Lord, Abbett & Co., the sponsor of Affiliated Fund, Inc., is the distribution of investment-trust securities—mainly the debentures and common shares of Affiliated Fund, Inc.—and that "the bill as drawn prohibits us from the future sales of debentures." Mr. Lord suggests the fear that the sale of the common stock of Affiliated Fund, Inc., also, will be terminated because investors will not buy common stock upon which dividends cannot be paid in the absence of a 300 percent coverage for the debentures; and the debentures of Affiliated Fund, Inc. are not covered to that extent. To the inquiry of a member of the subcommittee as to whether Affiliated Fund, Inc. could not liquidate the debentures and issue only common stock, Mr. Lord replied that his company would then be no different in capital structure from several other large and successful open-end "mutual companies," better established and with better records than Affiliated Fund, Inc.; and that, without the attractive characteristics of leverage, he would find it difficult to sell Affiliated Fund, Inc. common stock in competition with these companies.

It is, of course, regrettable that, in seeking to place the investment industry on an economically sounder foundation and to make its administration more responsive to the expectations and needs of the small investor, legislation should create practical problems for sponsors of investment companies. It cannot, however, be seriously contended that such features of capital structure and such practices as long-term borrowing, which have proved themselves a menace to the investor, should be preserved because they are helpful to sponsors in merchandising investment-company securities. Mr. Lord testified that the present coverage of the debentures in Affiliated Fund, Inc. was approximately 240 percent. Perhaps the "rubber" in the proposed bill, which Mr. Myers severely criticized, may come to the aid of Affiliated Fund, Inc. The Commission might perhaps find—in view of the unusual safeguards with which the charter and trust indenture have voluntarily surrounded the debentures, such as the yield index and the redemption privilege of the debentures—that the payment of dividends to common stock with a 200 percent debenture coverage would not constitute an injury to the debenture holders.

It appears from the testimony of Mr. Myers and Mr. Lord that the continuous marketing of investment company securities, either debentures or common stock, is a primary objective of Lord, Abbett & Co., Inc., and that the common stock of the leverage company sponsored by it has not performed nearly as well as the common stock of the "mutual" open-end companies. The continued issuance of both debentures and common stock is apparently the objective of Affiliated Fund, Inc., as "leverage" is the particular feature of this open-end company which it can profitably publicize in its sales efforts. But it is this very element of "leverage" which exposes the common stock to such dangers and hazards as to make it unsuitable as an investment vehicle for the small investor.

The witnesses representing Affiliated Fund, Inc., point to safeguards in behalf of the debentures to distinguish that company from other leverage companies. Nevertheless, major intrinsic defects of the leverage structure, heretofore pointed out, are to be found in Affiliated Fund, Inc.

As in the vast majority of leverage companies, the rate of the net regular income of Affiliated Fund, Inc., has been lower than the cost of hire of the senior capital. The ratios of net regular income to average assets for the last three years have been: 1937, 2.99 percent; 1938, 1.39 percent; and 1939, 2.66 percent. The ratio of interest payable on the debentures until October 19, 1939, was 5 percent on a $6,000,000 issue and 4½ percent on a $2,000,000 issue. On October 19, 1939, the 5-percent issue was refunded by a 4-percent issue and on January 31, 1940, an additional $1,761,000 of 4-percent debentures was issued, bringing the total debentures to $10,000,000, consisting of $8,000,000, on which 4 percent interest is payable and $2,000,000 on which 4½ percent interest is payable.

Mr. Lord urges that "many important corporations employ senior capital for the benefit of the equity holder." That, of course, visualizes the case of industrial companies which cause the borrowed capital to produce a higher rate of return than the cost of the borrowed capital. In Affiliated Fund, Inc., as in other leverage investment companies, the common-stock capital has to be put to work to make up the deficit in earning capacity of the borrowed capital.[16]

[16] It has been shown in the hearings before the committee that many leverage investment companies have failed to earn the amount of fixed charges by the use of the entire fund, both the senior and junior capital.

Under such circumstances it would be fairer to say that investment companies are compelled to employ their equity capital for the maintenance of the senior securities. In other words, the common-stock holder of the leverage company must yield part or all of the earnings on his contribution to capital to pay the prior charges on the senior securities.

The witnesses representing Affiliated Fund, Inc., conceded that that company had to borrow from paid-in surplus in order to pay a 6-cent quarterly dividend on the common stock in July 1939. The amount borrowed from paid-in surplus was restored by the end of the year by realized capital gains. A member of the Committee summed up the situation in the statement: "If you guess right, it's all right, of course."

The lack of investment quality characterizes the common stock of open-end leverage investment companies as well as that of closed-end leverage investment companies. The contributor to the open-end fund can easily be impressed by the representation that the senior capital is working for him; he can less easily be expected to realize that most of the time his capital is sustaining the senior charges and that upon any substantial market oscillation his investment will be vitally impaired or entirely swept away.

Mr. L. M. C. SMITH. I should like to point out to you a fact that we had not emphasized: That all these exchanges Mr. Schenker spoke of are primarily related to senior security companies. Everywhere you move you get into conflicts when you get into senior securities. You have many conflicts of interest. Even when you get down to the situation of no more than a third of senior securities which Senator Taft suggested, the same conflicts exist. You have to take care of your voting rights, the further issuance of senior securities and you have to enlarge all your dividend protective provisions. Soon you will have something that is comparable to the 10 or 15 or 20 pages that they write when they have a preferred stock indenture or, provisions in the charter.

Senator HUGHES. In submitting these long statements for the record, I think we had better reserve the right to place in the record what we think should go in—at some meeting when we have more members present.

Mr. SCHENKER. Senator, just two things: There were quotations, by some members of the industry, from the Christian Science Monitor. We should like to introduce an editorial which appeared in that paper with respect to the investment trust bill.

(The editorial from the Christian Science Monitor, Boston, Mass., dated March 20, 1940, is as follows:)

AN INVESTMENT TRUST BILL

The coming hearings on the Wagner-Lea bill for regulation of investment trusts should prove a workshop for the hammering out of a highly useful regulatory law. It is not to the point to say that regulation of investment trusts now is merely locking the door after the horse wandered away. Not only are new kinds of investment trusts constantly being invented and sold to the public, but another cycle might produce something like the growth of investment trusts with assets of $7,000,000,000 in the twenties which subsequently shrunk to $3,000,000,000. Progressive investment trust managers have no quarrel with the establishment of legislative standards which will prevent less scrupulous persons from capitalizing on the record of the better-run trusts.

The Securities and Exchange Commission has made a thorough preliminary investigation, taking over 4 years, during which the problem itself was in process of change. It has refrained, in the bill before Congress, from repeating the "death sentence" imposed on the utility holding companies. It has consulted with the investment trust leaders before sumbitting its bill, and is making no effort to high-pressure the bill through Congress.

There will therefore be proper time allowed for consideration of the bill. It should be examined not only to see that investors will be protected, but also to make sure that the burden of new rules and regulations imposed on invest-

ment trusts is not excessive. The bill should be scrutinized to see that dangerous discretionary powers are not granted to the Securities and Exchange Commission, and that the drafters have not capitalized on the misfortunes of the early thirties to introduce punitive legislation into the bill in the guise of preventive measures.

Mr. SCHENKER. I should also like to have introduced into the record an editorial that appeared on April 17, 1940—that is, after these hearings were started. I think you might like this, Senator. This is from the Springfield (Mass.) Republican; and I just want to read two sentences, to show the way in which it begins (reading):

If it is the last thing it ever does in the direction of reform, the New Deal should bring investment trusts under Federal regulation. For the night is coming. It seems remarkable that definite action has been so long delayed, in view of the scandalous history of so many of the buccaneer trusts in the period that culminated in the collapse of speculation a decade ago.

The Securities and Exchange Commission, however, was first created and its exhaustive reports concerning investment trusts, or companies, of various types, have been slow in reaching Congress. Based on them is the Wagner bill for the regulation of the trusts, which is now the subject of hearings before the Senate banking and currency committee.

Then it goes on to discuss our reports and to discuss the nature of the bill; and as I read this editorial, it says it is a very moderate bill. Then it goes on to conclude as follows:

The Wagner bill, as has been said, seeks to give the small investor in trust shares a minimum of protection. To that end the bill reasonably requires that an investment company keep its shareholders fully informed as to its investment policies; that the company's size have maximum limits; that the salaries of managers be given full publicity; that there be periodical reports; that the Securities and Exchange Commission prescribe uniform accounting and auditing methods and examine the company's books.

A bill substantially along these lines ought to become law at the present session.

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The Securities and Exchange Commission, however, was first created and its exhaustive reports concerning investment trusts, or companies, of various types, have been slow in reaching Congress. Based on them is the Wagner bill for the regulation of the trusts, which is now the subject of hearings before the Senate Banking and Currency Committee. Critics and opponents of the bill are being patiently heard. Some of them, like one trust executive from New York City, tells the committee that investment companies might "better go out of business" than attempt to operate under the regulation proposed.

Perhaps that would be the best solution, if no middle ground of regulation can be found. The investment trust, or company, is a comparatively new piece of machinery in the field of private investment. The flow of private investment capital went on substantially without its aid until after the World War. But nothing drastic, nothing killing, is embodied in the Wagner bill. It is even so moderate that its chief reforms would apply only to trusts hereafter organized. The worst abuses are doubtless in the past; yet some of them, according to the Securities and Exchange Commission, date since 1933. That they require looking after is seen in the fact that since 1933, also, nearly 2½ billions of capital investment-company issues have been registered with the Securities and Exchange Commission, indicating that the going is not so bad even in these times.

The Wagner bill is based on the proper theory that the investment trust is intended to serve the small investor, who has neither the opportunities nor

the special knowledge nor the capital necessary to make him expert in investing his savings in the securities market. Actually many of these trusts have been managed for the enrichment of their sponsors and managers, who have often prospered on rascality while their stockholders have gone broke.

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A bill substantially along these lines ought to become law at the present session.

Mr. SCHENKER. I just want to add one word, Senator: I have been in rather close contact with this whole investment company situation, and I think if there is going to be legislation, it ought to be done pretty expeditiously because, in my opinion—and I do not want to appear to be a Calamity Jane—if you do not have legislation, you are going to have difficulty. Our study is over. We can no longer even ask a person to come down and talk to us. With the state of securities selling at discount, I honestly feel that there is going to be difficulty, and I honestly feel that the industry may be injured without regulation. That is why we feel the legislation ought to be passed this session.

Senator HUGHES (presiding). Has the Commission closed?

Mr. HEALY. Yes.

Mr. SCHENKER. Yes; I am through.

Senator HUGHES (presiding). Of course, you are allowed the right to introduce such statements as you may see fit by, we shall say, Tuesday.

Mr. HEALY. No, Senator; Mr. Schenker has finished, but I want to say something; and then Mr. Hollands wants to say something; and then we shall conclude our presentation very briefly.

Senator HUGHES (presiding). However, I shall make that statement now: That until Tuesday of next week, anyone having a statement that is reasonably admissible into the record will be permitted to submit it. Of course, we cannot let these statements occupy an indefinite amount of space, as you all understand. However, with that limitation, up until next Tuesday we shall receive any such statements; and that privilege is extended to all parties.

FURTHER STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. May I proceed, Senator?

Senator HUGHES (presiding). Yes, certainly.

Mr. HEALY. I want to say a few words on the subject of the provisions of the act giving the Commission the power to bring about an equitable redistribution of voting rights. It is stated that that is somewhat a novel proposition and proposal—and it is. It is not completely novel, because a provision almost exactly like it is in the Holding Company Act of 1935, on which the present pending provision is modeled.

I do not for a minute believe that we should have a statute here which permits anybody to turn the voting control of a corporation over to the preferred-stock holders merely because the preferred stock

happens at a particular moment to be under water, or merely because the dividends have been passed, let us say, for one period or for a year.

On the other hand, I should like to call the committee's attention to this kind of a situation: You have corporations which have no debt; there is no default in debt or in the payment of interest, and therefore the company cannot be put into bankruptcy or into reorganization under the Chandler Act—the successor of 77B. Yet in those cases the preferred stock has not had a dividend for 5, 6, 7, or 8 years, and the preferred-stock holder is completely helpless. The common stock, which has no actual value, is in complete control of the situation; and the preferred-stock holder, in that predicament, is probably the most completely helpless type of security holder that there is in the United States.

Now, again I will make no plea for the language that is in the bill in this respect. If this language is not satisfactory, then I should like to suggest that the committee consider a provision of some such character as this: That after dividends have been in arrears for a certain length of time, the preferred-stock holders, voting as a class, can elect X percentage of the board of directors. If the dividends have been in arrears or are in arrears for an additional period of X years, then the preferred-stock holders should be given the right to elect a majority of the board of directors.

You might have a comparable provision wherein the preferred stock has been under water for a stated length of time. You might put an additional safeguard by providing that the control of the board of directors should not be turned over while the common stock can demonstrate that there is a fair chance or a reasonable chance that the dividends can be resumed and the arrearages cured.

In that connection I should like to comment upon the statement made by some witness whose name I do not now recall.

Senator HUGHES. To whom are they to demonstate that?

Mr. HEALY. That could be demonstrated to the Commission according to a standard written into the act, with the right of court review.

Senator HUGHES. Yes.

Mr. HEALY. The expression on which I should like to comment and the evidence with respect to which I should like to speak was something to this effect—I do not remember who said it, but some witness appearing for the industry said that the words "fair and equitable," appearing in this statute in connection with reorganizations, constitute an indefinite standard. I should like to point out that in a long line of cases decided by the Supreme Court of the United States, culminating in the *Los Angeles Lumber case*, the Court has held that the words "fair and equitable," as used in the Chandler Act and as used in equity reorganizations before 77B, were words of art and had a definite legal meaning, and that definite legal meaning was surveyed and stated in the *Los Angeles case;* and if we have got anywhere in this act words whose definite legal meaning is established by a long line of judicial decisions, they are those words "fair and equitable."

Mr. HEALY. Senator, Mr. Hollands would like to say a few words at this time.

Senator HUGHES (presiding). Very well. Please proceed, Mr. Hollands.

FURTHER STATEMENT OF JOHN H. HOLLANDS, ATTORNEY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HOLLANDS. Senator, I should like to take about 1 or 2 minutes to speak about section 36 (a). That section reads as follows:

SEC. 36 (a). The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it finds necessary or appropriate to carry out the provisions of this title, including rules and regulations defining—

And so forth. The rest of the subsection enumerates certain specific matters.

A good deal of the testimony presented by representatives of the industry has given the impression that the bill consists of an itemization of problems, with a provision for rules, regulations, and orders tied to its tail.

I think that, upon examination of the bill, it will be found to be much more discriminating in choosing the subjects with respect to which so-called administrative discretion is granted and with respect to which it is not.

The high point of the industry's testimony in regard to the subject of discretion has largely centered around section 36 (a). Mr. Bellamy, who is associated with National Bond & Share Corporation, introduced into the record a few days ago a copy of a letter which his company sent to its stockholders. In analyzing the bill in that letter, there appears the following statement, after a sentence running six or seven lines, which describes various specific matters dealt with in the bill. The sentence to which I have referred reads as follows:

In addition and over and above all, the bill provides that the Securities and Exchange Commission from time to time may prescribe such rules and regulations within the provisions of the bill as the Commission may deem necessary or appropriate. In other words, in addition to its specific provisions, the bill vests in the Securities and Exchange Commission a continuing supervision not only of the management of investment companies but of substantially every phase of activity in which such companies may engage.

I do not want to go into a detailed discussion of what the words in section 36 (a) mean. It seems to me that the words of the section are fairly clear.

What is more important, I believe, is that substantially identical provisions appear in section 19 (a) of the Securities Act of 1933, section 23 (a) of the Securities Exchange Act of 1934, section 20 (a) of the Public Utility Holding Company Act of 1935, and section 319 (a) of the Trust Indenture Act of 1939.

The Trust Indenture Act was before this committee at the last session of Congress.

In the committee reports, this committee pointed out that in that bill—which I may say, parenthetically, deals with a very different problem from the problem we have here—an attempt had been made to cut down administrative discretion to the absolute practical minimum; yet that bill contains a provision that is virtually identical with section 36 (a) of this bill.

What is more, when the trust-indenture bill reached the House, the Interstate and Foreign Commerce Committee apparently determined to cut down still further what little administrative discretion there was in the bill, and the report of the Interstate and Foreign Commerce

Committee states that they had absolutely eliminated administrative discretion; yet, the Trust Indenture Act contains a provision that is virtually identical with section 36 (a).

In other words, as Judge Healy said when we were presenting our affirmative case, and as Mr. White, I believe, noted in his testimony—though in a somewhat skeptical tone—this section does not give substantive powers; it is there for purely procedural purposes, to implement the other provisions that are in the bill.

May I give the citations for those references to the committee reports? Senate Report 248, page 2; House Report No. 1016, page 30—both of the Seventy-sixth Congress, first session.

Thank you.

FURTHER STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. HEALY. Now, Senator, with your permission, I should like to resume.

Senator HUGHES (presiding). Very well, Mr. Healy.

Mr. HEALY. Senators, this is the last speech that you will hear from anyone representing the Securities and Exchange Commission on the subject of this bill. There are two or three things left about which I should like to speak.

First, I should like to say that the principal reason why the bill is as complicated as it is is due to the fact that it is to a large extent a series of compromises on various topics where, instead of—for example—having a complete segregation of investment bankers or commercial bankers or brokers, an attempt was made to permit it and then to circumscribe it. Compromises of that character necessarily led to complicated provisions.

The second point that I wish to make arises in connection with some statements that have been made regarding the time taken in the investigation. I had the interesting experience, once, of appearing before either this committee or the House Committee on Interstate and Foreign Commerce, in connection with the Holding Company Act, where the Federal Trade Commission had conducted an investigation of holding companies, and the investigation had lasted practically 6 years; and I heard the industry's representatives stand up before the committee and say that no bill ought to be passed until there had been a thorough investigation of the holding-company problem.

I believe that these investigations have to be thorough in order to meet the expert ability of the people in the industry and in order to satisfy the committees of Congress.

In that same connection I should like to point out, in fairness to my associate, Mr. Schenker, that whereas at the beginning of this study he was given one job to do, after Dr. Gourrich resigned—Dr. Gourrich had been in charge of the study and had formerly been head of the research department of Kuhn, Loeb & Co. for many years, and was an outstanding man in that line—and after we had the misfortune to lose Bill Spratt, through death, Mr. Schenker had the task of doing three jobs instead of one, including the writing of this final report.

I should like to refer as briefly as possible to this matter of discretion. When I listened to some of the statements made here, I thought for a moment that I was hearing people say that there ought to be flexibility in this bill and that there ought to be no discretion lodged with the Commission. Of course, that is an impossibility. However, upon rereading some of the testimony, I realized that that was not the fact. I am speaking from memory, so far as Mr. Quinn's testimony is concerned; but my memory is that he said there should be no discretion in the Commission except in accordance with well-settled and well-written, clearly-defined statutory standards.

If I am wrong about that, I hope Mr. Quinn will correct me.

I agree completely with that position. I should like to repeat what I said before: That undefined and unfettered discretion is not consistent with the American principle of the supremacy of law; and, furthermore, if you gave it to us, it would not be any good, because it would be invalid.

The statement has been made here that just as little discretion as possible should be permitted to the Commission. With that I am in complete accord. So cut it down as much as possible without destroying flexibility, if you please; and then define the standards so that this Commission will not be in the position of trying to write law, but simply to implement and mechanize the law that has already been made by Congress.

Anything different from that would be completely undemocratic; it would be as completely undemocratic as some of the trusts that we have heard described here, where the people who own the trusts have absolutely no power whatever in connection with voting or directing the affairs of the trust; it would be as completely undemocratic as Mr. Trotsky, one of the founders of communism, and one of whose statements, strange to say, was quoted with evident approval here before this committee by a conservative Boston banker. That was a unique experience in my life.

Yet I venture to say that the sort of bureau that Trotsky was talking about was a bureau outside of law, not a bureau that was administering a law fixed by Congress; and I venture to say also that no bureau ever established by that author that Mr. Griswold seems to admire so much, was ever as undemocratic as that type of trust in which the shareholders and owners have no vote and no voice whatever in the management.

If you want to take section 36 (a) and make it perfectly plain that it does not give us substantive rights—we have never claimed substantive rights, under precisely the same provisions of other acts—and that its merely to implement the law and for procedural purposes, you will get no complaint from us. We will go along with it, all right.

Now just one or two other short observations, and I shall be through: I have had the fortune—or misfortune—of seeing a major Federal investigation that involved about twice as much capital contribution as this did, and I have seen something of other investigations. I do not recall any investigation that was conducted, where there was more cooperation from the industry, and which ended with less acrimony between the industry and the Government, than in this instance. I have heard very little criticism of the method of conducting the study.

To be sure, attack was made upon the statistical report; but as I stated this morning, statistics always seem to be attacked; and any exchanges that have gone on across the table, here, during the course of this hearing, I think are simply the result of the normal reactions of human nature under strain and when people are on opposite sides, acting as advocates to some extent in making the best case they can.

I have heard but one witness, out of all those who appeared here, who went on the witness stand and said that there should be no regulation.

So that despite whatever complications and stresses may have developed during these hearings, I think they have been rather unique in the respect that nearly everybody has agreed on the need of regulation, and very little criticism—outside of the statistical phase—has developed on the subject of the method of the study.

That is about all that I have to say.

Again I want to acknowledge the gratitude of the Commission to the industry, for their cooperation. I should like to say that if in the heat of these debates we have overstated anything or misstated anything—some of the speeches were made extemporaneously and from memory—if they are called to our attention, we shall make every effort to correct them.

Then, last and most of all, I think we are all indebted to the committee for its very courteous attention during the presentation that must at times have been somewhat monotonous. We are very grateful to you.

Senator HUGHES (presiding). I might say that as a member of this committee I have not heard all the investigations that have heretofore been made, but I did sit as a member of the subcommittee on the Barkley bill and on the Maloney bill, and I have had some experience with this sort of evidence before a committee. It seems to me that it has been signalized by unusual forbearance and courtesy and good feeling; and we are very much obliged to you for presenting it in that way.

We thank the Commission, and part with it with deep regret—although we realize that in the course of the years we shall probably cross each other's path again.

Senator HUGHES (presiding). Mr. Bunker, I think we shall hear from you at this time, if that is convenient.

Mr. BUNKER. Thank you, Senator. That is very nice of you.

FURTHER STATEMENT OF ARTHUR H. BUNKER, EXECUTIVE VICE PRESIDENT, LEHMAN CORPORATION, NEW YORK CITY

Mr. BUNKER. I have asked for the privilege of appearing once more before you, in order to submit briefly certain constructive proposals with respect to this bill.

Before doing so, however, I feel that I must say one word about the criticism which representatives of the S. E. C. have in the past few days directed at the previous testimony of myself, Mr. Traylor, and other members of the industry.

First, I wish to state to you that I reaffirm in all respects the color of the testimony which I have previously presented. In order that the record may be straight, I should like to file within the next few days statements in refutation of some of this criticism.