directorships or get off our board. If, as an alternative, the corporation determines, as a matter of policy, to dispose of and never again to reinvest in any of the securities of companies of whose boards some of our directors also are members, these directors become subject to all of the reporting requirements which apply under this bill to investment company directors. If these directors stay on our board, they would be required by section 9 to register. This is a requirement for directors that applies only to this business. Also they would have to report quarterly to the other directors on individual purchases and sales of securities of companies purchased and sold by our trust in the same quarter (sec. 30). This is getting pretty far into personal affairs. What would you do under these circumstances? Would you be a director?

Where are we going to turn for competent directors to replace these people who are required to retire? What incentive can we offer outstanding men of affairs to come on our board?

Secondly, from the various sections just quoted, it follows we would be forced, without the consent of our stockholders, to get rid of our management by this legislation just as effectively as though those now in control had sold it. Yet selling control is a practice rather generally criticized; and our banking sponsors, who constitute a majority of our directors and one of whom is president of our company and who is largely responsible for our record, would have to dissociate themselves from our management. Remember, gentlemen, when our securities were sold to the public, this management and sponsorship, which we are now required to eliminate, was one of the things which the investors who bought our securities sought.

Senator WAGNER (chairman of the subcommittee). Mr. McGrath, I think we had better adjourn right at this time until sometime after noon. Everyone seems to be needed on the floor of the Senate.

If it is satisfactory to all the members of the subcommittee, we shall recess at this point until 2:30 this afternoon.

(Thereupon, at 11:55 a. m., a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The subcommittee reconvened at 2:30 p. m., upon the expiration of the recess.

STATEMENT OF RAYMOND D. McGRATH, EXECUTIVE VICE PRESIDENT, GENERAL AMERICAN INVESTORS CO., INC., NEW YORK CITY—Resumed

Senator HUGHES (presiding). The committee will please come to order.

Very well, Mr. McGrath; will you continue?

Mr. McGRATH. Senator, I was telling you about how this legislation, as proposed, would affect our company; and I told you that, first, we would lose practically all our directors; second, by this proposed legislation we would be forced, without the consent of our stockholders, to get rid of our management.

Now I go on from that point. In that connection, the third matter to be considered is that unless we retire our senior securities, regardless of existing charter provisions, we would be forced to accept, pursuant to section 18 (d), whatever redistribution of our voting rights the S. E. C. might deem to be equitable. At the present time these voting rights represent an agreement between our various classes of security holders. Under this bill what do they have?

Senator HUGHES. Your company has a voting right confined to the common-stock holders?

Mr. MCGRATH. No, Senator; the preferred-stock holders have a vote—one vote to a share; but there is much more common stock outstanding than there is preferred stock outstanding.

Instead of a definite agreement, they would be faced with an unpredictable voting situation to be determined by the S. E. C. without their consent. If it was decided to retire our senior securities to avoid this situation, we would be left with a company approximately half its present size, which would result in the doubling of the present operating expenses per dollar of stockholder's investment.

Fourth, section 19 (a) makes it unlawful to declare or pay any dividend other than from "undistributed net income from interest and dividends", unless expressly authorized by the charter or stockholders. If we buy and sell securities at a profit, we cannot pay this out in dividends. Thus, although we have profits, for reasons beyond our control from time to time we may have to default on our preferred or common stock dividends. To date, our preferred stock dividends have an excellent record for continuity. This involves us in a square conflict with the tax law. As this point is somewhat involved, I shall refer to it in more detail later on.

Fifth, assuming that we did not retire our senior securities, we should probably very soon find ourselves under tax disadvantages with other types of closed-end and open-end trusts; for, presumably, the S. E. C. will recommend that diversified management companies have certain tax advantages.

Remember, Senators, that our business, like every other business, is competitive.

As I intend to develop the tax angle at considerable length later, I shall only refer to it here.

To present the problem concerning our company under this bill in another way, if this bill becomes law our stockholders will not know, first, who their directors can or will be; second, what our capitalization can or will be; third, what their voting rights can or will be; fourth, what their dividends can or will be; and fifth, whether our company can afford to stay in business at all.

Do you wonder that we say that a company like ours is being legislated out of business? We favor regulation; but after all we can hardly be expected to cheer for our complete elimination.

With your permission, I should like now to refer to the provisions covering classification of investment companies (sec. 5), restrictions upon change of their investment policies (sec. 13), and limitations of their size (sec. 14). This is a series of provisions which are loosely interrelated and which lend themselves to treatment at one time.

For the moment, let us take section 5 which classifies management of investment companies into a number of categories. The most controversial problems under this heading have to do with the subclassification of so-called "closed-end companies." Of these, our group is representative. I shall, therefore, confine my remarks to these classifications, namely, diversified investment company, securities trading company, and securities finance company.

A "diversified investment company" is one which has no more than 5 percent of its assets invested in any one company and at least 85 percent of the value of its total assets invested in situations in which no individual investment exceeds 5 percent of any class of securities of any other company. Its portfolio turn-over—that is, the ratio during its last fiscal year of the aggregate of its purchases and sales to its total assets—may not have exceeded 150 percent. It may have outstanding only one class of securities other than short-term paper. It may not control any voting security issued by any other investment company.

From the point of view of informing stockholders of the investment policy of a company, this definition of a "diversified investment company" in section 5 is completely misleading.

(At this point, Senator Wagner, chairman of the subcommittee, took his seat at the committee table.)

Mr. McGRATH. It is quite obvious that the fact that a company has senior securities outstanding, as our company has, or owns the voting security of another investment company, has nothing whatsoever to do with its investment policy's being diversified. Yet, a company like ours—despite our diversified investment policy—cannot qualify as a diversified company. In other words, we are called what we are not. To my mind this is misleading.

In passing, it is interesting to note that under section 35 (d) it would be illegal to use as part of the name or title of a company anything which, in the light of the business and history of such company, the Commission finds deceptive or misleading. Thus, if we were a diversified company, we could not include the name "trading" in our corporate name. Yet, under section 5, because of its arbitrary provisions, we are forced to masquerade under the misleading classification of a trading company, though we are not.

Senator Wagner asked Mr. Bunker, the other day, if stockholders should not be informed of the fundamental policies, so they would not be misled. I agree they should, but this bill requires us to mislead them as to our investment policy merely because we have senior securities.

A "securities trading company" means any management investment company other than a diversified company which meets the requirements of having no more than 5 percent of its assets in any company and no more than 15 percent of the value of its total assets invested in situations in which its investment exceeds 5 percent of any class of securities of any other company. I have just shown this definition is misleading because it means that a company such as ours with senior securities outstanding would be classified as a "securities trading company" for this reason alone and regardless of its diversified investment policy. In other words, the most important characteristic of a trading company should be its declared policy to trade and exceed a specified turn-over rather than to purchase and hold for investment. A pure trading company may be more speculative than a company like ours. Yet, companies whose turn-over may be way under the 150-percent percentage specified in this bill as characteristic of an investment company are **required to classify** themselves as trading companies. If classification is supposed to be informative, is this informative or misleading to stockholders?

A "securities finance company" means any management investment company other than a "diversified investment company" or a "securities trading company." This again would not necessarily mean that a "securities finance company" would be in the kind of a business which the statutory classification indicates. In fact, many semiholding companies will be forced into this category; because by declaring that they did not intend to comply technically, if you will excuse my abbreviation, with the requirements of not more than 5 percent of assets in any one situation and not more than 15 percent of total assets invested in excess of 5 percent of any class of stock—the so-called 5–5–15 diversification requirement discussed above, for "diversified investment companies"—they could still adopt an investment policy that would more closely approximate the policy of a diversified company than the popular conception of a "securities finance company" policy. Even if they adopted a 6–5–15, or a 5–6–15, or a 5–5–16 investment policy, which would disqualify them from being a diversified company, they would still be more of a diversified investment company than a finance company. Presumably, in making these categories the Commission had in mind certain social objectives of protecting investors; but I submit they are unrealistic; for, I ask you gentlemen, is it realistic or informative to stockholders to call a company by a name that the S. E. C. will not tolerate, on the ground that under the Securities Act of 1933 it is misleading to use such a name?

I have discussed the three types of closed-end investment companies set forth in section 5. Now let me discuss somewhat in detail the restrictions on "diversified management companies." We have just seen that in section 5 a "diversified investment company," in addition to the requirement of having not more than 5 percent of its assets invested in a single issuer, may have no more than 15 percent of the value of its total assets invested in situations other than those in which its investment is limited to 5 percent of any class of securities of any other company. In other words, a maximum of 15 percent of a diversified investment company's funds would be available for activities other than investment in a diversified portfolio of marketable securities. Out of this 15 percent, which I shall call the "reservoir," the company may, first, take underwriting commitments under certain restrictions and, second, make less restricted types of investments. That is to say, within the 15 percent it may not invest more than 5 percent of its assets in one company, but may invest in more than 5 percent of a single class of stock of another company. Assuming for purposes of argument that the whole reservoir would in fact be employed in underwriting activities or venture capital activities, a thoroughly arbitrary limitation is thus placed on the total investment company funds available for dynamic use. I feel that to place such a restricted mathematical limitation on future possibilities may be economically unsound. This is simply damming up another possible tributary of the flow of capital into industry. Serious consideration should be given to raising this reservoir to 25 percent.

Another thing that might unduly restrict the reservoir is the method of valuing assets. Suppose a diversified investment trust has assets of $1,000,000: The reservoir may not then exceed $150,000. Suppose it has made an investment of $100,000 in the securities of a young and growing company of which it purchases 6 percent of the common stock: This leaves $50,000 margin in the reservoir. Suppose that investment is successful, so that the value of that stock increases to $160,000, and the Commission requires that it be carried at this figure instead of at cost, as it has the right to do, pursuant to section 45 (a) (29): Then, as long as the company continues to hold that investment, it is forbidden to make any more of such venture-capital investments, because its reservoir has been used up.

On the other hand, if this investment were unsuccessful and its value declined to $50,000, and the investment were valued at market, then the company would still have approximately $100,000 in its reservoir. In other words, the reservoir provision penalizes successful investments by saying, "You cannot do it again," but permits unsuccessful companies to go merrily on. If this provision is to stay in the bill, at least the company should have the right to carry reservoir assets at cost and not at a higher valuation fixed by the Commission.

As a matter of principle, I believe that if one accepts the premise that venture capital is tending to dry up in this country and that its sources should be stimulated, then such narrow restrictions on the amount of such capital available from investment-company sources should not be imposed.

Now, Senators, the last restriction that I want to discuss is a restriction of 5 percent on any class of securities of another company; and I do not wish to make so very much of a point on that. I think that more serious consideration should be given to the limitation whereby a "diversified investment company" may not own more than 5 percent of any class of securities of another company. If the reservoir is made large enough, this need not trouble us greatly; but it should be pointed out that the larger investment trusts are frequently unwilling to make investments small in dollar amount, owing to the difficulty and greater expense of keeping in touch with a large list of small holdings. The prohibition, as mentioned, of investing more than 5 percent in any class of stock of a company could very well mean that the securities of many small but growing industrial companies would be unavailable to the more important investment companies. For example, any purchase of such securities in line with the investment company's general policy might require the purchase of an amount exceeding 5 percent of a class, although only 1 percent of the investment trust's assets. If a company has $1,000,000 of assets, all in common stock, no investment company may hold more than $50,000.

Ten percent has been regarded in a number of other acts as the dividing line between a casual investment and an investment tinged with the power of control. In the interests of greater flexibility, I should suggest that in addition to a larger reservoir than 15 percent, the other assets of a diversified investment company be available to the purchase of holdings of up to 10 percent of the securities of any class of other companies, rather than the 5 percent provided by the bill.

Another characteristic for qualification as a "diversified investment company" is that a company's portfolio turn-over—that is, the ratio of purchases and sales to total assets—during its last fiscal year did not exceed 150 percent of its total assets. The whole idea back of this provision seems to be based on an impractical view of the problem of managing an investment fund. There are years in which good judgment impels one to make virtually no changes in one's investments. There are other years in which, as I shall refer to later, quickly changing conditions cause one frequently to change one's investment policies.

In a situation where it is necessary to exceed the specific portfolio turn-over in the interest of good management, there would be the following consequences, under the bill as drawn: First, assuming preferential tax treatment—which I shall discuss later— is granted to diversified investment companies, such a company changing to a trading or finance company would lose the advantage of such preferential tax treatment. In other words, if you change from a diversified company to a trading company, then presumably you lose certain tax advantages.

Second, pursuant to section 13 (a), it would be necessary to go to your stockholders in order to change your classification; and, by the time approval was obtained, it might be too late; and, third, if you were registered as a diversified investment company, you would have to classify yourself as a trading company, in which case your size limitation would be reduced from $150,000,000 to $75,000,000, as far as issuance of new securities is concerned. This might be quite a price to pay for the exercise of business judgment.

If the answer to this dilemma were to be to give the Securities and Exchange Commission discretionary power to increase the rate of turn-over in special instances, it seems to me that in the final analysis this places the Commission in the position of passing on a matter of business judgment; because changing the rate of turn-over is a matter of business judgment; and time, alone, can prove the correctness of this judgment.

Last Monday Mr. Schenker referred to the fact that the Commission's study of the average turn-over of a great many companies during the years 1933, 1934, and 1935 was used as a yardstick in determining the turn-over limitation for purposes of this bill. If so, this may be misleading. To begin with, while the names of the companies whose turnover was studied are not available to us, it is fair to assume that the list includes a substantial number of large companies. Turn-over, I believe, is usually less in large companies than in small ones. In all probability it also includes a number of companies having substantial proportions of their assets invested in so-called permanent holdings. For example, the Petroleum Corporation was referred to by Mr. Schenker last Wednesday afternoon as having 70 or 80 percent of its assets permanently invested in the Consolidated Oil Co. If the average turn-over of many such companies were included in the companies making up the S. E. C.'s study of turn-over, then their conclusions as to turn-over might become largely meaningless. Furthermore, their conclusions as to turn-over might have to be materially modified if their study included the turn-over policies of companies which could not qualify under this bill as "diversified investment companies."

Today, there is a war going on in Europe, and no one can foresee what it may involve in terms of an investment portfolio turnover. Investment policy cannot be measured mathematically, and to do so will some day injure security holders.

Judging from last week's testimony, the Commission seemed to recognize that the question of turn-over is a troublesome matter, and I do not feel that any concrete suggestion can be made on this matter until it has been the subject of further discussion and consideration. Proper reporting to stockholders should solve this difficulty. In other words, in my opinion turn-over is largely a matter of publicity. If the subject of turn-over is handled by requiring a company to tell the stockholders what the company's investment policy is, then why isn't this object accomplished by, once a year, telling the stockholders what the company's portfolio turn-over has been during that year?

We always have been in sympathy with the view that stockholders should be informed of the fundamental policy to be pursued by their company and should have a definite voice in effecting any fundamental changes in or departures from such policy. Sharp changes in market conditions, however, such as the events of the last few weeks, may force management to act quickly; and the above statement is subject to the proviso that this should not be made so inelastic as to work to the detriment of security holders. For example, even though the management might think sharp changes in the market conditions were so imminent that it was in the stockholders' best interests to sell certain securities and thus exceed a diversified investment company's turnover ratio of 150 percent, nevertheless, without the stockholders' consent, under this bill it could not do so. By the time consent was obtained, it might be too late to act; so that at least in this instance the price for stockholders' consent might be too high.

Under section 13 (b), the S. E. C. is given the power to determine which investment and management policies are fundamental; and this part of the section provides that these may not be changed without the stockholders' consent. We consider unnecessary this wide-open delegation of absolute discretion to the S. E. C. as to what is a fundamental policy, and we believe that such a provision is certain to subject our all-too-uncertain industry to still another element of uncertainty. If this provision remains in the bill, Congress will be vesting in the S. E. C. a degree of control over the internal management of investment trusts, which probably never has been available to any governmental agency in this country. The Commission may not only by "rules and regulations" but by "order" designate what are the fundamental investment policies. The inclusion of the word "order" gives the Commission authority not merely to issue general rules and regulations governing all companies, but gives to it the right specifically to control an individual company with respect to its investment and management policies. In fact, as the bill is drawn, the designation by the Commission of what investment and management policies are fundamental must be with relation to specific companies.

Mr. Schenker stated that the Commission would not object if this provision were eliminated, but that it was thought management would welcome having the S. E. C. determine what are fundamental policies, before submitting these questions to stockholders. This might involve a company in long and expensive hearings before the S. E. C., when time was essential; and in practice it would probably be found that if the management had sufficient doubt to impel it to ask the S. E. C. whether a policy was fundamental, the S. E. C. would resolve the question in favor of submitting the matter to the stockholders.

The bill should set forth, within well-defined limits, what constitute fundamental policies. If these cannot be drafted in a bill, they probably cannot be drafted in rules and regulations; but if drafted in the bill, then both the stockholders and the directors would know what these policies are. In this manner, the proper purposes of the statute would be served; investor protection would be advanced; directors would know what they could do in the way of management; and management would not be required to sit on the "anxious seat" with other suppliants outside the Commission's door, before they could carry out their functions.

I am not afraid of an S. E. C. ruling on what is obviously a change in fundamental policy. We could easily decide that ourselves and submit it to the stockholders. I am greatly concerned with the misunderstandings, arguments, hearings, litigation, and confusion that could arise over borderline cases.

The provisions with respect to classification of companies, restrictions on turnover, and the reservoir, which I have just discussed, are interwoven in section 14 with the question of size of investment companies. A diversified management company, as far as the issuance of new securities is concerned, can have a maximum size of $150,000,000; but a trading or finance company is limited to $75,000,000.

As regards the classification problem, the matter of size really has nothing in it which is germane, nor is restriction on size necessary for the protection of the investor; yet, companies of different classifications are assigned different size limits. I think that this question of size should be looked at on its own merits. It is clear it does not afford a proper basis of classifying companies. Any limitation on size is putting a premium on incompetence, since it only penalizes those who are able to grow through merit.

As far as I know, the provisions in section 14, limiting maximum size of investment companies, are unprecedented in American law. There is no real proof that a larger company cannot be operated as well as a smaller one. A maximum limit on size probably increases operating expenses per unit of holding. Certain laws of the past, such as those dealing with monopoly, have had the effect of indirectly limiting size. This is the first time that there has been serious legislative advance of the proposition that companies of a certain kind, whose assets exceed a fixed dollar amount, shall be prohibited from further expansion. The dollar is not a fixed unit of value, and adopting a dollar measure may cause serious difficulties. If no size limit is introduced by statute, then it is to be presumed that natural limitations of efficiency would prove a more effective check on size. The idea that a limitation on size will either increase efficiency or solve social problems seems startling.

Section 14 of the bill does not advance any explanation for the proposed size limit. The only argument for it is found as part of the so-called declaration of policy of the bill, contained in section 2. The pertinent language is:

> It is hereby declared that the national public interest and the interest of investors are adversely affected * * * when investment companies * * * attain such great size as to preclude efficient investment management and to have excessive influence on the national economy.

There is no proof of either of such assertions. The limitations on the ratio of single investments to total assets and percentage of a single class of stock that can be purchased should afford adequate public protection against the controlling by trusts of other corporations. This was recognized by the Christian Science Monitor, in an editorial on March 20, 1940, in which it said:

> This top, incidentally, appears to be the expression of another theory, the familiary megalophobic notion that mere size is dangerous. This is curiously the same dollar limit once proposed for life-insurance companies during the Armstrong investigation. Here, however, the door has already been locked against the danger of octopus control by the "five and five" provision in the bill forbidding the trusts to own more than 5 percent of the securities of any one company or have more than 5 percent of their own funds invested in any one company.

This is an example, it seems to me, of one of the faults we find in this bill. In other words, having by the five-and-five provision cured any danger of octopus control, they go and put in the bill another provision, to cover something that has already been cured—in other words, layer on layer.

It is astonishing to us that the conclusions of the S. E. C. in regard to size have not yet received wider public attention. The idea of limitation of maximum size of enterprises, on the hypothesis that an investment company of great size would exercise too potent a social and economic influence, is a frank attempt to crystalize into law a social philosophy which is as startling as it is debatable. We do not feel that it is incumbent upon us to argue this controversial question that by statute those who, through merit, grow in size, consequently become suspect. We repeat that it is startling. We have pointed it out to show that in this bill the provisions limiting size really have nothing whatever to do with the protection of investors. These limitations go far beyond investor protection and enter an uncharted field of social legislation which, if adopted in this instance, may serve as a convenient precedent for the breaking up by Federal law of great American insurance companies, banks, and industrial enterprises. We should stop, look, and listen, before adopting anything so un-American as a measure to penalize success.

I now come to one of the most important matters interrelated with classification. I refer to the problem of the future taxation of investment companies. Although this problem is not mentioned in the bill, it is of such vital importance and is such an inherent part of the whole question of the future existence of the closed-end investment company that it seems to us it must have a prominent place in the policy of the bill. In fact, the question of tax treatment was mentioned by Judge Healy in his opening statement. I consider it a most important factor in the whole question of regulation. From the way the subclassification of closed-end companies is set up in section 5, it seems reasonable to assume that only the "diversified investment company," as defined in section 5, will be selected for favorable tax treatment. Should such relief be granted, there will obviously be a valuable premium placed on the companies which qualify as "diversified investment companies," and the others will correspondingly suffer.

We believe that the sole purpose of the S. E. C. in devising the classifications in section 5 should have been to provide a basis for future tax treatment. We strongly urge that classification as de-