DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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MR. HELLER. When I went to law school, they taught me that in order to understand legislation you had to know what was then called the "fact basis" for the legislation, or the underlying evils to be remedied. I propose to tell you how the Act came about, what the evils were, and what the Act does about them. Mr. Greene will tell you about recent developments.

I think the investment company movement got under way in the United States in the 1920's. In 1924 a very prominent investment banking house announced that it was forming an investment company to invest and deal in securities along "the English pattern." The English pattern had been to form investment companies which were closed-end. This is a word of art used in the Act and simply means that the stockholder cannot go to the company and demand his particular share of the assets in cash at any time. In order to realize on his stock, he has to sell it in the open market for whatever it will bring. This is more or less like the typical corporation --U. S. Steel, or any other corporation. The British, when they created investment companies with bonds and preferred stock and common stock, backed the bonds and the preferred stock of the company with a portfolio of bonds and preferred stock. The investments were backed in terms of the type of security the public wanted. If one wanted a bond, they sold him a bond but backed that bond with an equivalent amount of bonds in the portfolio of the company. The same with the preferred, and so on with the common.

The American method was somewhat different. With the rising economy of the 1920's and the opportunity for investment bankers which a large aggregation of money would bring to them, there were certain advantages to be had for investment bankers. So, with the help of their corporation lawyers, who were then making corporation laws more flexible throughout the Union, a company such as General Investment Corporation was formed--to take a typical case history. This company was formed by a prominent banking house. It had $1,000,000 of preferred stock. All of the common stock was taken by the banking house. The common stock had the sole voting rights. The bankers put in $100,000 for the common stock and the public bought $1,000,000 of preferred stock. The preferred stock had no vote; there was no due date; it cannot be called; you cannot get your money back. That created, in effect, a margin account in favor of the common stock. It had the opportunity to use $1,000,000 of public money without any effective check whatsoever. This fact brings into play what the statisticians and financial analysts call "leverage." There is $1,000,000 put in by preferred stock, which has a claim of no more than $1,000,000, and then only if the company liquidates; but the company cannot liquidate unless the common stock votes to liquidate it. It has the sole vote. The common stock has put $100,000 into the picture. Let's examine what that means. If the assets go up 10%, which is roughly $110,000, you will note that the assets attributable to the common stock have gone up 100%. The assets attributable to the common stock are now $210,000, whereas the preferred stock of $1,000,000 remains where it was. You can see the opportunities in that type of structure for those who own the common stock to buy volatile securities--securities with speculative promise of sharp rises in value for their benefit. On the other hand, if the assets went down, the common stock was theoretically wiped out, but the preferred stock could do nothing about it, since the common stock controlled the vote. The common stock still remained an asset because the opportunity to control a large sum of money is a valuable one and the common stock was always salable on that basis. Secondly, the common stock could be used to formulate a plan of recapitalization which would sheer away a little more of the assets of the preferred stock and give it to the common stock. So the common stock never really lost in value even though it had gone down, and the opportunities for profit because of the phenomenon know as leverage were tremendous.

Next the investment company offered the investment banker an opportunity to get control of other companies so that he could get their banking business. He could get the brokerage business of the investment company, and he could do a large number of other things. For example, one company which was formed in the late 1920's was called a trading corporation, which would suggest that it would buy and sell securities. It immediately got control of five banks, a barge line on the Mississippi River, and real estate in New York, and a passenger bus company, from all of which the bankers who formed the new company got banking business.

That is what happened, and you can see readily what the evils were and what had to be remedied. In the 1920's mostly all of the companies formed were closed-end companies. They were of the leverage type. They were formed by bankers and brokers. There was a sharp and distinct bias in their management in the direction of the people who had formed them. All of the pecuniary emoluments in the venture went to the bankers and brokers--not to the public holders who usually held preferred and very small quantities of common, or perhaps bonds. That is the background of the closed-end companies.

Also in the 1920's there began to be formed open-end companies, largely in New England and Boston. The open-end company usually has one class of stock. The stockholder has the right given to him by the charter of the company at any time to turn his stock back into the company and receive his proportionate shares of the value of the assets of the company--not what he paid for it, but whatever it is worth at that time by the simple method of taking the market value of the assets and dividing it by the number of shares and getting a per share value payable either in cash or securities. These were formed by persons primarily concerned with investment. There were far less of those evils described in the case of the closed-end companies. But professional dealers had to be used in order to sell the securities and get the money to manage. Dealers saw certain advantages in these open-end companies which I will describe. The securities of open-end companies are constantly being sold. They are sold at a price which is the asset value. Let's say there is $1,000,000 in assets at market and there are 1,000,000 shares outstanding. Each share is worth $1. To that $1 there is added a commission, usually 9%. So the offering price to the public is $1.09. In order to have a price which is firm that they can sell on, the practice was to use the closing price the day before the sale. So if the day before the asset value was $1, the offering price of $1.09 prevailed all day the next day even though there was a sharp rise in the value of the assets. In other words, if the assets went up 20% that day so that the asset value was $1.20, it was still being sold for $1.09. This presented attractive possibilities to the dealers. Whenever they felt the market was going up, they would execute orders for their own account in the morning at $1.09 and then would redeem the shares at $1.20 in the afternoon and make themselves some profit. So that was one evil that had to be remedied. The primary evils in the case of these open-end companies are these selling evils: (a) the types of literature used; and (b) the opportunities for profit by dealers.

These two types of companies I have described are called management companies because the managers can select the securities to be invested in at their discretion subject to deferred limit in the case of particular companies.

In the 1930's when the public became disillusioned with management, there was a movement to start what was called unit investment trusts. in which a firm package of named securities was put into trust and pieces of that sold to the public. The particular securities could not be changed. The theory of this was that a good bunch of securities could defy management and do as well as any management, a proposition which I would not be willing to dispute. They raised little or no problem other than to be sure that there is a competent trustee who would take care of the interests of these people and to be sure that the sponsor or selling people don't get too much of the income or assets of the trust in various ways, such as by loads and fees, etc. The Act prevents these possibilities of harm.

Finally there is a group of companies, the leading one of which has been in existence since the 90s, which sell what is known as a face-amount certificate. This is a contract whereby if you agree to pay specified sums of money over a period of years, at the end of that period the company will pay you a larger sum of money. In other words, the certificate is a fixed contractual obligation to pay a specified sum at a certain time, larger than the amount you pay in at a conservative rate of interest in order to reach that amount at the due date so that they can pay it for you. The real problem in this type of investment was that if there was a default or lapse by the investors at the early stages, they lost every cent and got nothing out of it. The loads were high. Some of the promises were extravagant in the sense that by conservative investment you could not possibly invest the funds contributed by the investors at any kind of a safe yield that would result in reaching the amount of money contracted to pay.

I have reviewed the basic ends inherent in each type of company. How does the Act deal with them. First consider the management, bankers, brokers, etc. The Act says that none of these persons -- bankers, brokers, investment advisers, or others -- can constitute the majority of any board of directors of any investment company. They can be on the board, but no one type can be a majority of it. The theory is that they will be so busy watching each other that they won't have time to engage in dishonest or other schemes. One of the purposes of the statute is to get at least an unbiased management. It cannot guarantee the smartness of any of them or deal with their investing ability, but it does try to get them honest. It has provisions which will make it difficult for them to be dishonest, or if they are dishonest, to punish them. It can also seek to remove investment biases in the direction of the management. Those things the Act can do and does. At least 40 percent of the membership of the board must be independent of the officers so that some one can watch the officers of the company, and also independent of the investment adviser. It is a system whereby the guards are guarded by the guards. As far as we can see now it seems to have worked very well. The Act prohibits self dealing between insiders and their companies.

Secondly, the Act deals with the problem of leverage by requiring, in the case of closed-end companies, that if you propose to sell preferred and common stock in a closed-end investment company, 50% of the money at least must be contributed by the common stock. If you are going to sell bonds and common stock, two thirds of the money paid to the company must be contributed by the common stock. If you are going to sell bonds, preferred and common stock, then half of the money must be common stock money and roughly 1/6 preferred stock money and the rest debt money.

The Act also does what the state laws didn't do, it gives the preferred stock a vote -- a right to elect a majority of the directors if there is a default in the payment of two years of dividends. Peculiarly it even gives bondholders a right to vote if the bonds are under water for a period of 12 months. In other words, if the company has been insolvent for 12 months, the bondholders get the right to vote. That would seem to have very little meaning since the Bankruptcy Act will catch them long before that, if I know enterprising lawyers. That generally is how the Statute deals with the problem of leverage. It permits them to borrow money only if the value of the assets covers the debt three times. So it deals with capital structures in that manner.

It deals with the opportunities of management to engage in unfair plans of recapitalization, mergers and consolidations by providing that the Commission has the right to prevent unfair plans by applying to a court of competent jurisdiction to stop them if, in the Commission's judgment, they are grossly unfair. It prohibits the sales of securities or other property by insiders to the company, or sales by the company to insiders without the approval of the Commission. So there is a check on their use of the companies for their own interest. The Act requires the companies to set forth their policies, whether they are diversified or non-diversified, and prevents them from changing without a vote of the security-holders themselves. It also requires reports, both to the Commission in complete detail as to the company's operations, its portfolio, the emoluments of its management, salaries, share ownership, and semi-annual reports to shareholders along the same lines so that they have the information available to them and they can check the corporation and its management to see if policies are being carried out.

In addition in respect to open-end companies, it empowers the National Association of Securities Dealers to make rules dealing with this problem of the dealers trading against the company and deriving profits on rises in the price of the security. These rules generally require the open-end company to price the security twice a day, at 3:30 p.m. for sales up to 1:00 the next day, and at 1:00 for sales the rest of the day. The theory of that is that you then get prices close to the actual value of the security and prevent this dilution which occurred with the opportunity for profit which dealers had in the old days. Also, the rules directly prohibit dealers from buying securities of an open-end company except (1) for resale to their customers against an order actually previously received or (2) for their own account for investment. A redemption the same day the shares are bought is not "i[illegible]ent" as far as the Act is concerned.

In the case of the face amount certificate companies, the loads have been sharply defined and limited to 7% overall. If the payments have been made for six months, the certificate holder cannot be cancelled out if he fails to pay, but is required to be given a paid-up certificate at that time equal to the present worth of what he would get at a later date, depending upon how that investment is invested and at what yield. The Act also prescribes an improvement rate so that they have to calculate their improvement on a 3% basis, which results in fairly conservative investments.

Finally the Act limits their investments to investments which are legal under the insurance laws of the District of Columbia for insurance companies. So these face-amount companies are given an extremely conservative investment policy by the Statute -- at least the drafters thought they were until recently the insurance laws of the District of Columbia have been amended to permit the insurance companies to invest in common stock. A number of the face-amount certificate companies have taken advantage of that. This introduces a factor not contemplated by the Statute, namely, the right of management to invest in common stock the funds put in primarily by people who hold debt securities. Generally in these companies the amount put in by the common stock of the company is very small -- $250,000. So there you have again a leverage factor of extremely dangerous proportions. I think the Commission is advocating legislation to correct that.

The present problems are largely in the open-end securities and largely in the selling method of open-end securities. The closed-end company has not been a serious factor in the business. There are very few left. They have a minority of the assets of the industry, the great majority of the assets being in the open-end companies. That is disturbing because the open-end company appeals to standardization. It buys generally the blue-chip securities, it buys them in the open market, it contributes very little to industry.

MR. GREENE. My plan is to discuss some of our current problems, but before I do, George has asked me not to forget to mention the Investment Advisers Act of 1940.

In the course of the investment trust study we found that there was such a thing as investment advisers and investment counsel. Apparently there is a difference. We did not make as thorough a study of investment advisers as we did of investment companies. But we managed to get a statute through in 1940 which does provide some regulation for investment advisers. One of the reasons was that we had the backing of the Investment Counsel Association. They were interested in this legislation because there is a provision in here that says you cannot call yourself an investment counsel unless you conform with certain requirements which only they have.

All that the Investment Advisers Act provides is for a registration form to be filed by any investment adviser who offers advice to more than 15 people. There is a provision which says that an investment adviser cannot commit fraud, but if he does, his registration cannot be revoked.

MR. BLACKSTONE. We have to first get an injunction or con[illegible]im of a crime before it can be revoked.

MR. GREENE. There is a provision, however, which is perhaps more stringent than anything we have under the Investment Company Act. That is, an investment advisory contract cannot provide that the investment adviser can get a share in the profits of his client's investment -- the idea being that there might be a tendency to over-speculation, excessive activity in a client's account if the investment adviser got a share of the profit only. There is nothing in the Investment Company Act like that, although we might like to see something like that.

In addition, there can be no assignment of the investment advisory contract without the consent of the client, something which did exist in the investment company industry.

Getting to the Investment Company Act: The first problem that should be considered is the recognition of an investment company --

just what it is when you come across it in connection with your day to day work. Frequently the recognition of it is not so obvious. Companies today frequently sell their operating assets and are left with cash, and they decide temporarily to put their money into securities. Those companies are actually investment companies. The minute they have more than 40% of their assets in investment securities, they come within the definition of an investment company contained in Section 3(a)(3). That is the so-called quantitative definition of an investment company. There is also a qualitative definition of an investment company contained in Section 3(a)(1), which we have rarely had occasion to use except for those companies that want to engage in the business of investing, reinvesting and trading in securities.

Frequently these companies which have sold their assets want to continue for a temporary period to take advantage of some tax situation. There may be some tax advantage in continuing the business, and they don't want to liquidate and distribute their assets to the stockholders, so they invest their funds temporarily. Now there is no exemption for a temporary investment company. By and large we have insisted that such companies register under the Act. I say by and large because one company recently filed an application under Section 3(b)(2) which gives the company an automatic 60 day exemption. During that period it attempted to work out its problem so that it would not come within the definition of an investment company under Section 3(a)(3). They came in and promised that they would be in another business within 30 days. It turned out that they bought some controlling blocks of stock (which they thought would be controlling), but somebody else had a majority interest in the company, much to their dismay, and they were still an investment company and had to register as such; we should have moved before the Commission to dismiss the application under Section 3(b)(2).

In addition, there are companies which intend in the future to be holding companies. Frequently under Regulation A, or in connection with a private offering exemption, or rather an intra-state exemption, or a full registration, you will find a company that claims it's going to be a holding company for insurance companies or a holding company for oil companies, except that they don't have any particular company in mind, they are just going to raise the funds from the public and intend in the future some time to be a holding company. Since there is no assurance that they will be a holding company, but there is every assurance that they will be an investment company, we have taken the position that they are in fact an investment company until they can show that they will definitely be a holding company.

Another type of company of which one should be wary is the company that is actually a face-amount company but doesn't look like one. A mortgage company, for example, may offer debentures to the public. We had one case where they offered two-year debentures to the public. You will notice that the statute provides that a face-amount certificate is one in which there is an obligation to pay at a stated time more than 24 months after the date of its issuance. So they felt that they were not coming within the Statute when they had a two-year debenture. The only difficulty was that the debenture provided for extensions every two years for a ten-year period, and there was an overall contract involved. In other words, there was paymentof a sales load which entitled the investor to insist upon renewal for the two-year periods. We took the position that that was just an evasion of the Statute and that, in effect, it was a face-amount certificate providing for periodic payments for more than two years.

There are exceptions to the definition of investment companies in the Act. They are listed in Section 3(c).

The most important one with which you should be familiar is the one in Section 3(c)(1), which is the private investment company exemption. There are two conditions to this: first of all, the company must not have more than 100 stockholders, and if any corporation owns more than 10% of the stock of a company, then its stockholders must be considered in counting the membership. In addition, such company must not be making a public offering. We have had recently a vast surge of private investment companies known as investment clubs. There must be 10,000 of them throughout the country. We have taken the position that they are entitled to the Section 3(c)(1) exemption so long as they are not making a public offering and don't have more than 100 members. We have taken the position that the membership is, in fact, an investment contract with security and that the investment club is, in effect, nothing more than an investment company. Most of these clubs have 10 or 15 members. When they get above 25, into the realm of 30, 35 or 40 members or where separate clubs are set up -- ostensibly separate, but all having a common link -- we have taken the position that a public offering is involved and the clubs have to register under the Act or disband. So far we haven't had any investment clubs register under the Act.

I should like to mention some problems involving the new investment company. There was a period during the 1920's when companies were being organized at the rate of one per day, and many of them were organized by people without banking traditions or traditions of investing other people's money, but people who just wanted to gamble with other people's money -- irresponsible persons. The Statute provides that before an investment company can make a public offering it must have a net worth of $100,000. That sum of money, even today, is still a sizable sum and we haven't sought to amend it upwards in the light of the dollar deflation. It still provides an obstacle to irresponsible formation of investment companies. The position of the Commission with respect to the $100,000 net worth is that it has to be a bona fide investment. They cannot obtain a temporary loan from some friends just to have the $100,000 in the till, or an accomodation from some other source.

Another problem in connection with the raising of the $100,000 is that it ought not to be obtained through an evasion of the purpose of Section 14. I should say that there is a method for raising the $100,000 in connection with a public offering. In other words, the company can raise the $100,000 from the promoters or a private group of people, but it can also raise it through a method that the Statute in Section 14(a)(3) provides whereby a registration statement becomes effective, but as a condition of the registration statement under the 1933 Act, as a condition of the effectiveness of the registration statement, there is an assurance that the $100,000 will be raised from not more than 25 responsible persons before any monies will be received from the rest of the public. Before any subscriptions will be accepted from any members of the public at large, there will be in the till of the investment company $100,000 received from not more than 25 persons. We have had two instances where there have been attempts at evasion of that provision. I can really say three, because one was involved in a recent stop-order case. One method is this: There is a provision in Section 6(d) for a small closed-end intra-state investment company of less than $100,000. Such a company may apply to the Commission for an exemption from the Statute. And the Commission has granted an exemption to such companies where there is a local operation involved from most of the provisions of the Act. One of the provisions of the Act being Section 14. We had one case where a company came in with such an application in order to operate as a small closed-end intra-state investment company, and they wanted the exemption from Section 14. In connection with the application we insisted that they state that they had no present intention of making a public offering after they raise the $100,000 in the small intra-state way from perhaps hundreds of people, and in that way raise $100,000, or close to it. Then, of course, they could later come in and comply with Section 14 in connection with full registration. After thinking it over, they did not file that statement and chose to withdraw. They have now decided to become a full-fledged investment company and raise the $100,000 from the 25 people.

Another instance of evasion is the formation of several investment companies. This was a case in New Jersey. The names of the various companies were Fortune, Fortune 1, Fortune 2, Fortune 3 and 4. In fact the evasion was so obvious that they had organized two of these companies at the very same time. They made an offering to very few people in each company, but all of the companies were supervised and managed by the same person. He promoted them organized the, and then operated them for a time. He claimed that he had received some legal advice to the effect that it was perfectly all right under the Statute to do it that way. He had some misgivings, however, so he came in and asked us for our advice about it. Now he is registering with a new prospectus and filing under the Investment Company Act and the Securities Act fully.

The other case gets back to the question of the bona fide investment of $100,000. This was the recent Automation Shares case where the company stated in its prospectus that it had received $100,000 from various persons. After the statement had become effective under the 1933 Act, it turned out that two investors who had put up $60,000 actually had no intention of keeping their investments with the company. They had planned to redeem it as soon as the company had obtained monies from the public to the extent of $125,000, and, in fact, were going to be paid interest for the time that they kept their funds with the company. This was to be paid by the management company. They were also going to be guaranteed against loss if there were any loss involved. The management company would pay such losses. We have taken the position that those are the type of things that should be disclosed to the other stockholders.

One of the major problems is that of investment policy. We take the position that, with respect to those matter, the Statute requires a recital of policy by the company, the policy should be stated as definitively as possible. Actually we run into a lot of difficulty with new companies who want to state their policies in as broad terms as possible. This is particularly true in connection with such items as the borrowing of money, the concentration of investments in any industry or group of industries, and in connection with the issuance of senior securities. Strangely enough, the Statute does not require that the company set forth its investment objectives. It has to recite its policy; but in the original bill the Commission wanted the company to state its investment objectives and the types of securities in which it was going to invest. This was vehemently opposed by the industry. They said it would hamper management. The Statute was enacted with the unanimous cooperation of the industry and the Commission and Congress, and went through without a dissenting vote. One of the reasons for this was that it was a compromise Statute. This item was left out. We now are seeking to have it amended to provide that, to some extent, the investment policy of the company be set forth, and that the company adhere to that unless it gets a vote of stockholders. Actually I think that the compromise was that the company could set forth any policy which it deemed to be fundamental at its own election. Many of them have the policy of seeking capital appreciation, or seeking income, or going into special situations, but they decide not to make them fundamental because otherwise they have to get the vote of stockholders if they changed it. If that occurs, we insist on full disclosure.

This question of investment policy also has interrelations with the question of the names of investment companies. This is particularly true in recent years. Section 35(d) provides a rather novel administrative procedure. It provides that no new company may use a title, or may use as the title of its securities, any name which the Commission finds deceptive or misleading. It is novel in that it is a preventive type of fraud statute. We found during the course of the investment trust study that companies were using names such as: Assured Income Builders, Financial Independence Founders, Capital Savings Plan -- these were the so-called periodic payment plans or what the industry calls "front-end load." Today the names used by investment companies, of that kind with which we have to deal, are quite a bit more subtle, such as: Investing For Your Future, Future Incorporated, Great Companies of America, Expanding Industries Fund, Capital Gains Fund. We have objected to all of these names and had them changed.

There is one anomaly in the filed, and that is the use of the word "growth." That came into vogue before I had anything to do with the regulation. A company filed the name "XYZ Growth Fund." They argued that there was such a thing as a "growth stock", and that it was a word of art, and should be used. The staff, on the other hand, argued that growth stock carried with it the implication that there would be some increase with it a hedge clause in parenthesis, right beneath it, whenever it was used to the effect that the name carries no assurance of increase or appreciation, etc. Somehow that hedge clause got lost, and today it is not used. As a result the word "growth" is permitted purely on the basis of stare decisis. Recently we had occasion to take to the Commission a question involving "Capital Growth Fund Series" of the Group Securities Corporation, and argued that this was different because this was capital growth and not growth stock. The Commission said that in the light of the precedent we could not object. But they did agree that the word "growth" was misleading.

We get names that do involve investment policy, names like Atomic Development Mutual Fund, Automation Funds, Life Insurance Fund, and others. Those carry with them implications as to investment policy and we have to be very careful that the investment policy carries out the implication contained in the name.

I want to get into some of the questions in connection with capital structure. Long-term warrants are prohibited under the Statute, and a recent case concerning Allegheny Corporation involved an interpretation of what is meant by long-term warrant. In that case there had ostensibly been issued a convertible preferred stock which carried with it the right to convert the preferred stock into rights to buy 47 shares of the common stock of Allegheny Corporation at a price which was far less than the market. The purpose for the stock issue was to take up the arrears on old preferred stock, supposed to have a value of about $250 per share -- $150 of that being the arrears. Since so much of it was value in connection with rights to purchase stock rather than value in connection with part of the security, the Commission decided that this was in substance nothing more than a long-term warrant and therefore it would have been prohibited by Section 18(d). The case also involved a Section 6(c) exemption from the Statute, which is an all-pervasive exemption provision used by the Commission in those situations which were not specifically contemplated under the Statute. It is frequently used. Section 18 also requires that voting securities be issued, and although the Statute says "every share of stock hereafter issued shall be a voting stock," we have taken the position that covers any kind of equity security, including a certificate of interest or investment contract. So you cannot evade the voting security requirement of the Act by organizing a trust fund. That also carries with it the right to elect directors. We had one case where they organized a trust fund and issued what they called voting certificates of interest. But they didn't elect a board of trustees or a board of directors. They elected a board of governors who, in turn, elected a custodian or trustee. In any event they had a management contract under which the management company took over all the functions of the operations of the fund. We said that that was really not what the Statute intended when it insisted upon the election of directors.

The problems in connection with the distribution and repurchase of securities, both of open-end companies and closed-end companies, are covered in Sections22 and 23. You should know that the Commission has the policy of suggesting that companies use advance pricing methods. In other words, any shares that are offered for sale today, or any shares that come in for redemption today, should be priced at today's closing prices. The Statute requires that all redeemable securities be offered at a single offering price. This is, in effect, a fair trade provision in the Statute, originally insisted upon by the industry to avoid the short-circuiting of the principal underwriters. Brokers were buying shares in the market at a little above the redemption price and selling it at a little below the public offering price and making the spread themselves rather than dealing through the principal underwriter. I don't think that would be a problem today because dealers now are getting from 5 to 6% of the public offering price, whereas the principal underwriter gets only about 1 or 2%. They claim that even that does not suffice to pay all their expenses.

In connection with the management of the company, Harry has mentioned the qualifications of the board of directors and how certain percentages of the board must be independent. We are recommending legislation to tighten that up a little because we have found that it was possible under the Act to have a board, for example, of five directors, three of whom are officers of the company and two of whom are regular brokers for the company. You won't get an independent director out of that board.

Most open-end companies are managed through an investment advisory or management contract. It is a rather unusual thing in corporate finance. The board of directors doesn't really direct except on a very broad level, frequently not even on that level. The investment advisory or management contract provides that the management company, which is, in effect, the sponsors of promoters, will take over all the operating functions of the company, supply all of the executive personnel, pay the rents, supply the office, and in exchange for a management fee of 1/2 to 1%. At first this is rather a drain on the company, but when it reaches the $50,000,000 level or beyond as many investment companies do today, it provides quite a handsome profit for the sponsors. I'm quite sure that most investment companies of any great size could do very well by employing their own investment advisers and paying their own rent. But that is a practice in the industry, and one which we are going to look into in connection with our size study.

MR. HELLER. If you want a really good account of the history and background of the Act, read the <u>10th Annual Report of the Securities Exchange Commission</u>.

MR. GREENE. After you read that, and if you are interested to follow through, read the annual reports thereafter. They will bring you up to date.

Adjourned.