that you really intended to engage in this type of business in the immediate future.

Senator WAGNER. I see; I beg your pardon.

Mr. HOLLANDS. Section 21 (c) deals with borrowing by investment companies. There are a number of minor questions that arise there; but the principal question is this: The Commission feels, as I think the testimony yesterday made clear, that an investment company should not be operated substantially as a margin account. An investment company may have no debentures or preferred stock outstanding; it may have only common stock; and yet the same effect of a margin account can be obtained by large bank borrowings. Those bank borrowings will be a fixed charge against the company; and, because of the fixed charge, the value of the common stock will shoot up and down in the same way that it would if they had debentures outstanding.

The problem that we had to meet in this section was to cut down the leverage arrangements of that type and at the same time not embarrass companies that need to borrow in order to get over a brief period of time.

As far as we can see, there should be no need for long-term borrowings by the investment companies—certainly not by the diversified type. They have marketable assets; that is what their entire assets consist of—marketable securities, with relatively few exceptions. But there may be need for short-term loans.

So this section provides that a company may borrow up to 5 percent of its assets, for temporary purposes. Temporary purposes are put at 60 days. Perhaps 30 days would be better; perhaps 90 days would be better; I do not know.

Incidentally, the 60-day provision is only presumptive; if the actual use is a temporary use, even though the loan is extended for more than 60 days—and the company can establish that fact—the loan is not invalidated.

Senator WAGNER. What do you say is the purpose of a loan of that kind?

Mr. HOLLANDS. For instance, they might want to borrow money in connection with dividend payments; in other words, they might have made profits but they may have invested them and they do not want to liquidate at the moment, and they wish to borrow money for the purpose of paying the dividends, and then liquidate a little later when the market is in a better position.

Senator WAGNER. All right.

Mr. SCHENKER. Section 22 deals with the problem which Mr. Bane discussed in detail—that is, the possible dilution of the equity of certificate holders in open-end companies.

Section 22 (a) gives the Commission power to formulate rules and regulations to meet that situation. The only thing I wanted to say about that, Senator, is if the industry has any difficulty with giving the Commission power to formulate rules and regulations, then the Commission is prepared to recommend to the committee a specific provision which in its opinion will meet that situation.

We talked to the industry; we had the feeling that, although our plan to meet that situation is at least theoretically perfect, they say it may have some undesirable consequences in connection with their distribution activities. The suggestion was, then, "Why do you want to get yourself locked into a statute? If the formula does not work,

you will have to go to Congress. Why don't you make it subject to rules and regulations, and we can experiment with that."

That is the reason for the rules and regulations provision.

The purpose of subsection (b) is to take care of what we call "riskless trading," where the dealer or "insiders" or people who are "in the know" can take a position against the trust. If I may, for a moment, I shall just explain that.

Remember that we said that in these open-end companies they sell on Tuesday, based on Monday's prices. The dealer can go and confirm orders on the basis of Monday's prices. If the market goes down on Tuesday, he can say to the trust, "You sell me the shares on the basis of Tuesday's prices."

Then he takes the shares that he bought on the basis of Tuesday's prices and delivers them to the customer to whom he sold the shares, on the basis of Monday's prices, which were higher.

Senator WAGNER. That is a dilution process?

Mr. SCHENKER. That is a dilution process, coupled with what we call a riskless trading process. It is a sure thing; you cannot go wrong; because in effect he has a call for the stock of the investment trust at a fixed price, and if the market goes down he exercises the call, and if it goes up he says, "Give it to me at today's price."

That is a complicated problem, and we are not making the charge that it was done helter-skelter. We have found cases of it; it is possible to do it. But unless the problem presented by this situation is met, an injustice may be done to the certificate holders. That is reason for the provision in subsection (b) of section 22.

The (c) provision deals with this type of situation: we have used examples where the sales load ranged anywhere from 5 to 20 percent of the price of the security. They compute the price of the certificate and then on top of that they pile the sales load which is to reimburse the distributor for his effort in distributing the security and, of course, to give him his profit. You can see what that means, Senator. That means that if you have a very high load the performance of that investment trust will have to be so good that it would have to overcome the sales load which the public is paying.

If you get a very high rate of load, then the investor can never win, because the performance of the management may never be of the caliber to earn enough money to compensate the certificate purchaser for the price he paid for the privilege of having the management manage his money.

Senator WAGNER. In other words, may I put it simply in this way—or am I wrong? In the case where the load rate is 9—they are as high as 9 percent, are they not?

Mr. SCHENKER. They are as high as 20 percent in some cases, or 17 percent.

Senator WAGNER. How much must my investment earn on top of that load, before I can get any dividends?

Mr. SCHENKER. Before you can even talk about a dividend I am trying to figure out what the management must do before you will even get your money back.

For instance, with a load of 20 percent, which today is not unusual, that means that the market value of the money you invested and which went into the trust after the sales load was deducted would have to rise at least one-fifth, before you are even. Isn't that so?

In other words, suppose the price of the certificate is $100 and they put a 20 percent load on it: That is $120 that you pay, but only $100 of your money is invested. Under those circumstances the management has got to make $20 on $100 before you are even. Isn't that so?

Senator WAGNER. Exactly.

Mr. SCHENKER. That is the situation.

Senator WAGNER. So that difference has to be over 20 percent before you get anything, does it not?

Mr. SCHENKER. That is right.

Now, Senator, we did not assume to recommend to the committee that a fixed maximum load be incorporated in the statute—at least, not in this type of company. We did fix a maximum in the installment plans.

Now, Senator, why do we not do that? Well, you can see what happens. Today some of these companies sell with the load at 5 percent or 6 percent. If we fix it at 9 percent—and some people say they need a 9 percent load at some times, to be able to sell them—immediately the maximum would become the minimum in every case. They would say, "The S. E. C. in its recommendation to Congress said that 9 percent is all right"; and then everybody would charge 9 percent.

We think that for the present, at least, we ought to leave that to competition among the different distributors. We do say this—and we say it because we do not want to see our face get red at the same time: Suppose a fellow comes in and says, "I want to charge a 40 percent load", and he makes the disclosure. Then we have no power to say, "You cannot charge 40 percent." Although he discloses it and the person still buys it, it is clear that he did not understand it and therefore, it necessarily is inherently a fraud.

Therefore, we have made the recommendation and we have used this strong language because we do not want the industry to feel uneasy because of any belief that once this legislation is passed, if it is passed, we are going to require a low load.

So we say that if it is an unconscionable or grossly excessive load, then the Commission can institute a proceeding to have them stop selling the securities. That would give them an opportunity to be heard, and we tried to set forth standards with respect to what the Commission should consider in determining whether the load is excessive. For example, we state on page 50 that you shall give weight to the denominations of the certificates. If you sell a $10 certificate, perhaps there should be a different consideration than if you are selling a $100 certificate. We also state that due weight shall be given to the incidents, the selling price, the kind of organization, the investment policy, the past and prospective earnings, the management expenses, management and sales methods of the issuer, the distribution cost, and so forth.

So, Senator, with respect to the sales load, the Commission has not recommended any specific amount; but if the industry wants a specific recommendation instead of this rule-making power, I think the Commission would be prepared to tell the committee what they think the maximum load ought to be.

However, we felt that this is a technical problem. Since they sell continuously, there may be conditions where they ought to have a little more sales load or a little less sales load. We are prepared to

recommend to the committee that it be left to competition, in the first instance.

The next provision states:

The Commission is authorized, by rules and regulations or order in the public interest or for the protection of investors, to prohibit—

(1) The suspension, in whole or in part, of the redemption privileges of any redeemable security of which any registered investment company is the issuer.

They sell these securities to the investor on the sales talk: "if you are dissatisfied with the management, you can come and get the value of your certificate at any time you are displeased."

However, you will find the situation where the management has the power to suspend that right of redemption. Thus, although the fellow in the first instance bought it in reliance upon the fact that he could come to the company and tender his certificate and get the value of the certificate upon request, there is buried somewhere in the trust indenture a provision saying that the management under certain circumstances can either suspend it for a short period or, in some instances, for a comparatively long period. We have made an analysis of all the trust indentures.

We are not prepared to say to this committee that you ought to prohibit the suspension. You never can tell whether an emergency may arise. Suppose war is declared, with the result that the stock market "fell out of bed" and you had a tremendous "run." Then it might be a matter of the industry's saying, "Take your time; for the next week you cannot redeem your certificates."

That is different from a case where there is an ulterior motive, where a man is getting a lot of redemptions and his management fees are being cut into, and he says, "From now on nobody can redeem."

We pointed that out in the report, and it sounded very theoretical and hypothetical; but, sure enough, several weeks after we handed in our report, two open-end companies suddenly completely suspended redemption. They may have gotten the permission of the stockholders, but you know what control of the proxy machinery is.

We get a letter, such as this letter addressed to the chairman [reading]:

Re Maryland Fund.

Sometime ago the above-named church made a substantial investment of endowment bonds in the Maryland Fund, Inc. At the time said investment was made we understood that our stock was redeemable at any time at its liquidating value. We have now been informed by our broker that the directors of the said Maryland Fund have recently declared this provision to be no longer in effect.

We are also informed that the liquidation value as of today is $5.27 and that the best obtainable bid for the shares is $4.

From the portfolio of securities held as per the last statement of the Fund, we see no justification of the action as above reported to us. Your opinion and suggestions as to this matter will be greatly appreciated. As the shares owned by our church cost us approximately $9 per share, bought at the market, we stand to suffer quite a loss on our $10,000 invested—

Their investment today is worth $4,000; they paid $9,000 for it—

Thanking you for your consideration, I am,

Very truly yours,

_____,

Treasurer of the Trustees of the Union Methodist Episcopal Church of St. Louis, Mo.

Now, Senator, this is not an unusual letter; we have received these by the hundreds. We have our file here. We are absolutely helpless, and we say that some provision ought to be made in that situation.

Senator WAGNER. You say the trust indenture had a provision. Was there a limit on the period during which the suspension of redemption could continue?

Mr. SCHENKER. As I remember it, there was a limit; but it did not give them the right to do it specifically. We have written for all the information from the company. They may or may not have been required under their trust indenture to get the certificate holders' consent.

However, even if that provision is there, you know what can happen. It all depends on what explanation you give these people when you ask them to give you the right to suspend. That is a rather important problem, and we feel that it ought to be a subject of rules and regulations to prevent a recurrence of this type of thing.

Senator HERRING. They retain the right to revise the conditions between themselves and the stockholders?

Mr. SCHENKER. In most trust indentures, Senator, and in practically all of these open-end companies, there is some provision for the suspension of this right; and the rationale for that provision is, "Well, we have got to meet emergencies."

However, some of the provisions permitted suspensions for a very substantial period.

What was happening in this case, I suspect, was that the certificate holders of the Maryland Fund were being switched out into other open-end companies. You see, it is an easy matter to switch somebody out into another open-end company; the investor can get his money or the dealer will do it for him, and then the dealer says, "Why do you want to bother with this Maryland Fund? We can give you our certificate, and this other one is much better."

Of course, I say that is merely a theory of what may be the fact.

I did get a letter from another company, sometime back, stating that the management of this company had some difficulties with the whole concept of an open-end company. The writer felt that here you had a big fund which was always subject to demand liabilities. He felt that was a big headache. I understand that he has asked for an opportunity to come before the committee. He probably will elaborate on the difficulties of the open-end company and why he did this.

Now coming to subparagraph (2) of (d), it just says that the Commission shall have the right to make rules and regulations with respect to any restrictions upon the transferability or negotiability of any redeemable security of which any registered investment company is the issuer.

There are some companies that have a provision in their certificates to the effect that you cannot sell that certificate to anybody else, and the only way you can sell it is to sell it back to the company. That is a technical problem. It presents a whole problem which they call the bootleg market. What happens is that dealers keep switching people from one company to another. In order to prevent these switches, some provisions require that you cannot make these switches but must sell the certificate back to the company. That is a big problem; but it seems to me they are taking away a very valuable indicium of the ability of the company, and it seems to me you are taking away a big portion of the owner's right of initiative.

If the committee wants the provision, we shall recommend what, on the basis of our experience up to the present time, it ought to be; but we think subjects like that ought to be a matter of rules and regulations.

Senator WAGNER. You provide rules?

Mr. SCHENKER. That is right.

Senator WAGNER. You provide rules, I suppose, under which they make application to the Commission with respect to whether they may or not?

Mr. SCHENKER. No. If this bill becomes law, and after we study the whole situation, if we feel there are abuses which cannot be corrected except by putting in a restriction on alienability, then we shall formulate rules, after discussing them with the industry.

Senator WAGNER. I mean to say that those who desire to suspend redemption would have to come, I take it, to the Commission and give their reasons; and then there may be a modification?

Mr. SCHENKER. Well, we can deal with that in two manners, under that section.

Senator WAGNER. How else can you do it?

Mr. SCHENKER. We can do it by rules and regulations which would be applicable to everybody or we can do it by order, which would be by application by a particular company.

Senator WAGNER. But if you do it by rule, you have got to provide some standard under which this provision may be suspended?

Mr. SCHENKER. That is right.

Senator WAGNER. That is difficult, is it not?

Mr. SCHENKER. Well, that is why we say that is a matter for rules and regulations.

Senator WAGNER. All right.

Mr. SCHENKER. We would sit down and talk to the industry and get their ideas and their reactions; and you could work it out.

Senator WAGNER. I see.

Mr. SCHENKER. But once you put it in the statute, and if it thereafter does not work out, then you are in trouble, unless you have a broad exemptive power, that we provided in the first instance. Remember that we say we can exempt any particular transaction from the purview of the regulation.

Now we go on to the distribution and repurchase of securities.

Section 23 (a) in substance says that no registered closed-end company, as contra-distinguished from an open-end company, shall sell the securities of the company in violation of such rules and regulations, at a price below their asset value.

What we say is that a company shall not sell its present stockholder's dollar to anyone else for less. However, we are not unmindful of the fact that there may be situations where it may be to the interest of the corporation, and not to the substantial detriment of the stockholders, that the company be permitted to do so.

You take the situation where they have observed the stockholders' preemptive right and have offered the securities to them, and they cannot raise the capital. Then under those circumstances possibly the company ought to be able to sell its securities to other people at less than the asset value. There are a number of situations like that.

We feel that is such a technical problem as to be a matter properly subject to rules and regulations.

However, now it is not subject to rules and regulations and you have the instances where you can see that the controlling company stock can be sold at blank dollars and at blank dollars—so many less, you see.

Now, we come to (b), and that is the matter I discussed with Senator Taft, who manifested the feeling that no investment company should have the right to buy back its stock at all.

That is true in England and in Australia. However, it is not an easy problem. In the first place, in the case of the open-end companies—and I think it just slipped the Senator's mind—the whole theory of the open-end companies is that the company may be able to buy back its stock.

But in the closed-end companies, if the investors were going to sell that type in market, they might take a substantial loss; and perhaps in that case the company should have the right to buy back its stock. However, we say we want to make sure the legislation will protect everybody and not just the insiders, to be able to sell back their stock to the company. If the size of the company is to be reduced, then everybody ought to have an opportunity to reduce his interest in the company proportionately.

That is subsection (b) of section 23.

Mr. L. M. C. SMITH. May I just say there, for the purpose of the record, that over five hundred million dollars' worth of securities were repurchased by investment companies; and each one of those repurchases raises the question in my mind as to the fairness of the price that was paid—because the great majority of the securities repurchased were repurchased at prices which were below the actual market value of the securities. That is true of the situation over a period from 1927 to 1935. So it is a major problem.

Mr. SCHENKER. Mr. Hollands will discuss section 24.

Senator WAGNER (chairman of the subcommittee). I am going to ask Senator Hughes if he will not preside. I have an important bill coming up on the floor of the Senate this morning, and I must be over there to take care of it. I think that will be disposed of by this afternoon. I am sorry to have to miss this much; I have not missed a moment as yet.

Senator HUGHES. Yes; you have been very faithful.

(Senator Wagner, chairman of the subcommittee, then left the committee table.)

Senator Hughes (presiding). Proceed, please.

Mr. HOLLANDS. On the general problem of distribution of investment company securities, there can be several approaches. Regulatory statutes very commonly require the administrative body virtually to approve the securities in some way or other. Except in the case of reorganizations and exchange offers, we have in general taken a different approach in this bill. There are certain specific provisions such as the provisions regarding dilution and others that Mr. Schenker referred to, that deal with specific problems. Except where those specific problems are dealt with, it was felt that disclosure was adequate; and, of course, the disclosure statute administered by the Commission, in the case of distribution of securities, is the Securities Act of 1933.

Section 24 fits into the Securities Act of 1933 and is designed to give certain additional disclosure in certain particular circumstances.

The provisions are fairly technical; and I shall try to go through them rapidly and just give the gist of what they provide.

Subsection (a) says that in connection with a public offering by the issuer or a principal underwriter of an investment company there shall be registration under the Securities Act of 1933. In most cases registration is already necessary; but there are a few peculiar exemptive provisions in the Securities Act, that make sense as applied to most companies, but not as applied to registered investment companies, that this subsection (a) eliminates.

Subsection (b) is to eliminate any duplication of filings under this bill and under the Securities Act. You will recollect that back in section 8, which provided for the registration of investment companies under this bill, there was a provision that if the company already had filed a registration statement under the Securities Act of 1933 or the Securities Exchange Act of 1934, it could file a copy of the statement for its registration statement under this bill—with, of course, the addition of a current report bringing the material up to date.

Section 24 (b) is the converse of that provision of section 8. This enables the company, when it wants to distribute securities and register under the Securities Act, to employ the registration statement that it filed under section 8, and file a copy of that and file also a current report and the prospectus bringing the data up to date. In that way I think any duplication of filings is eliminated just about as far as it is possible to do so.

Subsections (c) and (d) deal with a slightly different problem. In effect they are designed to strengthen the Commission's powers under the Securities Act, regarding prospectuses of certain types of investment companies. Neither subsection (c) nor subsection (d) applies to closed-end investment companies. With relatively few exceptions they sell their securities in a lump. They have offerings when they need new money, and sell their securities, and then sit tight until they need some more new money. The distribution is commonly through dealers, in much the same way that industrial securities are distributed. So they are not dealt with in this provision.

However, the other types of investment companies are, almost all of them, engaged in continuous sales activities. They have large sales forces run either by the company or by an independent distributor. Occasionally they work through dealers; but that is perhaps the exception as much as it is the rule. There is a good deal of variation there.

The important feature is that there is continuous distribution of the securities and continuous use of sales literature. Mr. Boland described, the other day, some of the misrepresentations that have been not too uncommon in the sales of these securties. Any misrepresentation of that character or any fraud in the prospectus filed under the Securities Act of 1933 would have to be taken out, or the Commission would institute stop-order proceedings. However, the Commission's power in that connection extends only to the formal prospectus, as you may call it, filed under the Securities Act. It does not extend to other literature given along with the prospectus or used as follow-up literature.

There have been a number of instances where companies, after considerable discussion with the staff of the Commission, have finally agreed that certain provisions of the prospectus were misleading and

should be taken out; and then the registration statement became effective; and then, promptly, those same representations were put in the follow-up literature.

Subsection (c) requires that any sales literature which is to be used by the company be filed with the Commission as part of the registration statement; or if they decide to use it after the statement becomes effective, then it must be filed with the Commission as an amendment of the registration statement. That means that it is subject to the Commission's stop-order procedure.

This subsection does not attempt to specify what goes into the literature, but merely requires that what goes in it be truthful and not misleading.

Subsection (d) specifies that a prospectus may be required to contain summaries of information and that the information may be required to be presented in a certain order. There has been some suspicion, although no one can prove it, that the very complicated set-ups of these plans have been emphasized, rather than underemphasized, in order to make their presentation that much less intelligible to the investor, giving that much more weight to the oral representations of the salesmen.

You will recall that it took quite a little while for Mr. Bane, and later for Mr. Boland, to explain even to this committee the complicated pricing arrangements and the complicated set-ups of these companies. The investor is in a difficult position in these cases.

Section 25 deals with plans of reorganization and offers of exchange. May I call your attention first to subsection (d), on pages 55 to 56, which gives the grounds for the Commission's disapproval of a plan of reorganization or offer of exchange, if it decides to disapprove.

The grounds are that the plan or offer is not fair and equitable to all persons affected, and in the case of a plan of reorganization, that the plan is not feasible.

Those are very general words and they sound very loose, but they have, in fact, as I presume you know, a long judicial history. Those are the words that have been commonly used in equity receiverships, in reorganizations under section 77B of the Bankruptcy Act, and opinions as to their meaning are still being ground out under chapter X of the amended Bankruptcy Act.

Senator HERRING. Here you prohibit any person submitting to any court of the United States to approve such a plan. You are taking authority away from the courts to determine these matters, are you not?

Mr. HOLLANDS. No, Senator; we are not. What we are doing is saying that before the court passes on it, the Commission should pass on it. It is the same problem, really, that you have in railroad reorganizations.

In that connection may I say that we had a little discussion about paragraph (4) of subsection (a), and have decided that the phrasing, if I may put it that way, is a little unhappy. There are statutory precedents for saying that a court shall not pass on a plan of reorganization until the administrative body that specializes in that field has had an opportunity to pass on it; but the phraseology there is unhappy, and I am not entirely sure that paragraph (4) is necessary. Perhaps paragraph (3) is adequate.

Essentially, if you are going to have an administrative body pass on these plans, Senator, it is questionable whether the procedure should be an immediate recourse to the district court. The facts are all developed before the Commission. As a matter of fact, the issues of fact are much less in these cases than issues of law or issues of fairness.

Senator HERRING. I think that so far as administration and regulation are concerned, I am well content to leave those things to the courts yet. I think we are going too far altogether with semijudicial boards and commissions. I prefer to have them go to the courts. Let us take a chance on the courts yet awhile.

Mr. HOLLANDS. I think, Senator Herring, a distinction could be made there between cases where the reorganization is in court and cases where it is accomplished outside of court, by what are known as voluntary adjustments.

Senator HERRING. There is not much voluntariness about this, when you say they may not.

Mr. HOLLANDS. I mean a voluntary adjustment by the company itself, as distinguished from a receivership where the company is forced into court to work out a reorganization. I am quite sure that we have no fixed feeling on what the exact mechanics should be here, except that the investor is extremely helpless in these situations, and some power must be given to the Commission.

Mr. HEALY. I suppose it grows somewhat out of some experiences that we have already had under the Holding Company Act in connection with reorganizations of companies in holding company systems, which have to be strained through the S. E. C. before they get to the court. Our decision does not bind the court; that is, we may say a thing is all right and the court may say it is all wrong; but we have to take a look at it. You have a similar procedure in the Interstate Commerce Commission in respect to railroad reorganizations, and I am not sure but you have the same thing in communications, with respect to reorganizations of companies engaged in communications.

The work that has been done under chapter X of the Revised Bankruptcy Act, the Chandler Act, where we write advisory opinions for the courts on reorganization plans has brought from the courts a great many expressions of gratitude. That is, the courts are very busy and very pressed and they are not specialists in the field of reorganization law. I could produce a number of letters, if you cared to see them, from judges saying that they appreciate that kind of assistance very much. We have even had such a letter from one man who was very much opposed to the idea in the beginning, but who now feels very definitely that it relieves him of a great deal of work, and is very useful to him.

Senator HERRING. I am not as much concerned about the judges as I am about the investors and the individuals. What is the use of their going to court?

Mr. HEALY. I think the experiences in reorganizations, if you will permit me to say so, are somewhat in the other direction; that is, the court not being a specialist in that field, and being very much pressed with too much work, permit a good many reorganizations that are completely unfair to the stockholders, and especially the unorganized, scattered security holders, to get through the court; and I do not think they would get through the S. E. C.