you get some indication of the difficulties encountered by the S. E. C. in getting a fair, adequate, and accurate disclosure of these practices under the Securities Act of 1933.

I believe thoroughly in the principle of the Securities Act of 1933. There is nothing paternalistic in it. The principle of adequate and accurate disclosure is, in the usual case and with reference to the ordinary situation, enough; but there are some situations where admitted abuses and the effects of such abuses, even though explained, would be little understood or appreciated by the types of persons to whom the securities are offered, or the abuses are hidden in the nature of the set-up or organization. In such situations, further steps are necessary to protect the investors.

I concur wholly in the opinion of Mr. Mathews expressed before this committee, which was also quoted favorably by Mr. Adler:

> I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impress its restraints may be very misleading to those whom it professes to protect.

and I don't mean by this to endorse every section in the bill as drafted. I have not thought through each section of the present bill.

It is with reference to these practices I have been talking about, and not with reference to the bill as a whole, which I have not completely analyzed.

I shall be very glad to answer any questions you may have.

Senator HUGHES. Thank you. I believe that is all.

Mr. HEALY. Senator, will you be kind enough to call Mr. Francis Greene as a witness?

Senator HUGHES. All right; Mr. Greene, will you please take the stand?

STATEMENT OF FRANCIS GREENE, ASSISTANT DIRECTOR, TRADING AND EXCHANGE DIVISION, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. GREENE. Senator, my name is Francis Greene. I am an Assistant Director of the Trading and Exchange Division of the Securities and Exchange Commission. I wrote the letter, part of which Mr. Eberstadt read during his testimony on last Thursday, April 18. Because of the impression of the S. E. C. staff, which Mr. Eberstadt may have created by his references to that letter, I should like, if I may, to explain the background of the letter and to explain why it was written.

Pegging, fixing, and stabilizing of security prices is a type of market manipulation commonly used by underwriters to support market prices and thus to speed up their distribution of securities to the public. Under the Securities Exchange Act of 1934, the Commission is charged with the duty of regulating this type of market operation. Earlier congressional investigations, as well as the experience of the Commission itself, since 1934, have shown the grave abuses which may be made of this type of market operation. The Commission, in order to achieve the objectives, first, of regulating stabilizing—at least to the extent of scrutiny—and, second, of getting definite information on all of the angles of the problem, adopted a rule which requires underwriters who want to stabilize in order to facilitate security distribution to file current reports of just what they do in their operations.

At this point I should like to explain that the Commission administers several statutes, and that the rules which it has promulgated under those statutes are prefixed by a letter indicative of the statute under which they are put out. Thus, rules under the Holding Company Act are prefixed by the letter "u", for "public utilities"; rules under the Trust Indenture Act carry the letter "t"; and rules under the Exchange Act carry the letter "x", for "exchange". The numerals in the rules show the section under the statute pursuant to which it was adopted; and the last digit in the name of the rule shows whether it is the first or the second or the third rule under that section of the act, and so on; so that the rule, right on its face, tells anybody who is interested just exactly what it deals with and under what provisions of the legislation it was promulgated.

Eberstadt & Co. was the manager of the stabilizing syndicate on a public offering of some $900,000 of Hydraulic Press Manufacturing Co. stock, made last December. Eberstadt & Co. violated the reporting rule, by its failure to file any reports showing the transactions of the underwriting and stabilizing syndicate, as such, on the day of the offering.

On March 23, 1940, this firm wrote us a letter about its reports, which indicated that it was thoroughly confused as to how to report its operations. Accordingly, I wrote the letter to which Mr. Eberstadt has referred during his testimony.

First, I should like to point out that my letter was addressed to the attention of Mr. Edward B. Conway, a lawyer whom I know personally, who was formerly on the staff of the General Counsel of this Commission. I knew that he was familiar both with the details of Federal securities regulation and with the mechanics of security stabilizing and distribution. Consequently, I wrote to Mr. Conway as a technician, knowing that he was a technician, and I used technical language, in an effort to help this firm by a careful and comprehensive explanation of just how the reports should have been made out. My letter was not, nor was it intended to be, a layman's letter. Subsequent events indicate that Mr. Conway must have fully understood the suggestions which were offered in my letter.

My letter of the 27th went into extensive detail, for several reasons. First, I wanted to do a thorough job in clearing up the firm's wholesale misunderstandings. Secondly, Eberstadt & Co. was the syndicate manager to whom the other underwriters usually turn for advice and suggestions in matters of this kind. I hoped to be able to prevent its making similar errors on the future reports that I knew it would have to file covering similar future operations of which it would be the syndicate manager. Thirdly, the reports first filed by this firm were so incomplete and so erroneous that if Eberstadt & Co. was to get any useful advice as to how to comply with the requirements, I had to discuss varying combinations of assumed but, nevertheless, possible circumstances which may have affected the way in which it would have compiled these items of information.

I must, of course, confess that my letter, as it was read aloud, sounded—as it was—both technical and complicated. I have explained why it was written in technical terms. On the other hand, its complexity resulted from the fact that modern syndicated security distributions, and their accompanying stabilizing operations, are themselves highly complicated processes. It is hard to write a simple letter about a complicated matter.

Faced with incomplete and, indeed, even misleading reports of the market operations, such as these, there were three courses open to the Commission. We could have written a short and simple letter calling for the prompt filing of correct reports. This would have been easy for everybody concerned except Eberstadt & Co., which would have had to go to its lawyers; or, second, we could have instituted court proceedings based upon the firm's inadequate and inaccurate reports.

However, we had a third alternative. In an effort to help this firm, I sat down and wrote Eberstadt & Co. as careful and as thorough an explanation as I could of just what the rules required and of just how its corrected reports should be made out. Of course, such a letter requires meticulously careful drafting, since the legal rights and legal liabilities not only of this but of other security houses are dependent upon its accuracy.

This kind of explanation, given in conference as well as by letter, has proved a real help both to the underwriting industry and to the Commission, in the past. By now, the filing of stabilizing reports has become pretty much a matter of mere routine on the part of the three-hundred-odd firms who regularly underwrite security issues. The fact that my letter of the 27th actually did help Eberstadt & Co. is shown by the entirely correct report which it filed shortly thereafter.

I might also add that another result of my letter of the 27th—and one which I hoped it would achieve—is that the stabilizing reports which Eberstadt & Co. filed on its next operation came in on time and correct in all details.

Finally, may I point to the last paragraph of my letter of the 27th to Eberstadt & Co., which was not read, and which reads as follows:

> If you encounter difficulty in applying the provisions of the rule to the transactions in question, may I suggest that you confer with the regional office of the Commission at 120 Broadway—

that is just around the corner from Eberstadt & Co.'s office—

> New York City, which will be glad to render any assistance in this respect which you may require.

Thank you.

Senator HUGHES (presiding). Thank you, Mr. Greene.

The committee will recess until 2:30.

(Thereupon, at 12:45 p. m., a recess was taken until 2:30 p. m. of the same day.)

AFTER RECESS

The subcommittee resumed at 2:30 p. m. on the expiration of the recess.

Senator HUGHES (presiding). The subcommittee will resume. We will count Senator Herring present without his being here, and Senator Wagner will be delayed a little while. I hope to have him with us later.

You may proceed, Mr. Schenker.

ADDITIONAL STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. Senator Hughes, before we start discussing the specific provisions of the bill you have under consideration, I will try to answer some of the difficulties the investment trust industry have had with the bill.

I would like to make the record clear on one point: Yesterday when I discussed the experience of a stockholder in the Lehman Corporation, I said that $8.80 per share for each share outstanding at the present time was attributable to the fact that the corporation bought back about 33⅓ percent of its outstanding shares at a discount—that is, at a price below the asset value. That discount aggregated about $6,000,000. If you divide it among the number of shares outstanding you get $8.80.

I think in fairness I ought to make the additional observation, that by virtue of the fact that they used the money they did use to retire their own stock, the fund which they could invest was decreased by that amount. In other words, the money they used to buy back their own stock and retire it, of course was no longer available to them with which to make investments.

When we studied the Lehman Corporation I think the Commission made some calculation with the representatives of that corporation. I think it was established then that had they used the money which they did use to repurchase their own stock, and made the same type of investment they had been making, they would have made an amount equal to $8.80 per share.

Senator HUGHES. Were those their own shares that they did buy back?

Mr. SCHENKER. Yes, sir; those were their own shares.

Senator HUGHES. Were those shares offered for redemption voluntarily?

Mr. SCHENKER. No.

Senator HUGHES. Or did the company seek to buy back its own stock?

Mr. SCHENKER. The Lehman Corporation is a closed-end company, you will remember.

Senator HUGHES. Oh, yes. I now recall that it is.

Mr. SCHENKER. Their stockholder has no right of redemption. What the Lehman Corporation did was to go into the open market. It bought its shares on the New York Curb or the New York Stock Exchange. I do not think you were present at the time I was discussing that subject.

Senator HUGHES. No; I am sorry I was not.

Mr. SCHENKER. In my statement I showed at what price they were buying back their stock. This was money they used to buy their own stock back in the open market from their own stockholders, most of which repurchases took place in 1931, 1932, and 1933. It was approximately 3 years after Lehman Corporation organized in September of 1929.

Senator HUGHES. Then the stockholder had no option about it. They were not buying it directly from the stockholder but in the market. However, they were using the money of the corporation to do it. It was done as a policy, I take it?

Mr. SCHENKER. Yes, sir. The stockholder had no right to compel the corporation to buy the stock back. The corporation did it voluntarily, and of course the stockholder sold his shares voluntarily.

Senator HUGHES. I understand.

Mr. SCHENKER. There is only one other point I wanted to make: Senator Taft asked about the discount at which closed-end companies' securities are selling at the present time. We indicated that, for instance, the Lehman Corporation's stock today sells at about a 25 to 30 percent discount. That means that if a share of stock has an asset value, we will say, of $1, it is selling in the market at only 70 cents.

Senator Taft made inquiry as to what we attributed this discount, and as to whether it was not due to the tax feature.

It is pretty difficult to determine or to attribute it to any particular cause, but I do think your record should indicate that before there was any tax discrimination between closed-end and open-end investment companies, which took place in 1936, stocks of closed-end investment companies were selling at a discount. They were selling at a discount in 1932, 1933, and so on.

So I do not think you can attribute the entire discount to the tax exemption granted to open-end investment companies. I think there is some element of the public's appraisal of the management of closed-end companies in the discount.

Now, Senator, may we go to the bill?

Senator HUGHES (presiding). I ought to return to the Senate Chamber to vote on a bill that is coming up in a few minutes. The clerk of the committee has notified me of a vote. Suppose we suspend for a few minutes while I go to the floor and vote.

Mr. SCHENKER. All right.

Senator HUGHES. Perhaps Senator Herring may come along in the meantime——

Mr. SCHENKER (interposing). We will wait for you.

Senator HUGHES (continuing). And you may proceed as though I was sitting near by.

Mr. SCHENKER. We prefer to have you here.

Senator HUGHES (presiding). I will be back in a few minutes.

(Thereupon at 2:55 p. m. the subcommittee took a short recess.)

Senator HUGHES (presiding). All right, gentlemen.

Mr. SCHENKER. Senator, the first section that was discussed in detail by the industry, as I recall it, is section 5. There was not much discussion or any discussion on sections 3 and 4, and there was evidently no comment on those sections.

On section 5, what were some of the difficulties? There was some discussion about (b) on page 10, with respect to our definition of a diversified investment company; and in connection with that definition some of the witnesses, particularly Mr. McGrath, had some observations on (b) (1) (B), about the 85-percent provision. He felt that possibly the reservoir in which they can invest not more than 15 percent of the assets of the company in underwritings and so forth should be increased to 25 percent.

Now, Senator, this diversified investment company was what we visualized as the simple company which does not put a substantial part of its money into risk capital or venture capital but is going to give the public diversification in seasoned securities. Really the only reasons why we made the provision for the 15 percent—and there was some feeling that it should not be even 15 percent but should be the type of company that has just diversified securities—were two: In the first place, we wanted to make some provision for a reservoir, so that if that type of company wanted to make available venture capital or risk capital, it could so do. However, we also had in mind that if we were going to make the reservoir 25 percent, a substantial part of that person's money is being subjected to that type of risk. That is one reason why we were persuaded not to go as high as 25 percent.

The other reason is a factual one or historical one. The fact of the matter is, Senator, that if you study these companies you will find really two broad classes with respect to the type of investments they make. There are companies that have 100 percent of their money in diversified securities and companies which have about 90 percent in undiversified securities and which use 10 percent for venture capital. And then there is the other type of company which has big blocks of stock and where they have a controlling influence in the portfolio corporation. This 85-percent provision has two bases: One, we felt that a company that can subject a person's capital, to the extent of 25 percent of his investment, to venture capital risks should not have the name of diversified investment company for then it is quite substantially a finance company. The other thing is that most companies which we concede to be investment companies can fall into that category. It is the natural division.

On the 150 percent portfolio turn over, as we stated to you when we presented our affirmative case, we were not unmindful of the problems with which the industry dealt at great length. We indicated that we were conscious of these emergency situations. My recollection is, from all the testimony, that there is not any violent dispute as to the principle that a person ought to know whether he is going into an investment company or going into a pool or a trading company. We do not say he cannot go into a trading company or a speculative company, but that type of company should not bear the label of an investment company. It ought to have a different name. On that problem of the 150 percent, we thought that possibly the industry would have some idea regarding how to meet the problem. We got the criticism, all right; but I do not recall the affirmative help on that subject, Senator.

I think we can work that out with the industry. Possibly in order to meet these emergency situations, you ought to make the period a little longer: That is, if it exceeds the 150 percent ratio, over 2 years instead of a year; or perhaps we ought to put in a little rubber and a little elasticity to meet the emergency situation.

I do not think there is any dispute that there ought to be a distinction between an investment company and a speculative trading company. That is just a matter of language. As far as we are concerned, add just some additional clause which will say that if you happen to overstep the 150 percent, you are not violating the law, under certain circumstances.

With regard to the 15-percent reservoir, there was some analysis to the effect that if an investment of 15 percent was and the market value of the investment went up, the company would not be able to make another investment in the reservoir. Well, under our definition of value, if the securities do not have a ready market, then it is valued on the basis of cost; and if you are going to use venture capital and go into small situations, they are very unliquid—and therefore, in our opinion, under the definition of value—you could use cost. On the other hand, if there is any doubt about that, we have no difficulty in saying that it should be on the basis of cost rather than on the basis of market value. I do not think it is a matter of great significance.

There is another point on that, Senator, on which we shall elaborate a little bit when we discuss in more detail the nature of open-end companies and what their problems are and why we approached the open-end situation as we did. You must appreciate, Senator, that an open-end company is subject to demand liabilities—if tomorrow morning all stockholders demanded their money they could get back the value of their investment; the company could hold them off a day or two, depending upon the provisions in the indenture. Necessarily to meet that situation open-end companies must hold liquid securities; there cannot be any great amount of illiquid securities.

In my opinion, whether it is 15 percent or 25 percent, that is entirely academic as far as the open-end companies are concerned; they just cannot use a substantial portion of their funds as venture capital. I shall discuss that later on. They cannot go into underwritings; they do not go into underwritings; and that type of company just does not lend itself to that activity.

We feel strongly that a 15 percent reservoir, if a company wants to call itself an investment company, is sufficient.

With respect to the category of securities trading companies, there was quite an elaborate discussion of that subject, as I recall, by Mr. McGrath and Mr. Quinn. As I remember it, the basis of their objection was substantially that the S. E. C., by virtue of this provision, is fostering a deception or is encouraging a misleading situation because the only distinction between the diversified investment company and the securities trading company, in the instance they cited, is that the securities trading company may have only senior securities yet the companies would have different designations; that is, they may have the same portfolio and may have limitations of 5 percent in one company and not more than 5 percent of the outstanding of any company, just because that company has preferred stocks and debentures it is a securities trading company. Our recommendation is that they must call themselves a securities trading company; whereas if the company did not have senior securities and debentures, it could call itself a diversified investment company. There was a great deal of elaboration on it and indications of how the name was misleading.

Of course, I assumed that when they got through, they would say, "The name securities trading company is misleading, therefore change the name."

However, they did not say that. They say, "Therefore, let down the bars completely, and no matter what the company's portfolio is and no matter what its investments are, the company should be called a diversified investment company."

They could not understand why a company with senior securities, although it has the same portfolio and the same activities as a diversified investment company, should be called a trading company and not be called a diversified investment company.

There are two reasons that persuaded us to do that: In the first place, we visualize the diversified investment company as the sort of basic company in the industry—a simple company without any elaborate structure, one class of stock, diversification, no rapid trading. That is the basic company.

Now, therefore, some distinction had to be made between that type of company and the type of company that does not have a simple capital structure. That is the first reason.

Reason No. 2 is—and I may be wrong about that, but this is my concept—that if they have senior securities, the company is a margin account. If it is trading in securities on margin, just as if it were running a margin account in a brokerage firm under our concept that company is a trading company. If it had one class of stock, you could say it was an investment company.

As soon as senior securities are in the capital structure; as soon as the company buys securities on borrowed money, then in my opinion the company is no longer an investment company. You no longer have a mutual company. Under our concept that type of company is then a trading company.

Now, Senator, perhaps the name can be changed. The principle is clear. The type of company, which we feel is the basic company, is the company that has one class of securities; all security holders are on a parity, everybody takes the same risk, there are no conflicts of interest between the debenture holders, the preferred stockholders, the common stockholders. It is a mutual enterprise. That is the basic company.

Any company that deviates from that basis should bear a different label. That is the philosophy of that section.

The securities finance company is the type of company that is not subject to the restrictions of 5 percent and 5 percent. I heard a lot of talk here about venture capital and limitations on venture capital and limitations on underwriting. Senator, they could raise $100,000,000, under this bill, and put every nickel of it in underwritings, or they could loan $100,000,000 to any industry, big, small, or anybody else; all the company has to do is to tell the stockholders that that is its business, and call itself a securities finance company.

What they want to do is to bear the label of an investment company, which would indicate that they are an investment company, and not be subject to the limitations which the popular mind conceives that an investment company should be subject to—small blocks and diversification.

What they want to do is to be able to go into these risks, and venture situations, and yet bear the same label as a company which is going to go into diversified situations. There is nothing in this bill that in the slightest prohibits an investment company from going into underwritings or venture capital. The only thing this bill says is that, "You have got to tell your stockholders that that is your business, and you cannot bear the label of investment company."

I do not recall any difficulty with subsection (c).

Senator HUGHES. May I ask you how many securities trading companies and how many finance companies there are? Are there a great number of them?

Mr. SCHENKER. Yes, I think I can help you on that, Senator. The fact of the matter is that when you consider the number of companies which are in this finance activities, with which Mr. Glore of the Chicago Corporation is concerned, in my opinion you can count them on one hand and still have a couple of fingers left, do you see?

That is, even before the 1933 act and before the 1934 act, the number of companies that did financing was negligible; and the few companies that did that did not have a very happy experience. We shall develop that a little later.

The answer to your question, Senator, is that there are very, very, very few companies that do that with a substantial portion of their assets. Lehman Corporation does a little of it; Chicago Corporation does a little of it; the Atlas Corporation does a little of it; perhaps the Phoenix Securities Corporation does a little of it. However, aside from those situations, there are no companies that engage in that type of activity to any appreciable extent. The rest of the companies buy seasoned securities on the New York Stock Exchange; and that goes for fixed trusts, that goes for open-end companies, and that goes for closed-end companies, Senator.

Does that answer your question?

Senator HUGHES. Yes; that is all right, thank you.

Mr. SCHENKER. Thank you.

The next subsection upon which there was a good deal of discussion is (d) on page 11, Senator. On that section, Senator, in my opinion—and perhaps understandably—the industry read into that subsection a very great deal that was not intended to be put in there or, in my opinion, a great deal more than the language used in that section actually embraces. An effort was made to infer that this section was going to give the Commission the right to tell these people how to run their business, what securities to buy, and what not to buy, and so forth.

There are certain situations, Senator, that I think may have to be dealt with; and judging by a few of Senator Wagner's questions, I think he had the same difficulty.

May I give you one example, Senator: You can have a company which buys small blocks of steel, small blocks of railroads, small blocks of oil companies, utilities, and so forth; that is a diversified company, in that it diversifies into various industries, and even within the particular industries it can buy into different companies.

Now, you have some companies like Mr. Eberstadt's company that invests all its money in chemical companies and allied industries. He diversifies among chemical companies, but he does not diversify among the industries of this country. Some time it may prove misleading if the name "diversified investment company" is used. They may get the feeling that it is a diversified company in the broader sense—that he invests in every industry, rather than among companies in a single industry.

This subsection just provides that the Commission shall have the right to make further classifications, according to certain standards; and the important thing is that they must be consistent with the definitions contained in this section and in section 4. We just cannot create new classes that conflict with the classes that Congress created; and that is all that subsection is intended to mean.