a general voting permit thereafter issued to it by the Board of Governors and which is determined by such Board to be primarily engaged, directly or indirectly, in the business of holding the stock of, and managing or controlling, banks, banking associations, savings banks, or trust companies. The Commission shall be given appropriate notice prior to any such determination and shall be entitled to be heard."

Make such amendment as may be necessary to exempt from the "investment adviser" provisions of the bill those holding company affiliates which are exempted from the provisions of the bill relating to investment companies.

Make an appropriate amendment to section 26 (a) of the bill to make it clear for the purposes of such section that at least in the case of any trustee which is a member bank of the Federal Reserve System the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive.

The Board recommends that such amendments be made to the bill.

Very truly yours,

CHESTER MORRILL, *Secretary.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, April 18, 1940.

Re Investment company bill (S. 3580).

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, D. C.

GENTLEMEN: The Securities and Exchange Commission is prepared to recommend to the subcommittee of the Banking and Currency Committee of the Senate, before which hearings on the above bill are currently being held, that the bill be amended in the following respects:

1. By adding to section 3 (c) an additional paragraph which will exclude from the definition of "investment company" those bank holding-company affiliates which hold general voting permits issued by your board and which are primarily engaged in bank holding-company activities.

The necessity of distinguishing between investment companies on the one hand and those companies which are primarily holding companies on the other is, of course, recognized in the bill. Section 3 (b) of the bill is particularly addressed to this problem, various phases of which are also dealt with in sections 3 (a) (2) and 3 (c) (4). The Commission understands, however, from conversations between members of its staff and members of the staff of your Board, that the exceptions provided in section 3 (b) may not in all cases be adequate to exclude bank holding-company affiliates of the type above referred to. The Commission also recognizes that the determination of borderline cases, which under section 3 (b) (2) of the bill is committed in the first instance to the Commission, can more appropriately be made a function of your Board when the company involved is a bank holding-company affiliate. On the other hand, the Commission feels that in any proceeding of this character before your Board, the Commission should be entitled, if it desires, to appear as a party and present evidence and advance arguments bearing upon the question at issue.

The Commission also deems if of the utmost importance that only those bank holding-company affiliates which are primarily engaged in noninvestment company activities be excluded. In other words, although the letter of section 3 (b) may not be applicable in all of these situations, the Commission feels that the principle of that section should apply. In particular, it is important that the amendment be so drafted that it will not be possible for an investment company to escape the bill by the simple expedient of using a relatively small portion of its assets to acquire control of two or three banks.

2. By making such amendment of paragraph (16) of section 45 (a) as may prove necessary in order to make it clear that the term "investment adviser" does not embrace bank holding-company affiliates of the type above referred to.

3. By amending paragraph (1) of section 26 (a) to make it clear that, at least in the case of any trustee which is a member bank of the Federal Reserve System, the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive. It is expected that the specific language which will be recommended will closely follow that of paragraph (2) of section 310 (a) of the Trust Indenture Act of 1939.

We should appreciate being advised whether, in principle, the above recommendations meet with your approval. We shall also be glad to consider any precise language to accomplish the above objectives which you may care to suggest.

Very truly yours,

ROBERT E. HEALY, *Commissioner.*

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, April 19, 1940.

Hon. ROBERT E. HEALY,
Commissioner, Securities and Exchange Commission, Washington, D. C.

DEAR MR. HEALY: This refers to your letter of April 18, 1940, advising that, in accordance with conversations between representatives of the Board and members of your staff, the Securities and Exchange Commission is prepared to recommend to the subcommittee of the Banking and Currency Committee of the Senate, before which hearings are being held on the investment-company bill, S. 3580, that the bill be amended in certain respects in order to avoid additional duplication of supervision by Federal agencies of banks and holding-company affiliates of banks.

The Board considers appropriate the suggestion that holding-company affiliates of member banks which obtain and hold voting permits issued by the Reserve Board under the provisions of the Banking Act of 1933 and which are primarily engaged in the business of holding the stock of and managing or controlling banks be exempted from the provisions of the proposed Investment Company Act, since these companies are subject to examination and supervision by the Reserve Board.

As you know, from the information which has been submitted to representatives of your Commission during the conferences which have been held with members of the Board's staff, there are a number of holding-company affiliates of member banks which now hold voting permits issued by the Reserve Board. When it granted these permits, the Board, pursuant to authority given in the statute, in effect determined that such companies were engaged as a business in holding bank stocks and managing and controlling banks. If the Board should be required to make a determination in these cases, it would, on the facts now in its possession, determine that they are primarily engaged in the business of holding bank stocks and managing and controlling banks. Accordingly, the Board feels that it would involve unnecessary consumption of time and expense, both to the Federal Government and the holding-company affiliates, and would not serve any useful purpose, for such a determination to be made in each of these cases. For these reasons, the Board suggests that these holding companies, a list of which has been furnished to your staff, which now hold voting permits and are therefore under supervision and examination by the Board be exempted from the provisions of the proposed investment company act by the terms of the act itself. The Board believes that such an exemption would be in conformity with the suggested principle under which only companies which hold voting permits and are primarily engaged in holding the stock of and managing or controlling banks would be exempted from the provisions of the proposed investment company act. (In addition to the holding-company affiliates to which reference is made above, there are a few banks which control other banks and hold voting permits issued by the Board. However, these are already exempted from the provisions of the bill under exceptions relating to banks.) In order to accomplish the exemption which the Board has in mind, it is suggested that section 3 (c) of the bill S. 3580, be amended by adding an additional paragraph as follows:

"Any holding company affiliate, as defined in the Banking Act of 1933, which is under the supervision of the Board of Governors of the Federal Reserve System by reason of the fact that such holding company affiliate holds a general voting permit issued to it by such Board prior to January 1, 1940; and any holding company affiliate which is under such supervision by reason of the fact that it holds a general voting permit thereafter issued to it by the Board of Governors and which is determined by such Board to be primarily engaged, directly or indirectly, in the business of holding the stock of, and managing or controlling, banks, banking associations, savings banks, or trust companies. The Commission shall be given appropriate notice prior to any such determination and shall be entitled to be heard."

You will observe that under this proposed amendment any holding-company affiliate of a member bank which hereafter desires to obtain a voting permit from the Reserve Board and be exempted from the provisions of the Investment Company Act must, after your Commission has had an opportunity to be heard, be affirmatively determined by the Board to be engaged primarily in the business of holding stock of and managing or controlling banks. It is believed that this procedure would effectively prevent evasion of the Investment Company Act by investment companies which might attempt to evade it by using a relatively small portion of their assets to acquire control of two or three banks.

It is understood from your letter that the Commission will recommend such amendment as may be necessary to exempt from the "investment adviser"

provisions of the bill those holding company affiliates which are exempted from the provisions of the bill relating to investment companies. It is also understood that the Commission will recommend that an appropriate amendment be made to section 26 (a) of the bill to make it clear that at least in the case of any trustee which is a member bank of the Federal Reserve System the statement of the trustee's combined capital and surplus in its most recent published report of condition shall be conclusive.

As representatives of your Commission were advised by members of the Board's staff, the Board has felt for some time that the statutes relating to the supervision of holding company affiliates of member banks should be strengthened. The Board feels that it would be more appropriate to consider these matters in connection with a broad investigation of banking and credit matters such as that which the Banking and Currency Committee of the Senate has been authorized to undertake under the provisions of Senate Resolution 125.

The Board and its staff appreciate the cooperation of the representatives of your Commission in working out this problem.

Very truly yours,

CHESTER MORRILL, *Secretary*

SECURITIES AND EXCHANGE COMMISSION,
WASHINGTON, *April 20, 1940.*

Re Investment Company bill (S. 3580).

Hon. CHESTER MORRILL,
Secretary, Board of Governors of the Federal Reserve System,
Washington, D. C.

DEAR SIR: This will acknowledge receipt of your letter of April 19, 1940, regarding the above bill.

The Commission understands from your letter that, if the Board were now required to determine whether those holding company affiliates referred to therein, which hold general voting permits issued by the Board prior to January 1, 1940, are primarily engaged in the business of holding bank stocks and managing and controlling banks, the Board would make an affirmative determination with respect to each of such holding-company affiliates.

From information which the Board has made available to the Commission, it appears that the bank-holding company affiliates referred to in your letter are the following: BancOhio Corporation; Bank Shares Corporation; Barnett National Securities Corporation; Citizens & Southern Holding Co.; First Bank Stock Corporation; First Security Corporation of Ogden; Florida National Group, Inc.; Marine Bancorporation; Marine Midland Corporation; New Hampshire Bankshares, Inc.; Northwest Bancorporation; Old Colony Trust Associates; Shawmut Association; Transamerica Corporation; Trust Co. of Georgia Association; Trustees, First National Bank, etc.; Union Bond & Mortgage Co.; United States National Corporation; Wisconsin Bankshares Corporation.

In view of certain financial information regarding these companies (which the Board has made available to the Commission in confidence), the Commission, with two possible exceptions hereinafter referred to, readily accepts the Board's conclusion that these holding-company affiliates are primarily engaged in the business of holding bank stocks and managing and controlling banks.

The two possible exceptions to which reference has been made are Transamerica Corporation and Shawmut Association. It is understood that, as of December 31, 1939, the former company had approximately 40 percent of its assets invested in stocks of banks which it controls, and that approximately one-third of its assets consisted of securities of nonbanking subsidiaries, most of which were wholly-owned and operated almost exclusively as adjuncts or virtual departments of controlled banks. Shawmut Association, as of the same date, had approximately one-fourth of its assets invested in stocks of a number of banks; such investment was equal to approximately one-third of its investment in stocks of other corporations; and the total assets of banks controlled by Shawmut Association, consisting substantially of investment securities which are under the control and management of the Association, aggregated several times as much as the amount of its investment in stocks of nonbanking corporations. The Commission recognizes that, despite the fact that a considerable portion of the assets of these two companies is invested in securities other than those of controlled banks, various other factors may properly be considered in determining

whether they are companies primarily engaged in the business of holding bank stocks and managing and controlling banks. In view of the Board's familiarity with the operations of both of these companies, it is felt that it is appropriate for the Commission to accept the Board's judgment in this matter.

Accordingly, the Commission will recommend to the subcommittee of the Banking and Currency Committee of the Senate before which hearings on the above bill are now being held that the bill be amended as suggested in your letter. The proposed wording of the amendment is likewise agreeable to the Commission.

Very truly yours,

ROBERT E. HEALY,
Commissioner.

Mr. SCHENKER. Senator, with respect to that correspondence, this point is involved: There are certain companies which hold stocks of banks. For instance, take one of the Shawmut trusts: It has 20 percent of its assets consisting of majority holdings of a number of banks, and 80 percent of its assets consist of diversified securities. That investment company has qualified for a voting permit as a bank-holding company and, therefore, had to enter into an agreement with the Federal Reserve Board with reference to its supervision of its activities. That is one extreme example.

On the other extreme you have the Transamerica Co., out on the coast, which has a great deal of its assets in banks but which does not own a majority of the outstanding; it owns only 40 percent of the Transamerica Bank. However, it has qualified as a bank-holding company, with a voting permit, with the Federal Reserve Board.

Our purpose by this exchange of letters is to make it clear for the record that these are two situations which exist, that you have the problem, When is it a bank-holding company and when is it an investment company?

We want specifically to call attention to the fact that if bank-holding companies are exempt, that exempts the type of situation such as Transamerica and exempts the Shawmut situations.

With respect to this matter of auditors, Senator, may I say just one word: We have made an analysis of many thousands of auditors' certificates. The fact of the matter is that we took 76 companies and analyzed every certificate that the auditors issued, and we found this—you talk about limited scope of audit: In 50 percent of the cases there was no disclosure as to whether or not the auditor checked the physical custody of the securities—which constitute the only asset the investment trust has.

To indicate what can happen, just consider the C. D. Parker Co. case: The securities were in the custody of the manager and sponsor, C. D. Parker. The auditor testified to the effect that when asking about the custody of the securities, he accepted from the manager the statement that he had the custody of the securities—when as a matter of fact the manager had hypothecated those securities with a bank for a personal loan; and when the company went broke, the investment trust lost its securities.

The purport of that provision, Senator, as I visualize it and as I think the Commission visualizes it, is to set down some minimum requirements regarding what these people should do—to say, "You have got to check the physical custody of the securities," and so forth.

However, the accounting profession, as they appeared here, stated they had no difficulty with any of the other provisions, and they thought that they were analogous to lawyers; and they did not like the idea that anybody was going to tell them how to conduct their business, just as you would be telling a lawyer how to prepare his case.

However, as Judge Healy indicated, we are still talking to them; and I think we can work out that problem.

The thing that persuaded us to put in that provision was the essential fact, "Do you have the physical custody of the securities, which are your only assets, or don't you have it?"

Yet, in 50 percent of the cases, there was no disclosure. I am not saying that in 50 percent of the cases it was not done. In many cases there was the specific statement that he checked with the company or that he got a certificate from the trust company which had custody of the securities; but in 50 percent of the cases there was no specific examination by the auditor.

FURTHER STATEMENT OF ROBERT E. HEALY, MEMBER OF THE BOARD OF COMMISSIONERS, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. I think that I may be under some obligation to say a word on the subject of dividends. As I stated when I first spoke before this committee, I am not in sympathy with the provision on the subject of dividends, that appears in this bill. My brother Commissioners know that, and they have said that it is entirely agreeable to them that I should come here and say what I want to say on that subject. I shall try to be brief about it.

I do not believe, myself, that you can in a statute prescribe a rule on the subject of dividends that will apply to all these various types of trust companies. I think you have got to make differences and distinctions, because there are differences between them. That is one part of my trouble. The next part of my difficulty is that I have a constitutional prejudice, I guess, against the payment of dividends out of capital. We often hear how desirable it is to maintain the record of dividends and how hard it is on the preferred stockholders not to do so; and, of course, I have to agree to all that. Yet, the preferred stockholder has no right to dividends unless they are earned; as a general rule, I think that is the contract: he has a preference on the earnings.

So I have some trouble with all of these situations where the capital contributed by common stockholders or the capital contributed by the preferred stockholders, themselves, is returned to them in the form of dividends.

With 48 States grinding out all the different kinds of laws on the subject of corporations, and with each one trying to outdo the other as to what safeguards can be let down—and it seems to me that is just about the kind of race that we have had, at least in some places—you get some results that are rather startling. I saw a case the other day, that was not an investment trust, where there was a preferred stock which in case of liquidation was to be paid off at $100. It had a $5 dividend rate. Its par value was $1.

We have seen case after case, some of them among investment trusts, where you get this situation: You buy a share of stock—let us

say, common stock—for $30 and under the laws of the State the directors have the right to divide that $30 between the capital stock account and the capital surplus account, just as they please. In many instances the stockholders do not know that; and $25 of your $30 capital contribution may go into a capital surplus account, which of course is a capital account and does not represent earnings; it represents contributed capital. Sometimes it is there available for dividends. I am not sure that it is entirely fair to the common stockholder to use his capital in that manner.

When we turn to the case of the open-end investment trust, it seems to me that every time an open-end trust redeems a share of stock, it is returning to the shareholder his capital contribution at its worth at the time of redemption—either appreciated or depreciated. That immediately raises serious problems as between that common stockholder whose shares are redeemed and the senior security holders, if there are any.

Fortunately, and I think very wisely, a very large percentage of the open-enders have recognized the difficulties and, perhaps, the lack of wisdom of having senior securities in these open-end companies; and the result is that you have less than 6 percent of the open-end industry which have more than one class of stock.

However, when you have, let us say, common stock and debentures or notes, I think a serious question of law arises as to the rights of the debenture holders or creditors, when you turn back to a stockholder his capital contribution. You can hark back to Justice Story's opinion, in 1824, in Wood versus Dummer, when he was in the Supreme Court of Maine. The reasoning of that decision has often been questioned, but very seldom does anyone question that in essence many of these payments are against the rights of the creditors. Likewise, if you have preferred stockholders, very difficult questions arise when you make a capital distribution to common stockholders, and the preferred stockholder still sits there.

Incidentally, since this seems to be a chance to say it, let me state that whatever this committee decides to do with respect to the subject of future senior securities, I beg of you not to permit the open-end trusts to have any more senior securities. It gets them into all kinds of difficulties about accounting. For example, you buy a share in an open-end trust for $30, and a few days later you redeem it for $25, if that is the value, or you redeem it for $35. In one case the trust gives you $5 more than you put in, and in the other case $5 less. I have seen at least three different methods of accounting for that kind of situation, all carried on by different open-enders; and I have to be honest enough to say that I do not know which one is right. I have never talked to anybody who seemed to have a good answer or a good prescription as to how that thing ought to be handled in the accounts.

Senator TAFT. The open-end trust really differs from the whole basic idea of corporations, as we have understood in the past.

Mr. HEALY. It does; yes, sir.

Senator TAFT. Except it is very similar to the building and loan association shares which we have in Ohio, which have the same result; and it really requires almost as completely different kinds of rules for incorporation and for dividends.

Mr. HEALY. That is right—and for accounting, I think.

Senator TAFT. Yes; and for accounting.

Mr. HEALY. That is, I suspect that; I do not know.

Senator TAFT. Yes.

Mr. HEALY. However, if you have only one class of stock——

Senator TAFT (interposing). And the theory that the capital cannot be impaired is washed out completely in that kind of situation.

Mr. HEALY. Well, you return capital to the shareholder every time you redeem his share.

If you have only one class of stock, possibly you can get along with that situation without much trouble, if everybody understands it and agrees to it; and possibly the question of dividends does not become so important, because you redeem the share at its market value or its value at the time of redemption, which will reflect market value and any accumulated earnings.

Senator TAFT. The only law regarding dividends that would seem to be wise would be that you could not declare dividends except out of earnings, so far as open-end companies are concerned.

Mr. HEALY. That might be too strict a rule for open-end companies with only one class of securities.

Senator TAFT. Why?

Mr. HEALY. I could stand it, but I think the industry might make a good deal of objection to it, on these grounds: that if you have only one class of stock, you are treating everybody more or less alike. If I come in and want to redeem my share, the value at which my share is redeemed will reflect the market value of my share of the portfolio, and it will also reflect any gains or losses that may have taken place.

However, all I can hope to accomplish by what I say is, not to make a good answer, but to demonstrate that the accounting problems and the senior-securities problem and the dividend problem in the open-end trust may be wholly different things from such problems as applied to other types of companies; and these problems may vary even inside open-end companies, when the open-end company has senior securities. If I had my way, I would not permit an open-end company to pay any dividends out of capital while there were senior securities outstanding.

Now may I speak of something else that bothers me, under this dividend provision that is here before us? You have a provision to the effect that if you pay a dividend on a class of securities, you have to maintain a certain asset coverage for the securities above it. I do not remember the figures; but it could work out in this way: Suppose you had a corporation, 60 percent of whose capital was raised by debentures or notes and 40 percent by common stock. You go along for a period of time, and there is absolutely no impairment of the capital. The company accumulates some earnings; but it is not permitted, by these proposed provisions, to pay out those earnings to the common stock, in the form of dividends, although there is no impairment of capital; because before you can pay it out, you have got to increase the asset coverage for the senior securities to a point that is better than the original 60–40.

I am not sure that that is fair to the common-stock holders who went into that situation.

Another point that bothers me in connection with this is the provision for improving or maintaining asset coverage as to senior securities. It does not work in this kind of a situation. Suppose

you have only common stock and preferred stock. You pay a dividend on the preferred stock. There is nothing senior to the preferred stock; therefore there is no asset coverage ratio to maintain.

In that situation there is nothing in this bill that prevents the payment of dividends on the preferred stock out of capital contributed either by the common-stock holder or the preferred-stock holder himself.

Senator TAFT. Are there any provisions in any State law as to any kind of a corporation in which the power to declare dividends is limited on common stock if earned?

Mr. HEALY. Yes, sir.

Senator TAFT. There is some provision that banks have to set aside a certain amount of surplus.

Mr. HEALY. In my native State I think it is the law, unless they have changed it since I left there, that if you pay dividends out of capital; you are subject to fine and imprisonment.

Senator TAFT. I do not mean that.

Mr. HEALY. Oh. I beg your pardon.

Senator TAFT. Is there any provision that limits your right other than by saying that you must have an extra coverage or an extra supply of securities?

Mr. HEALY. I do not remember running across anything of that sort.

Senator TAFT. This strikes me as a novel provision not only for investment trusts but for any kind of a corporation.

Mr. HEALY. We had quite a difference of opinion among the Commissioners, and we discussed this at some length, and I was very much prejudiced against the payment of dividends out of capital.

Senator TAFT. So am I, a hundred percent.

Mr. HEALY. My brother Commissioners thought I was taking too harsh an attitude, and they tried to devise something that would ease off that situation. I am a little fearful that in trying to ease it off they may have made it a little worse. If you asked me to write a provision for all of these corporations, I do not know whether I could do it nor not. It would be a very difficult task. Whether you want to try to put it into this bill, whether you want to handle it as part of the general accounting problem, or whether you want to commit it to the Commission to be carried out in conformity with some definite standard that this committee can write, is a thing that you will have to answer.

Senator TAFT. Mr. Chairman, I will have to leave.

Mr. SCHENKER. On the question of whether there is any analogous situation, the fact of the matter is that every good preferred stock will have a provision that you cannot pay any dividends unless there is a certain——

Senator TAFT (interposing). Why not leave it to them? They have all kinds of fancy provisions. In some they don't and in some they do. I do not think it makes much difference. I cannot see why you cannot leave it to them to decide it. I would not want to express any final opinion about it at this time, because I have not studied it enough.

(Senator Taft withdrew from the hearing room.)

Mr. HEALY. From my discussion I would not want to have it understood that I think the payment of capital gains which have been

reduced by unrealized depreciation is a distribution of capital. It is not necessarily that.

I have one or two other things in my mind that I would like to present. I would like to put in my "two cents' worth" along the same line that Senator Taft spoke; that is, if this Commission is not going to be allowed to have some real power with regard to accounting, it is better to tear the bill up. Accounting is at the heart of the whole thing. I do not think that accounting should be put into a strait jacket and not be allowed to grow and improve and expand or anything of the sort. You can very easily harm the situation by casting accounting standards into too rigid a mold. Improvement comes in this field as time goes on. I think, however, it is necessary to have some real regulation as to accounting. That was Mr. Bailie's recommendation, and I think he was perfectly right about it.

Now I would like, if the committee please, to turn to section 13 for just a moment.

Senator HUGHES. Before you do that, Judge, let me say that I am somewhat concerned about how far the bill should go. If it goes only part of the way and a general impression goes out to the country and to the people who do business with these companies that the Government has control over them and is regulating and safeguarding them, and so forth, it gives a wrong impression.

Mr. HEALY. That is, if you get a half-way bill?

Senator HUGHES. If it is not effective, it is going to be misleading. Probably we had better not do anything at all if we are going to have something that is misleading to the investors.

Mr. HEALY. I think you are right.

Senator HUGHES. I mean, we do not want some half-way measure.

Mr. HEALY. Yes. I think there should be reasonably pervasive regulation.

In discussing section 13 I am not going to try to defend language. I am going to do what I did yesterday—to try to show the committee why the provision was put in, and I shall undertake to prove that it was based, as some of these other provisions were, on some actual experiences that we have had over the last couple of years in administering statutes.

Subsection (b) of section 13 provides that no registered investment company shall change any fundamental investment or management policy unless each such change is authorized by the vote of a majority of its outstanding voting securities.

Then follows the provision that we can designate those things that are fundamental and that we shall give due weight to certain items that are enumerated.

I do not remember, of course, what all the witnesses said about this, but there were some witnesses at least who approved the first sentence of section 13 (b), but thought that the Commission ought not to have the power of defining.

Of course that power of defining that is given there is not, in my opinion, a legislative rule-making power. It is an interpretative power.

I do not intend to battle for it. If the industry and the committee think it ought to go out, it is perfectly all right with me. But let me tell you why it was put in.