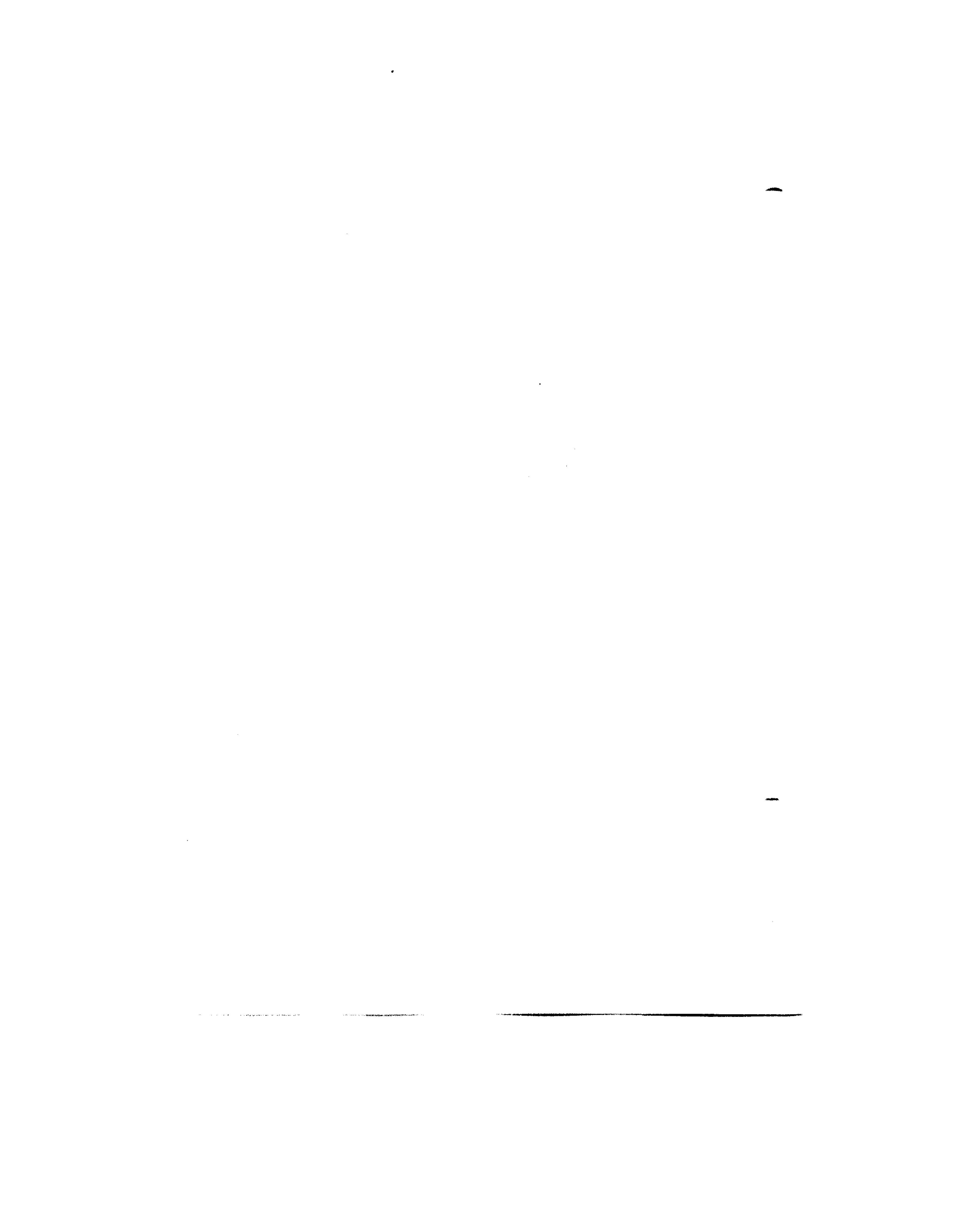
I want to make it very clear that my statement is entirely from the point of view of open-end management investment companies, with which general field I have had over 7 years of intimate experience.

Senator WAGNER (chairman of the subcommittee). Mr. Adler, I am sorry to interrupt you, but we have just learned that a vote is being taken over in the Senate, and we shall have to suspend at this point. I am sorry we shall not be able to hear all of your statement today.

Very well, gentlemen; we shall recess at this time until tomorrow morning at half past ten.

(Thereupon, at 4:10 p. m., an adjournment was taken until tomorrow, Thursday, Apr. 18, 1940, at 10:30 a. m.)



INVESTMENT TRUSTS AND INVESTMENT COMPANIES

THURSDAY, APRIL 18, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE
OF THE BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Downey.

Present also: Senator Tobey.

Senator WAGNER. Gentlemen, the subcommittee will come to order, if you do not mind—and I added that last because of the noise in the room.

Senator Tobey, won't you come up close to the committee table?

Senator TOBEY. Mr. Chairman, I am not on this subcommittee.

Senator WAGNER. That is all right. Subcommittees are only a convenience in the dispatch of the full committee's business. You have the same right to be here, if you wish, that any other member of the full committee has.

Senator TOBEY. I thank you, Mr. Chairman. I will be glad to be a listener.

Senator WAGNER. Mr. Adler, you represent Selected American Shares, I believe.

Mr. ADLER. Selected American Shares, Inc.

Senator WAGNER. Very well. You may proceed with your statement.

STATEMENT OF ROBERT S. ADLER, CHICAGO, ILL., OFFICER AND DIRECTOR, SELECTED AMERICAN SHARES, INC.

Senator WAGNER. Very well. Will you proceed now?

Mr. ADLER. I am Robert S. Adler of Chicago, Ill., an officer and director of Selected American Shares, Inc., an open-end management investment company with assets of about $10,000,000. It was organized during 1932. I am also an officer and director of two other companies, not publicly owned, one of which is the sponsor and principal distributor of the shares, and the other of which performs among other business the function of manager of Selected American Shares, Inc.

Although I have some views concerning various sections of this bill, and later shall make one or two brief references, I shall save you from repetitious discussion and direct myself primarily to one section. This does not mean that I have no difficulty with a number of other sections, however.

I want to make it very clear that my statement is entirely from the point of view of open-end management investment companies, with which general field I have had over 7 years of intimate experience.

Let me say first that I fully subscribe to the statement made to this committee by Commissioner Matthews, when he said:

There is no doubt of the need of effective and comprehensive regulation. A form of control which is less than that may be about as dangerous to the public as complete freedom from administrative restraint. I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors, but any course which does not impose those restraints may be very misleading to those whom it professes to protect.

Senator WAGNER. Then that represents your view of the proposed legislation?

Mr. ADLER. No, sir; I am here quoting Commissioner Matthews.

Senator WAGNER. But you said you fully subscribe to that statement.

Mr. ADLER. I said I fully subscribed to that statement, yes.

Senator WAGNER. And that represents your view.

Mr. ADLER. Yes, sir; but you understand I am here quoting Commissioner Matthews.

Senator WAGNER. Yes. I understand. You may proceed.

Mr. ADLER. I particularly urge your attention to the Commissioner's words:

I would be very much opposed to any program which, under the mask of regulation, sought to do more than to impose those restraints upon management which are really necessary for the protection of investors * * *.

In my opinion section 11 provides one of a number of examples of a program which seeks to do more than impose necessary restraints.

This section says that a promoter of a new investment company may not serve in any capacity with such new company if within 5 years he has been a promoter of another investment company. (I might say parenthetically the word "promoter" is nowhere defined in the act, and being a very broad term it may be very inclusive as to the persons who may be brought within the category. Probably even the lawyers who drew the documents might be included, though Mr. Schenker assured Senator Taft he had seen to the exemption of lawyers.) Section 11 also provides that the Commission has the power to exempt if, after giving due weight to certain specified factors, it finds that an exemption is consistent with the purposes of the bill.

During the testimony relating to this section, Senator Frazier asked why, if people were doing an honest business, they should organize more than one company. I should like to try to answer Senator Frazier's question.

This bill provides for classification of investment companies. It also provides for the notification to and approval by shareholders of fundamental changes of management policy. These factors indicate a recognition of the need for different types of investment service by various investors. There has also been much discussion concerning capital structure and of the distinct differences between open-end and closed-end companies and a number of other types. These discussions likewise indicate that different types of companies may very properly exist.

Now let us ask ourselves a few questions.

Is there any reason why a person managing, let us say, an investment company maintaining a highly diversified portfolio should not organize another investment company devoted entirely to securities of one industry such as, for example, aviation or chemicals? Is there any reason why the organizer of an investment company placing its principal emphasis on common stocks should not also manage one whose portfolio is primarily in bonds? What possible reason can there be to assume that a person organizing a company which is essentially devoted to investments in the country's leading well-established companies should not also organize another company to participate in the furnishing of venture capital to new enterprise?

Senator WAGNER. If, say, you organize a company to deal entirely in aviation stocks?

Mr. ADLER. Are you asking me if I have done so?

Senator WAGNER. No. You were suggesting that that might be done. Is there any objection to the organization of an investment company which would deal entirely—did you say—in aviation stocks?

Mr. ADLER. Yes, sir.

Senator WAGNER. Would you call that a diversified-investment company?

Mr. ADLER. It might very well be a diversified-investment company, with the meaning as between various companies within that particular industry, it is diversified.

Senator WAGNER. But in a case like that I am sure you agree that those who invest their money in such an investment trust should have absolute notice that the money is to be invested only in aviation stocks.

Mr. ADLER. Oh, definitely so.

Senator WAGNER. Well, that is my point. In other words, if I give my money to an investment trust with that understanding, then I know that my money will go into such stocks.

Mr. ADLER. Yes, sir; definitely so. But the point I am trying to make is that the mere fact an organizer of an investment company organizes one which is essentially a diversified company over a lot of different types of industries, should not mean that he should be barred from organizing one—or, rather, I raise the question here: Is there any reason why he should be barred from organizing one devoted to diversification among aviation companies?

Senator WAGNER. What prompted the question was this: There has been some testimony here, very early in our hearings, when we heard of companies that indulged, in many instances, at least, in looting—and you read some of that testimony, I take it?

Mr. ADLER. Yes, sir.

Senator WAGNER. Where some of such companies did represent that the money was to be invested along certain diversified lines, and then, without any notice to their stockholders, the money was taken and invested in some venture of some kind.

Mr. ADLER. That is an entirely different thing.

Senator WAGNER. You disapprove of that sort of thing, do you?

Mr. ADLER. Definitely I do.

Senator WAGNER. You may proceed with your statement.

Mr. ADLER. Again, is it not a fact that some investors may wish to place their funds in a company which has as its principal objective the

obtaining of dividend and interest income, while others may desire to place their funds much more at the risk of the market in an attempt to seek capital appreciation?

Now, gentlemen, the answers to these questions make it clear to me that different types of companies have their proper place in the scheme of things, and may very well be organized and operated by perfectly honest men attempting to do an honest job.

Mr. Schenker said, "The basic philosophy of that type of institution should be—you turn your savings over to us and we will manage them." I do not believe that the responsible elements in this business disagree with that philosophy. Is there anything inherent in the starting of another investment company, particularly of a different kind and to meet a different need, though not necessarily so, which contravenes such philosophy? I do not think so.

You have been told that one cannot organize bank after bank. Mr. Bunker made quite clear to you, I hope and believe, the vast differences in the true nature of the institutions. But even if the comparison were a fair one, let us examine the facts. I have been unable to find in the National Banking Act, any restrictions against starting a new bank on the ground that the organizers have already organized, within any period of time, another bank. In fact, I am advised that if the Comptroller of the Currency does not find that the location for a proposed national bank already has adequate facilities, he is required to permit the organization after the promoters have satisfied the other relatively simple and reasonable requirements.

True, there are minimum capital requirements, but for investment companies these have been dealt with in section 14 of the bill.

You have heard that section 11 was designed, in part, because the S. E. C.'s study indicated that in a great many instances the formation of investment companies of all kinds was not predicated upon any inherent belief in the soundness of the particular company, but rather was for the purpose of "switching," or having merchandise which the distributor could sell.

Now I ask you to remember in considering the S. E. C. testimony in this direction that the abuses arising out of those recurrent promotions were related entirely to two general classes of companies: (*a*) Those unrestricted companies which engaged so largely in cross ownership, circular ownership, and in the pyramiding of company upon company, as in the *United Founders case*; and (*b*) the unit type, or fixed investment trusts, some of which the record did indicate made a practice of switching. But I am not speaking of either of these classes of companies. Neither S. E. C. studies nor their testimony indicated that switching from one open-end management company to another organized by the same sponsor was engaged in to any important degree. It has not been shown at all that the organization of more than one company of the open-end management type by the same sponsor had any such motive.

On the contrary, the sponsor of an open-end management company has little incentive to promote switching, particularly if he has an interest in the continuing management. Reference was made in the S. E. C. testimony to the organization by one sponsor of several companies within 1 year. The inference was clear that No. 2 was created to enable the sponsor to switch investors out of No. 1; and that No. 3 to switch investors out of No. 2, and so on. But these

companies were organized within 1 year. It is not reasonable to suppose that the sponsor would have spent the substantial amount of time and money to organize a second one, even before the first one had an opportunity of becoming sufficiently large to have anything from which to switch. It would appear rather that if the motive were to provide such a medium, the second would not have been organized until the first one had—in the words of Mr. Schenker—"lost its sex appeal." Remember two things: first, they were started in 1932 when any sort of securities were extremely difficult to sell; and, second, they all had different investment objectives.

So you see, gentlemen, the answer to Senator Frazier's question is that an honest man may very well organize more than one investment company and may do so very creditably.

Of course, even if the contention of the proponents of this bill were correct, the principal stated objective of this section would not be achieved. There is nothing in any law—and there should be nothing—to prevent an investment dealer from advising his clients to dispose of one investment and acquire another. There is no restriction on the extent to which he may advise his customer to shift from one bond to another, or from one stock to another. This is the basis of a large amount of the securities business of the Nation. If a dealer believes that his clients' funds are not properly invested in one situation, he will undoubtedly advise its disposition and the acquisition of something else. This he will do, and often does, in investment company shares just as readily as he does in any and all other securities.

In passing, it should be noted that the very possibility of a dealer having his customer dispose of particular shares is an incentive of great force to the sponsor-manager of an open-end company to obtain the most efficient results, lest he lose through redemptions a portion of the assets which produce for him a management compensation.

Aside from not achieving the objectives, let us see for a moment what this section does to existing units in the business. It creates great inequities. It would tend to "freeze" the business of distribution of open-end management companies' shares as it now is. Those distributing organizations which can reach different investors through different types of existing companies, those that have several would be permitted to continue to do so, but those which are not now doing so would be unable to participate in the organization of new companies to fill a different need.

In other words, gentlemen, they could not expand their own business in this way. It would serve to penalize those very sponsors who, on the S. E. C.'s theory of section 11, are least subject to criticism. That is to say, those who have sponsored only one company would now be in a position of being unable to reach a different type of investors, whereas those who already have several companies have the advantage of continuing to reach these different people and serve their differing investment needs.

Now, Mr. Chairman, if this limitation is sound, why is it not sound to prohibit an insurance company from issuing several different types of policies; or a bank from offering to clients different types of trust service; or a lawyer from practicing in different branches of the legal profession? This is manifestly an unfair situation in which to place responsible persons who may desire to extend their ability and experience.

Now it is true that subsection (d) provides that the Commission may exempt a promoter from the restrictions contained in the section, but it is to be doubted whether it is equitable to so limit the right of a citizen to employ himself in his chosen field. This is the more true when the restrictions cannot be demonstrated as necessary to the solution of the stated objectives. Competent legal counsel incidentally has even raised the question of the constitutionality of such a provision. But I am not a lawyer and am not qualified to speak on that question.

Subsection (b), which the Commission did not touch upon in its testimony, would make it unlawful for the organizer of a new company to act as adviser or underwriter for it, if at the same time he is serving another investment company. This prohibition raises the fundamental question of whether there is anything inherently wrong about an adviser or underwriter increasing his own business by organizing a new company.

I am frank to say that I believe there is nothing wrong in such action. But if the present Commission, or any future commission, believes that there is something wrong in such action, I wonder whether the exemption provision in paragraph (d) would gain for such a person the permission to further his own business—even if he were an honest man doing an honest job.

Summarizing section 11, I believe—

First. More than one company may very properly be started by one person.

Second. The abuses, which section 11 presumably is designed to prevent, have not been proved to exist in the open-end management field.

Third. Even if such abuses were prevalent, section 11 would not cure them, in my judgment, of course.

Fourth. Section 11 would create great inequities and work unnecessary hardships.

Fifth. It would, upon totally inadequate grounds, limit the right of a citizen to engage in new business endeavors.

There is no doubt in my mind but that reasonable standards for open-end investment companies now exist and can be and probably should be more fully developed. If companies can meet such standards, which should be clearly stated in the law, there is no reason to prohibit their organization merely on the ground, and I repeat, merely on the ground that those starting them have within any period of time participated in the formation of any other investment company.

Section 10 has been dealt with by other witnesses. I wish to add, however, that I believe that the numerous and varied limitations upon persons who may or may not be on boards of directors, or who may serve in other stated capacities, would, in many cases, produce a segregation of interests which will needlessly upset existing situations; will make better investment management much more difficult to obtain and will, with few exceptions, be contrary to the interests of the shareholders of most of these particular companies of which I am speaking; that is, open-end management companies.

Many of the affiliations (such as those of underwriter and manager), particularly the ones in subsections (d) (4) and (5), have not been shown in the case of open-end management companies, to produce a detrimental conflict of interest. To the contrary, the reports of the

S. E. C. to the Congress clearly indicate, to the best of my knowledge, no record of existing or demonstrable abuses based on such conflict, and insofar as measurable performance records are concerned, no need whatsoever for such prohibitions.

Let me conclude: I am in favor of the development of sound regulation of investment companies. I believe that it can and should be accomplished and I shall be happy to assist in its accomplishment. I believe that there are a number of principles embodied in this bill which can, with proper treatment, lead to such an end. I do not believe that either this bill, as it now stands, or its authors' fundamental approach to many of the problems, is the correct path to those proper restraints upon investment companies, which are really necessary for the protection of investors.

Thank you.

Senator WAGNER. We thank you very much, Mr. Adler. And I might suggest to you, since you say, in the latter part of your prepared statement, that you believe there should be some regulation, and all of the responsible members of your industry seem to believe that too; and since, further, you suggest that this bill should be made into a bill for effective regulation, you ought to follow that up by making some suggestions to the subcommittee along that line.

Mr. ADLER. Mr. Chairman, I would like just to correct that impression if I have left it with you. I stated that I did not believe either this bill as it now stands or its authors' fundamental approach to many of the problems, is the correct path to those proper restraints upon investment companies which I have in mind.

Senator WAGNER. Well, I referred to what you said just before that. Will you read from the sentence just before you made that statement?

Mr. ADLER. I said I believe there are a number of principles embodied in this bill which could, with proper treatment, lead to such an end.

Senator WAGNER. Yes. Therefore are you not willing to present some suggestions as to what you think they would be?

Mr. ADLER. I am very willing to present suggestions.

Senator WAGNER. I know the subcommittee would welcome any suggestions from you.

Mr. ADLER. Thank you.

(Thereupon Mr. Adler left the committee table.)

Senator WAGNER (chairman of the subcommittee). Mr. Gardiner.

STATEMENT OF WILLIAM TUDOR GARDINER, CHAIRMAN, INCORPORATED INVESTORS, BOSTON, MASS.

Mr. GARDINER. Mr. Parker will follow me, and we will be very brief.

My name is W. T. Gardiner, chairman, Incorporated Investors, Boston.

In order to conserve the time of the committee Mr. Parker and I have condensed our statements, and will touch briefly on two parts of the bill that particularly affect the structure of our company.

We agree with the general criticism of the bill already expressed.

Let me just say a word about the prohibition in the bill against an officer of an investment company serving as a director of a company whose stock is in the portfolio.

It so happens that Mr. Parker is a director of Lowe's, Inc., and I am a director of United States Smelting, Refining & Mining Co. At the present time stocks of both of those companies are in our portfolio.

We feel there is no conflict of interest in that situation, and we feel that we should not be required, by a statute, to separate outselves from the world of active affairs.

Section 10 (d) as far as my companies go, requires segregation of management and sales contrary to the practice that we have followed for 15 years.

The section is not entirely clear, but it appears that segregation could be avoided only, in our case, by disqualifying as investment officer or manager the three principal executives in our organization. This provision does not seem fair in purpose, but other speakers will cover this section in greater detail, Senator Wagner.

Section 20 (b) of the bill prohibits the sale of voting trust certificates contrary to the practice we have followed for 15 years.

It is not our experience that these two practices of our company have heretofore met with any considerable objection. We have grown to have 32,000 stockholders and $47,000,000 of assets. We meet the requirements of the regulatory measures, and are qualified to do business in 24 States.

This is quite a lot of regulation, and Mr. Taliaferro, who will follow today, will take up the matter of State regulation in greater detail. He will refer to the effort of the State "blue sky" commissioners to develop and improve a law that some of them hope may become a uniform law for the regulation of the registration of securities to be offered for sale in any State.

Mr. Taliaferro will explain the terms of that act to you, but let me indicate in advance of his statement that it is not a complicated act, one that covers many important matters, and it is different. For instance, it prohibits such matters as self dealing, trading against the trust, and selling down the river, that we have discussed here. It limits such matters as charges for management or for sales cost, and such matters as borrowing by the trust. It insures such matters as proper custodianship of securities, diversification, reports, and description of source of dividends. That will indicate to you the extent of the regulation to which we are now subject.

Senator WAGNER. That is in what State?

Mr. GARDINER. That is adopted in Ohio; and in more or less identical language in your State, Senator Tobey; and is under consideration in other States.

Will you now permit Mr. Parker, president of Incorporated Investors, and one of the founders, to explain to you why this form of investment company, which is condemned in this bill, was adopted by Incorporated Investors?

Senator WAGNER. Mr. Gardiner, might I ask you just for my information, though it is purely an aside here: There was quite a distinguished citizen by the name of Gardiner who became known as a trustee, I believe in Massachusetts. I know that the State had great confidence in him, and that he had very large sums of money in his control as trustee. Does he happen to be related to you?

Mr. GARDINER. That was my father, and I trained in his office in 1916.

Senator WAGNER (chairman of the subcommittee). All right, Mr. Parker.

STATEMENT OF WILLIAM A. PARKER, PRESIDENT INCORPORATED INVESTORS, BOSTON, MASS.

Mr. PARKER. Senator Wagner, my name is William A. Parker. I am president of Incorporated Investors. I was one of the founders of Incorporated Investors 15 years ago. There has been no material change in our company or in its policies in those 15 years. A corporate form seemed desirable to us and we added to this a voting trust. Our voting trust agreement states that this was "to secure stability and harmony in the affairs of said corporation, and to assure as far as possible a conservative, permanent management."

The voting trust made it impossible for any outsider to force a change in the policy or the personnel of the company. Thus we had virtually a Massachusetts trust with a corporate form of existence.

The same group controls the management of the company and the distribution or sale of its shares. We have been able to select our own dealers and thus control how and by whom our stock should be sold. We believe that this is most advantageous. We have been very proud of the kind of dealer who has distributed our stock. It is plainly set forth in our literature that control of sales and management is identical and also that the shareholders have no vote. People have desired to invest their money with us presumably because they had confidence in our judgment and because they did not want to go to the bother or risk of selecting common stocks themselves.

Senator, I have been an officer of this company for 15 years and in that time I have talked with hundreds and hundreds of our shareholders. I don't suppose that this committee has any conception of how completely we live in a goldfish bowl. We have always issued reports quarterly with full disclosure of our affairs. Many of our shareholders have been critical of individual securities in our portfolio, and sometimes of investment policies, often constructively critical. Nevertheless, in all these years, I have never had a shareholder criticize our particular set-up of management and sales, and never a one who even intimated that he wanted a vote.

We were very glad in 1936 that we controlled sales as well as management. In the fall of that year we thought the market was pretty high and we closed—that is we stopped offering further shares. Subsequently it turned out that we were wise and that it was better for us not to have continued to take in new money from the public for investment at those levels. We could make this decision readily because we had no contract with an outside distributor and though many of our dealers begged us not to close, we were in a position where we could exercise our own judgment. We reopened and again offered shares in 1938, when the market was substantially lower. We see no reason for condemning identity of sales and management or requiring investors to vote when they do not wish to do so.

There is one point on which I am anxious not to have my position misunderstood. I disapprove entirely of this bill in its present form,