been painfully numerous in the past and will be painfully numerous in the future unless we regulate them in some way.

This bill proposes to regulate them by giving the S. E. C. the same sort of control over them that it now has in similar cases with regard to public utilities under the Holding Company Act.

There is also the danger to which I adverted: that if the common stock ceases to have any substantial asset value, then the present holders will be tempted to sell out to undesirable persons seeking to get control. Experience indicates that generally those persons who seek to get control try to do so not with their own money but with someone else's money and that, accordingly, what they do is to use one investment trust to buy control of another. For that and other excellent reasons, the bill makes it unlawful for one investment trust to buy securities of another. There are many reasons for that. One is this reason that I have just been suggesting: that investment trusts are often used as a means by which unscrupulous people will get control of another investment trust, wherel that can be done with a small outlay, owing to the fact that control is in the common shares, whereas most of the money belongs to the preferred.

Another obvious objection to the purchase of securities of one investment trust by another is that it leads to pyramiding one investment trust on another; and there, again, it leads to control by people who have no substantial financial stake in what they are controlling.

So, in my judgment, the bill very wisely prohibits one investment trust from buying control of another.

Another important provision of the bill is that with regard to dividends. Our State laws—notably, again, Delaware law—are extremely lax with regard to dividends. In Delaware, dividends may be paid out of any kind of surplus; and that means that the directors of a Delaware corporation, without consulting the stockholders, may label a large part of the stockholders' original contribution as surplus, and then later on ladle that out in dividends. That may be done without warning the stockholders, at the time when they are getting the dividends, that they are unearned.

Since, in normal American practice, dividends have normally come out of earnings, the investor normally assumes that is what he is getting. He thinks he is getting income. It may be merely a return of his principal; yet, under Delaware law, you do not have to tell him that it is return of his principal.

That is bad enough when you have only one class of stock. It becomes much worse when you have two or more classes; at least, if the Delaware law would be interpreted by the Delaware court to mean what it seems to say, there is nothing in that law to prevent the use of surplus, paid in by the preferred-share holders, by the senior security holders, to pay dividends even on junior securities. There is nothing in that law, if it means what it seems to say, to prevent the paying of dividends to common-share holders out of so-called paid-in suplus, even though the remaining assets are substantially less than the amount which has been promised to the preferred-stock holders as a preferential claim in liquidation.

In other words, you may issue preferred stock with $10 par or $10 stated value, if it has no par, with a liquidation preference of $100. You may issue that stock for $100, if you can get people to pay that much for it; and then, if the Delaware law means what most lawyers

think it means and what it literally seems to mean, you can use that $90, paid in by the preferred-stock holder, to pay dividends on the common stock, despite the fact that by doing so you make a mockery of the preferred-stock holder's liquidation preference.

We need a different sort of dividend law than that; and this bill, if enacted, will give us a different sort of dividend law with regard to investment trusts—which are, as I say, that type of security which is so largely invested in by the small investor, the man who is peculiarly unable to protect himself and who can peculiarly ill afford to lose.

Obviously, you cannot have effective dividend control unless you have some control over accounting practices. You cannot have publicity of accounts that means anything unless you have some control over accounting practices. Therefore, this bill necessarily, as I see it, gives the Commission some control over the accounting practices of these corporations; and the control that is thus given the Commission does not differ substantially from the control that the Commission already has under the Securities Act and under the Securities and Exchange Act, over corporations that come within those acts. As I have already said, many investment trusts do not come within either of these acts.

There is just one other provision of the proposed act about which I should like to say a word before I close; and that is a provision with regard to the settlement of litigation against the management. Litigation against the management of any corporation is normally carried on by the common-stock holders. Obviously, the management will not sue itself. Thus, except in those rare cases in which you get a complete overturn in the personnel of the management, litigation attacking misconduct by the management, which has injured the corporation, is practically always brought by the common-stock holders. That situation gives rise to this very dangerous state of affairs: The stockholder who litigates is ostensibly litigating for the corporation. In the majority of cases, however, he holds a relatively small amount of stock; and if he wins for the corporation, he gets relatively little out of it, himself. Therefore, he is under a strong temptation, if he gets the opportunity, to make some kind of settlement which will primarily enrich him rather than the corporation. His lawyer is also under a considerable temptation to consent to a settlement, if the settlement involves substantial lawyer's fees.

On the other hand, the defendants—the management—do not particularly care whom they pay. They are chiefly interested in paying as little as possible. The result is that very frequently you have a situation in which there will be some sort of agreement between the plaintiff—the shareholder, suing ostensibly on behalf of the corporation—and the management, for a settlement which will benefit the plaintiff's lawyer by giving him a good fee and, perhaps, benefit the plaintiff, either indirectly through splitting with his lawyer or otherwise by direct payment to him, but which will be of very little benefit to the corporation. There is no party to the litigation who has any interest in objecting to that settlement; it benefits everybody who is actually litigating.

Senator WAGNER. Professor Dodd, may I ask a question right there? Is there not a requirement under rule 23?

Mr. DODD. Yes, sir; I was coming to that in just a moment. There is now a requirement under rule 23 to the effect that, as far as the

Federal courts are concerned, such a settlement cannot be made without the consent of the court. That is quite true.

The difficulty, as I see it, is that it is extremely difficult for the Federal judge to know, except in the most obvious and flagrant cases, whether the settlement is reasonable or not. Let us suppose that the settlement is made in the early stages of the litigation. The plaintiff has made a lot of charges. The judge does not know whether the plaintiff can prove all of those charges or half of them or none of them. A settlement is proposed, in which the corporation is to get a little. The plaintiff is for it; his lawyer is for it, because it is part of the settlement that he will get a fairly good fee. The corporation gets something. It is argued to the judge that the plaintiff's chance of recovery is dubious and, therefore, anything the corporation gets is velvet, and he had better assent to it. The judge has no machinery for investigating whether that is so or not, and there is no person before him in the court who really represents the interests of the corporation. Consequently, the judge must get his information from people no one of whom really has the corporate welfare at heart at all.

It seems to me that it is clear that the judge needs help in making up his mind with respect to whether or not a proposed settlement of that kind is reasonable. This bill gives him a way in which he can get that help. If the litigation is in a Federal court, the judge must wait for an investigation by the S. E. C. and an advisory report. If the litigation is in a State court, the judge does not have to accept the services of the S. E. C., but he is offered the opportunity of availing himself of this service if he desires it; and I feel sure that many State judges would desire it.

There are many other provisions of the bill. The ones that I have mentioned are those that stand out in my mind as the most important and most necessary.

I shall say just a word with respect to the bill as a whole: We have here an industry which is somewhat comparable to a savings bank, in that it takes the small investor's money and invests it for him. It invests it in a somewhat different type of security, but it performs a very similar service. Unlike the savings bank, it is wholly unregulated at the present time. Serious abuses have resulted from that situation.

It is clear to me that it needs regulation and that it needs Federal regulation. An investor in California may buy on the New York Stock Exchange an interest in an investment trust incorporated in Delaware and subject to Delaware law. The only body that can adequately deal with that situation, by way of regulation, is the Congress of the United States. Every provision in this bill is aimed at an evil which has been demonstrated by evidence of what has actually taken place. There is no provision in the bill that, in my judgment, goes farther than is reasonably necessary in order to cure those evils.

The bill leaves the investment trust completely free as to its investment policy, provided only that the investment trust sticks to the type of investment policy that it announced when it organized and when it sold its securities. If the investment trust wants to be a somewhat speculative enterprise, it can be such, so long as it does not indicate to investors that it is going to be a more conservative enterprise.

Consequently, I say that the bill leaves investment trusts quite free to perform their investment functions; it merely puts certain limita-

tions on a kind of conduct that has been proved to be dangerous. In the main the bill does that by specific and definite provisions to be enacted by the Congress. However, it is obvious that a bill that proceeded wholly along those lines would have no flexibility in it, whatever. You would be ordaining a Procrustean bed for every investment trust, without regard to the circumstances.

Therefore, in order to introduce into the bill a certain flexibility, certain powers are given to the S. E. C. The majority of those powers are not powers to make the provisions stronger, but they are powers to grant exemptions from certain provisions which, although generally desirable, yet as applied to a particular situation might seem needlessly harsh.

I am sure that you will have a far more workable statute if you do give a substantial amount of discretion to the Securities and Exchange Commission. All the primary questions of policy are settled by Congress, if this bill passes. The discretion given is discretion as to matters of detail.

I believe that such discretion is necessary in order to provide that amount of flexibility which must be permitted if the proposed act is not to become too rigid.

That is all, Mr. Chairman, unless there are questions.

Senator HUGHES (presiding). Are there any questions to ask?

Senator WAGNER (chairman of the subcommittee). I believe not, thank you.

Senator HERRING. No; thank you.

Senator HUGHES. Thank you, Professor Dodd.

Is Judge Fletcher present?

Mr. FLETCHER. Yes.

Senator HUGHES. Judge Fletcher, we shall be glad to hear you.

Mr. FLETCHER. About 10 minutes is all I want; and I should be willing to go over until tomorrow, if that suits the committee better.

Senator WAGNER. There is only this, Mr. Fletcher: I talked to the S. E. C., and I think all of us are agreeable to what you want done. I think you can put your statement in the record, if you want to; because I think everybody will agree to what you want done.

Mr. FLETCHER. Well, I have no desire to be oratorical.

Senator WAGNER. We are practically in agreement on it, so just put your statement in the record.

Mr. FLETCHER. Shall I just address a letter to the chairman?

Senator WAGNER. Didn't you have a short statement ready?

Mr. FLETCHER. I did not have one written out; no, sir. However, I can prepare one.

Senator WAGNER. Well, get a statement ready and send it to the committee by tomorrow; and it will be inserted in the record.

Mr. FLETCHER. Surely; that is very nice.

(The statement referred to is as follows:)

My name is R. V. Fletcher. I live in Washington. I am a lawyer and general counsel of the Association of American Railroads. I speak here for practically all of the class I railroads of the United States, comprising more than 95 percent of the entire mileage of operating railroads in the country. I appear here for the purpose of suggesting a clarifying amendment, the effect of which, if adopted, will be to exempt from the terms of S. 3580 companies subject to the Interstate Commerce Act and companies whose entire outstanding capital stock is owned or controlled by companies subject to the Interstate Commerce Act.

Railroads are subject to the Interstate Commerce Act in the matter of the issuance and sale of their securities. Railroad affiliates and subsidiaries owning

securities are subject to a certain measure of regulation by the Interstate Commerce Commission. It has been the general policy of Congress to exempt from regulating statutes having to do with the issuance and sale of securities all such activities of railroads and their affiliates as are controlled by the Interstate Commerce Commission. Quite obviously such a policy is wise because there should not be any overlapping of authority or any conflict between two Government agencies. Upon these considerations, the acts relating to the work of the Securities and Exchange Commission invariably provide for the exemption of railroads with respect to all features that are under the control of the Interstate Commerce Commission.

The Interstate Commerce Act, as it stands now, contains a certain measure of regulation applicable to railroad subsidiaries and affiliates. It is perhaps not necessary to spell through the act and point out the extent to which these subsidiary and affiliated companies are regulated. I say this by reason of the fact that the Senate has passed and the House now has under consideration a bill known as S. 2903, which is an act to amend the Interstate Commerce Act by extending the regulating authority of the Commission over railroad subsidiaries not actually engaged in transportation.

That act defines subsidiaries as covering companies 10 percent or more of the outstanding voting securities of which are held by carriers or by subsidiaries or both. In addition, the term "subsidiary" is defined as a company which the Interstate Commerce Commission finds is controlled, whatever may be the method of control. The act deals also with controlling persons and with affiliates.

It is worth mentioning that by section 4 of this act, the Commission is given the power to require annual reports from railroads and from the owners of railroads and to require subsidiaries to answer any questions which may be propounded by the Commission. This section 4 of S. 2903 goes into great detail with respect to the visitorial authority of the Commission. I call attention particularly to the following language, which is found in lines 7 to 19, inclusive, on page 8 of S. 2903 as it passed the Senate:

"The Commission is hereby authorized to require that every subsidiary which is not a carrier or an owner or a motor carrier file with the Commission an annual report, which shall consist of its balance sheet as of the end of the twelve-month period determined under paragraph (2), its income account for such period, and its profit and loss account as of the beginning and the end of such period, and such report shall classify separately the accounts shown therein representing (a) transactions between the reporting subsidiary or subsidiaries and the controlling carrier, (b) transactions between the reporting subsidiary or subsidiaries and all other subsidiaries of the controlling carrier, and (c) all other transactions."

It will be seen that the authority is very broad.

By examining section 9 of S. 2903 and particularly the language found in subparagraph (13), it will be seen that subsidiaries of carriers, where the subsidiaries are themselves not carriers, are subject to the provisions of paragraphs (2) to (6) and (8) to (11) of section 20a of the Interstate Commerce Act. An examination of the paragraphs referred to shows that by reason of the language just referred to, the Interstate Commerce Commission has complete control of the issuance and sale of all securities issued by railroad subsidiaries, with one exception. There is a proviso that if the subsidiary issues securities to the owning carrier (a matter in which the investing public is not interested), then the Commission may not supervise such issuance.

An examination of subparagraph (14) of section 9 of S. 2903 found on page 16 of the bill as it passed the Senate shows that after a named date it shall be unlawful for any officer or director of a carrier to hold the position of officer or director of a subsidiary, without the consent of the Interstate Commerce Commission.

Not to labor the matter unduly, it is clear that S. 2903 covers in a general way, as to railroads and railroad subsidiaries, the same field which is sought to be covered as to other types of securities by S. 3580.

A careful examination of S. 3580 rather indicates that perhaps the bill was not intended to cover railroads and their subsidiaries. Certainly these subsidiaries are not investment companies in the oridinary sense of the word. However, there is language in section 3 of S. 3580, as well as in section 6, dealing with exemptions, which leaves the matter in doubt. In order that all doubt may be removed, the Association of American Railroads is suggesting that S. 3580 be amended by inserting on page 7, between lines 24 and 25, a new paragraph, reading as follows:

"Any company subject to regulation under the Interstate Commerce Act and any company whose entire outstanding capital stock is owned or controlled by such company."

It is respectfully submitted that unless an amendment of this character is embodied in the act, much conflict and confusion may arise.

APRIL 23, 1940.

Senator HUGHES (presiding). Is Mr. Sholley here?

Mr. SHOLLEY. I have a statement to make, which I am willing to file, if that will be satisfactory.

Senator HUGHES. All right.

(Mr. Sholley's statement is printed at p. 663.)

Senator WAGNER. Very well; and the statement of Professor Dodd is to be put into the record.

(The statement referred to is as follows:)

STATEMENT OF E. MERRICK DODD, JR., CONCERNING S. 3580, A BILL FOR THE REGULATION OF INVESTMENT TRUSTS

I am, and have been since 1928, a teacher of the law of corporation finance at the Harvard Law School. As such, I have devoted much time and attention to investment trust problems. I have done this for three reasons: In the first place, because I believe that investment trusts, properly managed, can serve one of the primary needs of the small investor, the need for some method by which he can invest in sound corporate equities with adequate diversification of his investment and, in doing so, have the assistance of disinterested investment experts: secondly, because I believe that it is vitally important to the successful operation of our whole economic system that investment in corporate equities be encouraged, and I believe that if the investment trust can regain the confidence of the investing public, which it has very largely lost, it can furnish us with institutional buyers of equity securities comparable to those large institutional buyers of bonds—banks and insurance companies—which provide a ready market for the senior securities of corporations; thirdly, I have been concerned about the investment trust problem because my studies of state corporation statutes and the court decisions interpreting them have made me acutely aware of the practically total absence of regulation of these trusts and the opportunities for injury to the interests of investors, which such lack of regulation makes possible.

That these opportunities for injury to the interests of investors have frequently been taken advantage of has long been well known. It was known to the Congress when in 1935 it instructed the Securities and Exchange Commission "to make a study of the functions and activities of investment trusts and investment companies * * * and the influence exerted by interests affiliated with the management of such trusts and companies upon their investment policies." That report has now been published and as a result in place of vague general knowledge that something was wrong we now have a thoroughly documented study which enables us to determine with precision the exact nature of the evils which have existed and which continue to exist under our unregulated investment trust system.

The investment trust resembles the savings bank in that both are institutions for the preservation of the savings of the American people particularly those of limited means. It resembles the savings bank also in that the persons who manage it are given control over a pool of liquid assets which in the absence of effective regulation, they can use as they see fit. It differs from the savings bank in that unlike the savings bank it is subject to practically no regulation. It differs from the savings bank also in that its portfolio is composed primarily of equity securities so that the investor expects to take somewhat greater risks than he expects to take if he puts his money in the savings bank. But he expects and is entitled to expect that the risks which he takes will be only those which are inseparable from investment in equities and that his money will not be used for purposes which benefit the management and those closely identified with it rather than the investor with whose savings the trust is financed.

As the Commission's report abundantly demonstrates, the unregulated investment trust has, in many cases, been operated in a manner which is not in accordance with sound fiduciary principles. There have been a disquietingly large number of cases of outright looting, but looting is already illegal. The primary need for regulation is not because of such looting but because of other evils which are much more widely prevalent. These evils, as I see them, are primarily two. In the first place, a very large percentage of our investment trusts are managed by persons who are, or are closely connected with, dealers in securities

or security brokers and hence have interests definitely adverse to the trust—in the case of the dealers, an interest in selling their own securities to it; in the case of the brokers, an interest in multiplying security sales in order to increase selling commissions. Many of these persons are persons of undoubted honesty, but honesty is not enough to prevent that warping of the judgment which comes about when a man is on both sides of a bargain—when arm's-length dealing is nonexistent. The other major evil is that, through the issue of large quantities of nonvoting senior securities and through the pyramiding of trusts, one superimposed upon the other, control is in many cases exercised by persons elected by those who have little or no financial stake in the enterprise, and often little or no hope of obtaining dividends from the normal operation of such trusts and who therefore frequently yield to the temptation of seeking to profit from their control in devious ways at the expense of the senior security holders whose investment they control.

Senate bill 3580 is designed to meet these and other evils which are not theoretical but actual. I can in the time at my disposal discuss only its major provisions.

First, there are those provisions which are designed to prevent the injury to investors which comes from management of these trusts by improper persons. These provisions are of two kinds. In the first place, a narrowly limited class of persons, including chiefly those who have been convicted of a crime in connection with some security transaction and those who have made willfully false statements in an application for registration, are made ineligible to act as officers or directors (sec. 9). In the second place, certain kinds of interlocking directorates, which experience has indicated are fraught with danger to investors, are—after 1 year—prohibited by section 10. It has been urged that the prohibition against self-dealing, which is contained in section 17, makes the prohibition of interlocking directors, contained in section 10, unnecessary; but the prohibition against self-dealing is not self-executing, and the history of American corporate finance plainly demonstates that such prohibitions are very difficult to enforce. Furthermore, if investment trusts and the corporations whose securities they hold have interlocking directors, certain undesirable results not prohibited by the provision against self-dealing are likely to follow. For example, if an investment trust owns securities of a corporation which has certain influential common directors, pressure is likely to be exerted on the trust to refrain from selling the stock of the other corporation because of the possible depressing effect which such sale may have on the market price of such stock, even though the interest of the trust may require that such sales be made.

Congressional precedents for imposing limitations on interlocking directorates are numerous. Such limitations have been imposed with respect to railroads, by the Interstate Commerce Act (49 U. S. Code, sec. 20a (12)); with respect to banks, by the Banking Act of 1935 (12 U. S. Code, sec. 78); with respect to competing corporations, by the Clayton Act (15 U. S. Code, sec. 19); and with respect to public utilities, by the Public Utility Holding Company Act (15 U. S. Code, sec. 79q (c)). Although it has been asserted that the prohibitions of section 10 will make most financiers ineligible as directors of investment trusts, that is by no means the case. If, for example, an investment trust owns shares of United States Steel, section 10 (e) would prevent the same investment banker from acting as a director of both the Steel Corporation and of the trust, but it would not prevent a partner in the investment banking house, other than the Steel director, from acting as director of the trust. Subsection (f) would, under those circumstances, prevent the principal underwriting house for United States Steel from having a director on the investment trust board, but the prohibition is applicable only to the principal underwriter and not to other members of an underwriting syndicate.

Section 17 of the bill, prohibiting officers and directors of investment trusts to sell to it or buy from it or borrow from it, is designed to prevent so far as possible what experience proves to have been one of the principal abuses in the investment trust industry. Here, again, there are a number of Congressional precedents for such legislation, notably section 10 of the Clayton Act, which, while it relates to transactions between common carriers and other companies having interlocking personnel with the carriers, nevertheless involves the same fundamental considerations (15 U. S. Code, sec. 20).

On the other hand, the bill wisely makes no attempt to limit managerial discretion as to the investment policy to be pursued, except by forbidding a few obviously undesirable practices, such as purchases on margin and the loaning of money to individuals. It does provide that the trust shall describe in its registration statement the investment policies which are intended to be followed and that it shall adhere to those policies unless the shareholders vote to change them

(secs. 4, 5, 8, and 13). It has happened far too often in the past that investors have put their money in an investment trust in reliance on representations that the trust assets would be invested in widely divesified and liquid securities, only to discover later that their money has been used for the purchase of control of a particular company, for participation in underwriting, or for the purchase of extremely unliquid assets.

The provisions as to capital structure, particularly the prohibition of future preferred stock issues, have aroused some criticism. Why, it is asked, should investment trusts be forbidden a capital structure which is permissible for industrial corporations? The answer is that, since the assets of investment trusts are invested almost exclusively in common stocks, preferred stock of an investment trust represents merely a limited interest in a pool of common stocks of widely fluctuating value. Statistical studies indicate that investment trust portfolios do not on the average behave in a substantially different manner from average prices of listed stocks, which means that in periods of falling common-stock prices, investment trust portfolios tend to shrink rapidly in asset value. Moreover, the same statistical studies demonstrate that, even where common-stock prices are substantially stable, it is difficult for an investment trust to earn its full preferred dividend which can, generally speaking, be earned only if common stock prices are advancing so that the trust is in a position to make capital gains.

As a result of this situation, most existing investment trusts which have substantial preferred stock issues have found themselves at some period of their history in a situation in which preferred dividends were in arrears and the total assets of the trust were insufficient or barely sufficient to cover the preferred-stock holders' liquidation preferences. In 1931 and 1932, nearly all investment trusts which had preferred-stock issues were in this position, and a very large percentage of them are still in that position. (See Securities Exchange Commission Investment Trust Report, pt. 2, p. 816.)

Under such circumstances, the common-share holders, despite the fact that their equity in the assets has been wiped out, so that the entire pool of securities held by the trust would be distributable to the preferred shareholders if the trust were liquidated, usually remain in voting control of the trust. Since their prospects of obtaining dividends are exceedingly remote, they are, in this situation, tempted to seek to profit from their control in other ways—ways which are highly detrimental to the interests of the preferred-stock holders. As I shall indicate in more detail below, the tendency has been in such circumstances for the controlling common-stock holders of investment trusts to capitalize on the value of their control in one of several ways: By speculating with the preferred-stock holders' money in an effort to recoup losses, by selling their control to undesirable persons, or by putting through a recapitalization plan by which the priorities of the preferred-stock holders are drastically reduced.

Provisions for a transfer of voting control to the preferred-stock holders in case of default in the payment of preferred dividends are a very imperfect cure for this situation. The difficulty of organizing scattered preferred-stock holders makes it almost impossible for those stockholders, even where voting control has in theory passed to them, to unite for the purpose of ousting a management which has previously been elected by the common-stock holders; and the danger that directors and officers, who are in reality the representatives of common-stock holders who no longer have any equity in the assets, will manage it in ways which are detrimental to the interests of the preferred-stock holders to whom the assets really belong is, as experience indicates, a very serious one.

Preferred stock which is nothing but a limited interest in a pool of common stock is an anomaly. It can be marketed only in a period of rising security prices and is a dangerous investment except on the unwarranted assumption that the period of rising security prices will not be followed by a period with a sharply reversed trend. The purpose of issuing it is to create leverage for the common stock—a purpose which cannot be accomplished without subjecting the preferred stockholders to risks which they do not anticipate—to the risk that when security prices decline, their theoretical priorities will prove to be no real protection to them.

Since, however, existing preferred stock issues will still exist, the problem of protecting the holders of this class of stock is one which must be given due consideration.

Where common stock retains voting control, despite the fact that it represents no assets, the holders of a controlling interest in such stock, despairing of dividends, are under a strong temptation to sell it to anyone who desires to obtain

control, without the sellers' concerning themselves with the motives which induce the buyer to purchase control. Sales of control of investment trusts which are in this kind of financial condition have in many cases resulted in the transfer of control to interests who have proceeded to loot the enterprise. Such interests have in most cases been other investment trusts, and for this and other reasons the bill wisely forbids the purchase of the securities of one investment trust by another (sec. 12).

Where the assets and earnings of an investment trust which has outstanding both preferred and common shares have declined to such an extent that there have been large accruals of preferred dividends and that little or no asset value is left for the common stock, the controlling common stockholders, instead of selling their control to outsiders, have in a large number of cases improved their position at the expense of preferred shareholders by bringing about a recapitalization which results in a drastic scaling down of preferred stockholders' rights. State laws are wholly inadequate to protect the preferred shareholders in such a situation. Many such laws permit a recapitalization without requiring the separate vote of the preferred shareholders as a class—such being the situation, for example, in Delaware—provided the recapitalization is brought about by merger rather than by amendment. Even where a class vote is required, no state statute compels the management to make a full and fair disclosure to the preferred shareholders as to the reasons for and consequences of the recapitalization for which they are asked to vote; and the proxy rules established by the Securities and Exchange Commission are inapplicable unless the stock is listed on an exchange. Moreover, regardless of disclosure, in many situations the common stockholders are in a position to extort unfair concessions from the preferred by refusing to consent to corporate changes which are in the interest of both groups unless the preferred stockholders will pay for such consent by scaling down their rights. Thus the "nuisance value" of worthless common stock, which the Supreme Court condemned in the *Los Angeles Lumber Products Co. case*, where stockholders of an insolvent corporation attempted to use it to scale down bondholders' claims, may be used to scale down preferred shareholders' priorities in reorganizations which do not involve creditors but only two or more classes of stockholders. Such reorganizations or recapitalizations take place out of court; and although they can in theory be attacked by dissenting stockholders if they are fraudulent, the State courts have so defined fraud as to permit an impairment of preferred stockholders' rights which the Federal courts would not tolerate in a case which came within the Federal bankruptcy jurisdiction.

These glaring defects in the State laws which govern recapitalization abundantly justify section 25 of the bill, which gives the Securities and Exchange Commission power to veto plans which it finds not to be fair and equitable. The section might perhaps be amended so as to exclude judicially supervised reorganizations under the Federal Bankruptcy Act.

Another type of serious abuses are those relating to management contracts. Despite the fact that the only justification for such contracts is to enable a trust to get the benefit of the services of a particular person or organization which is supposed to possess expertness, management contracts have been treated as assignable and have been bought and sold like so much merchandise. Section 15 forbids this practice and also forbids the making of the long-term management contracts which experience has indicated to be undesirable.

State dividend laws, and notably those of Delaware, which is the favorite State in which to incorporate investment trusts, are extremely lax. The Delaware law permits the payment of dividends out of unearned surplus, which are in substance dividends in partial liquidation, without any warning to shareholders that the dividends which they are receiving are unearned. That law, as generally interpreted by the bar, also permits the payment of dividends on common stock out of any kind of surplus, without regard to whether the remaining assets are sufficient to give adequate protection to the preferred shareholders' preferences in earnings and assets. The need of some such provision as that contained in section 19 of the bill is, therefore, obvious.

Neither effective control of corporate dividends nor intelligible publicity of corporate accounts is possible unless those accounts are kept in accordance with sound accounting principles. The majority of existing investment trusts are subject neither to the Securities Act nor to the Securities Exchange Act. The result is that there is neither any legal control over their accounting methods nor any requirement that their balance sheets or income statements be made public. Section 30 of the bill, relating to periodic reports, and section 31, relating to accounts and accounting principles, are designed to remedy this situation—a situation for which a remedy is a vital necessity.