section 16 are satisfactory except in respect to a special situation which now exists.

The bill is not to interfere in this respect with the operation of existing strict trusts except to provide for the right of removal of trustees by the holders of two-thirds of outstanding certificates. Provision is to be made in line with existing proxy regulations for distribution by the management of notices or letters by certificate holders desiring to call a meeting for the purpose of removing trustees. Exculpatory clauses are to be limited to a form approved by counsel which is to follow quite closely the draft proposed by Mr. Griswold.

16. *Transactions of certain affiliated persons and underwriters (sec. 17, present bill).*—The prohibition on self-dealing is approved and there should be prohibited any sales to or purchases from insiders whether of portfolio securities or other property and also any loans to insiders. Specified agency fees, such as brokerage (other than real estate), fiscal and transfer agencies and similar payments, and such others as the Commission may prescribe, are to be exempt. The Commission is also to have power to grant by general rules and regulations exemptions under certain circumstances to the flat prohibition on self-dealing as principal.

Provision is to be made that all portfolio securities be placed with (1) a bank or trust company subject to Federal or State supervision; (2) a private banking organization, if subject to State or Federal supervision; or (3) institutions subject to control and discipline of a national securities exchange under the Securities and Exchange Act of 1934, provided appropriate rules and regulations can be agreed upon between counsel.

Officers who have access to securities or funds may be compelled to be bonded against larceny and embezzlement in reasonable amounts under rules and regulations and by orders of the Commission.

The Commission is to have the right to bring proceedings in courts of appropriate jurisdiction to enjoin any proposed gross misconduct or gross abuse of trust, or for an adjudication of gross misconduct or gross abuse of trust for the purpose of disqualifying a person under paragraph 8. Larceny and embezzlement are to be made specific Federal offenses.

17. *Capital structure (sec. 18, present bill).*—In lieu of the prohibition on the future issue of senior securities, provision should be made for the limitation on the future issue of senior securities of closed-end companies as follows: In the case of debentures, there should be a minimum coverage of assets at the time of issuance of 300 percent and in the case of preferred stock, a minimum coverage of 200 percent, including any obligations senior to the preferred stock. Dividend restrictions to correspond should be provided as to future issues of senior securities. All stock, whether preferred or common, should have voting privileges, with protective provisions for preferred stock to be worked out by counsel. There is to be only one class of debentures and one class of preferred stock insofar as priorities are concerned, but provision may be made for different series to take care of such things as differences in interest rates. Provision should be made for some voting rights to debenture holders, on future issues, in the event that the assets of the company fall below the face amount of the debentures. The exception with respect to existing strict trusts heretofore discussed would apply to this situation.

No future issue of senior securities is to be permitted for open-end investment companies, but such companies are to be permitted to borrow from banks up to 33 $\frac{1}{3}$ percent of their assets at the completion of such borrowing, such maximum limitation to be maintained at all times.

Refunding of existing senior securities will be permitted irrespective of above restrictions.

The subsection dealing with redistribution of existing voting rights is to be eliminated.

18. *Dividends (sec. 19, present bill).*—Provision should be made for full disclosure to shareholders as to the source of any dividend. All other provisions of the present bill are to be eliminated.

19. *Proxies: Voting trusts (sec. 20, present bill).*—The proxy requirements of the Securities and Exchange Act of 1934 which now apply to such investment companies as are listed on any national securities exchange are to be made to apply to all investment companies.

The prohibition of voting trusts is approved except that voting trusts presently existing under State laws are to be permitted to continue.

20. *Loans (sec. 21, present bill).*—Borrowings are to be prohibited only to the extent of the limitation on indebtedness dealing with future capital structure and provision is also to be made permitting the refunding of any existing indebtedness and permitting borrowings for temporary purposes. Loans to insiders are prohibited as selfdealing. Upstream loans are to be prohibited, but existing upstream loans may be refunded.

21. *Distribution, redemption, and repurchase of redeemable securities (sec. 22, present bill).*—As to the subject matter of subsections (a), (b), and (c) of section 22 (of the present bill) relative to pricing, dilution, and load, the Commission is willing to agree to the following:

(a) An express provision authorizing an association under the Maloney Act (for example, N. A. S. G.) to make rules covering this subject matter.

(b) A grant of equivalent power to the Securities Exchange Commission, provided that the same shall not be exercised for 1 year from the effective date of the act.

Provision is also to be made that the redemption privileges of any redeemable security shall not be suspended except (a) for a period of not more than 7 days, or (b) in case of an emergency, including a period during which the New York Stock Exchange is closed, or (c) under such other circumstances as the Commission may by rules and regulations or by orders permit.

No security issued by an investment company shall be sold to insiders or to anyone other than an underwriter or dealer, except on the same terms as are offered to other investors. Appropriate provisions may be made for mergers.

Restrictions on transferability of shares shall be subject to rules and regulations of the Commission.

22. *Distribution and repurchase of securities: Closed-end management companies (sec. 23, present bill).*—The sale of common stock of closed-end companies below asset value is to be prohibited unless in an offering to all common-stock holders, or with the consent of stockholders, or upon conversion, or exercise of existing warrants, or under such circumstances as the Commission may by rules and regulations or by order permit.

The purchase by closed-end investment companies of outstanding securities should be permitted only on the open market or pursuant to tenders, in both cases with appropriate disclosures, or under such other circumstances as the Commission may prescribe by rules and regulations or orders.

23. *Periodic reports, accounts, and accountants (secs. 30, 31, and 32, present bill).*—Investment companies are to be required to send to their shareholders periodic reports. Bearing in mind the expense in relation to smaller companies, the requirement should probably not be for more than semiannual reports. These reports should be certified to at least annually by independent public accountants. Each report should include (and such additional items as counsel should decide):

(a) Balance sheet showing the market or appraised value of securities and a list of securities held.

(b) When certified by public accountant, the certificate should include a verification of securities held or confirmation thereof from the custodian in certain cases.

(c) The income account should show the source of all substantial items of income.

(d) Expenses should be broken down in detail at least as to those items constituting 10 percent or more of the total expenses.

(e) The report should include a supplemental statement of amounts paid to any director or interested person in the way of stock-exchange commissions, legal fees, or agency or similar payments.

The Commission is to have power after consultation with representatives of the industry and public accountants to provide for a reasonable degree of uniformity in accounting standards. The detail of this is to be left to counsel. Whether or not periodic verification of security holdings and transactions is advisable in view of the other provisions agreed to is a question to be left to counsel.

24. *Supplemental sales literature (sec. 24, present bill).*—Supplemental sales literature is to be filed with the Commission within 10 days after use but is not to be a part of the registration statement.

25. *Reorganization (sec. 25, present bill).*—The Commission is to have power to bring proceedings for an injunction in a court of competent jurisdiction to enjoin any reorganization the provisions of which are such as to constitute gross misconduct or gross abuse of trust on the part of the directors, managers, or other sponsors of the reorganization plan, or which are grossly unfair.

Plans of reorganization, etc., are to be filed informally with the Commission so that it may be advised in the premises. The Commission is to be authorized, if requested by any investment company or by 25 percent of its stockholders, to render an advisory opinion in respect of any reorganization plan, etc.

Provision must be made by counsel that on reorganizations or consolidations existing rights continue notwithstanding the provisions of the bill in respect of certain prohibitions as to future transactions.

26. *Destruction and falsification of reports and records (sec. 34, present bill).*—This section dealing with destruction and falsification of reports and records is to be confined to corporate documents and corporate accounts.

27. *Unlawful representations and names (sec. 35, present bill).*—The prohibition in the present bill in respect to unlawful representations is satisfactory and the adoption of misleading names should be prohibited. There is to be no discretion to the Commission.

28. *Rules, regulations and orders: General powers of Commission (sec. 36, present bill).*—The general authority contained in subparagraph (a) of section 36 of the present bill is to be more limited in scope, and is to state clearly that it is procedural only as to scope.

29. *Hearings by Commission (sec. 37, present bill).*—A policy should be expressed for consultation by the Commission with representatives of the industry, and for public hearings in the discretion of the Commission whenever it appears that there is a substantial demand for such hearings. Neither should be mandatory.

Provision should be made for hearings in respect of any formal proceeding before the Commission in relation to any proposed order.

30. *Enforcement of title (sec. 38, present bill).*—The Commission is to be given appropriate enforcement powers but less drastic than in the present bill, such to be agreed to by counsel.

31. *Court review of orders: Jurisdiction of offenses and suits (secs. 39, 40, present bill).*—The provisions of sections 39 and 40 in the present bill are satisfactory.

32. *Information filed with the Commission (sec. 41, present bill).*—This section is satisfactory as applied to the bill herein proposed.

33. *Annual reports of Commission, etc. (sec. 42, present bill).*—This is satisfactory.

34. *Penalties (sec. 43, present bill).*—The industry makes no objection to the provisions of this section.

35. *Effect on existing law (sec. 44, present bill).*—This section as it now stands is satisfactory.

36. *General definitions (sec. 45, present bill).*—Many of these definitions need revision, but this is a matter for detailed drafting.

37. *Separability of provisions (sec. 46, present bill).*—This is satisfactory.

NOTE.—In addition, provision is to be made applying to closed-end companies, section 16 of the Securities and Exchange Act of 1934, in respect of the liability of directors, etc., for profits made within 6 months on the purchase and sale of the corporation's securities.

Mr. SCHENKER. May I proceed, Mr. Chairman?

Mr. COLE. Yes.

Mr. SCHENKER. Section 1 (a) sets forth the findings of the Congress, and section 1 (b) sets forth the declaration of the policies of the bill.

Section 2 contains general definitions, and with respect to those general definitions, Mr. Chairman, I think the most expeditious way to handle them is, when we come to a section where the term has a meaning or significance, to expostulate that meaning and show the importance of the particular term in that section.

I may say this, generally, that many of the definitions were incorporated from the 1933 act and the 1934 act, and that was done at the suggestion of the industry. They felt that they would like to have the entire bill in one volume instead of having to refer to one act and then to another act, you see.

Mr. COLE. Has the work of the Commission under section 30 of the Holding Company Act, been pretty much a continuous job since the work started?

Mr. SCHENKER. We started in December of 1935 and have been continually at it since that time including the conduct of public hearings, investigations, preparation of reports, including the preparation of the conclusions which were incorporated in this bill.

Mr. COLE. And the conclusions reached which are found pretty much in section 1, entitled "Findings and Declaration of Policy," were not only recommended by the Commission following this study, but have been agreed to as proper findings by the industry itself?

Mr. SCHENKER. That is correct, Mr. Chairman. They accepted those findings upon the basis our studies and reports which substantiated these findings of the abuses.

Mr. COLE. All right.

Mr. SCHENKER. That brings us to section 3, Definitions of Investment Company.

Mr. COLE. What page is that?

Mr. SCHENKER. That is page 22. Now, with respect to that definition an investment company is a company or an issuer which is engaged primarily in the business of investing, reinvesting, owning, holding, or trading in securities. In order to eliminate any doubt that the face-amount-certificate companies are within the category of investment companies contemplated by this legislation, they are specifically enumerated as investment companies. The third subdivision is what we call our statistical formula. The definition was based upon a very detailed analysis we made of every corporation which was listed on any exchange in this country. On the basis of our studies and analyses, we devised this formula, which in essence says that if a company has 40 percent of its assets in securities other than securities of its subsidiaries, they are investment companies. Curiously enough, Mr. Cole, this definition has been in circulation since the time of our first report in 1938 and no company, virtually no company, that is not popularly regarded as an investment company, has been caught by this formula, except possibly one, and I will discuss that in a moment.

We have made an exception in that instance, and that company was not really caught.

The advantage of this formula has been and will be that a company examines its assets and if it does not have the prescribed percentage in diversified securities (securities of companies which are not subsidiaries) the company knows that it is not an investment company. Immediately, all of the holding companies in this country can look at their portfolios and say, "Well, we do not have 40 percent of our assets invested in securities other than our subsidiary companies, so we are not touched by this legislation." And the formula has worked out.

Now, we have, in order to be meticulously careful, specifically excluded some types of companies from the purview of this bill.

On page 23, section (3) subsection (b) (1) excludes an issuer who, through a wholly-owned subsidiary or subsidiaries, is engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. That subsection covers the pure holding type corporation like the United States Steel, or General Motors. That is, if you pierced the corporate structure and removed the corporate veil, and looked down through the companies, the General Motors is engaged in the business of making automobiles and not the business of holding securities. That provision therefore is an added caution to exclude companies which are not investment companies. If companies are engaged in a business other than that of an investment company, whether directly or indirectly through wholly owned subsidiary, this bill does not cover them.

Similarly, if a company upon application proves that it is engaged in business other than investment-company business, either through majority-owned subsidiaries or controlled subsidiaries, then the Commission can exempt them from this act.

Now, we make a distinction between wholly owned subsidiaries and a majority-owned subsidiary, because you might get a situation—and there are such investment companies in the country today—where they buy a controlling interest in a company, not because they desire to engage in that business, but as an investment in that company and get out of that investment when the value of the investment increases. So they are not engaged in manufacturing steel, or automobiles, for instances. Then they have made an investment, a substantial investment in a company, and if the stock goes up they get out of their investment. We have to distinguish between the company which, through a majority-owned subsidiary or controlled subsidiary, is in the business of manufacturing or operating a company, and a company which invests a substantial portion of its assets in a company merely for investment or holding for other purposes.

Now, we go on to subsection (3), which covers a situation where you may have a wholly owned subsidiary which might fall within the definitions of an investment company. A classic example of that is, Mr. Cole, an industrial company which may have some surplus funds which it wants to invest in blue-chip stocks or marketable securities. Rather than investing its funds indirectly, it organizes a wholly owned subsidiary to take a part of its fund and the wholly owned subsidiary invests in those securities. We have excluded that type of wholly owned subsidiary from the purview of this legislation.

In order to eliminate private holding companies or private investment trusts—we used this formula throughout our entire studies and it did not create any difficulties—unless the company has 100 public stockholders, it is not a public investment company within the purview of this legislation. That is paragraph (c), subsection (1).

In order to prevent circumvention, we have said that if any company owns 10 percent of an investment-company voting stock, and the 10 percent owning company is owned by more than 100 people, then you count the stockholders of the owning company as stockholders of the controlled company. We have to adapt this procedure. Otherwise you can see what would happen. A person organizes an investment trust, and has another corporation take all of the stock of the investment trust, which corporation sells its stock