Subsection (e) (2) prohibits an investment banker or broker or an affiliated person of an investment banker or broker from acting as director or officer of an investment company if he is also a director or officer of an issuer of which the investment company owns any security, regardless of the character or amount of the security so owned.

This provision would disqualify the single investment banker on our board even if he should escape the disqualification which I have already mentioned. The criticism made under subsection (c) is equally applicable here. An investment banker or broker is no less suitable as a director of an investment company because of the fact he is a director of a portfolio company.

As indicated above, I believe that that would make him a more suitable person.

Section 16 of the act requires directors or trustees of an investment company to be elected by the holders of the outstanding voting securities at the annual meeting or at a special meeting called for that purpose. Provision is made for the filling of vacancies not exceeding in the aggregate a third of the whole number of the board. Our indenture of trust provides for election of trustees by classes for three-year terms, the term of one class expiring each year. It is improbable that the drafters of this bill intended to prohibit that plan of election, but it apparently has that effect. Sinilar provisions are to be found in the business corporation laws of many States. Similar provisions may be made in Massachusetts for the election of selectmen by town meetings.

The principal purpose of having the directors elected by classes is to secure continuity of management and to insure, as far as possible, that each director will hold office for a period long enough to accumulate knowledge and experience in dealing with the problems of the company.

A provision for the election of directors by classes is particularly necessary in the case of Consolidated Investment Trust because of the investments in special situations which I have mentioned before. The most advantageous treatment of these investments requires considerable knowledge of the particular problems of the portfolio companies involved. We believe that the interests of our shareholders should be protected by allowing the existing provision of the trust indenture which stipulates that the trustees shall be divided into three classes, one elected by the shareholders each year, to remain in effect.

Regarding limitations upon investment policy, notwithstanding the statements of the Commission to the effect that it does not seek to control the investment policies of management investment companies, it is obvious from section 5 (d) and section 13 (b) that the Commission is asking for the broadest kind of control over investment policies. We agree that an investment company ought not without the consent of the holders of a majority of its voting securities to change the announced or declared investment policy of the company. The Commission, however, has asked to have the unlimited power to determine from time to time what the fundamental policies are and this means that the Commission may at any time make a determination which prevents the directors or trustees from using their discretion for the best interests of the stockholders.

The very unfortunate rules proposed in section 10 with respect to the selection of directors or trustees will operate to limit the invest-

ments which may lawfully be made by investment companies. I have already discussed this section above and so will not repeat here our objections to those rules.

As to the increased expense to our shareholders, one of the things which will affect shareholders in investment companies most is the increased expense of operating under the proposed law and the rules, regulations, and orders which the Commission in so many instances is empowered to make. The increment of expense for small investment companies will be greater per dollar of asset value than for large companies. Ultimately the stockholders will have to bear this expense in the form of reduced earnings. Now, of course, the increased expense is the price the stockholders must pay for the increment of protection which the proposed law may give them. It may be that the Congress will conclude that the increased expense is a reasonable price to impose on stockholders for this protection and it may be that the judgment of Congress will prove to be sound.

It seems well to point out some of the elements of this expense and how it will affect Consolidated Investment Trust.

As I have indicated, Consolidated Investment Trust has a very simple structure. We have already sought to reduce the cost to the stockholders of operating the trust and I believe that we may be justly proud of our results. The ratio of operating expense of the trust to income from dividends, interest, and net rents, that is, excluding capital gains, was 7.8 percent in 1939. From a comparison which we have made with the records of operation of other management investment companies, we believe that this is the lowest operating ratio of all such companies and we know of only two other companies which come even close to this figure. We are very anxious to preserve for our shareholders the low cost of operation which has obtained heretofore.

The bill will impose different kinds of expenses. In the first place there are the elements of what may be called initial or organization expense incident to registration under the proposed law and to amendment of the trust indenture as required by section 17 (f) to conform to the law as enacted and the rules, regulations, and all orders promulgated by the Commission during the first year and incident to setting up the system of accounts, cost-accounting procedure, correspondence, memoranda, and other records which the Commission is empowered to prescribe. These elements of initial expense will be considerable. Then there are the elements of expense of amendments every time the Commission adopts a rule, regulation, or order making the existing provisions illegal and of revising the system of accounts and records every time the Commission changes its rules, regulations, or orders. These elements of expense are, of course, problematical, but they may be considerable.

The elements of recurrent expense are considerable. They include the cost of keeping up the system of accounts and records prescribed by the Commission, the cost of making the periodic and special reports required by the Commission to be made to it, the cost of accountants' services for periodic audits, and the cost of periodic reports to stockholders.

Another very serious element of increased recurrent expense I have already pointed out in the discussion about selection of directors. If the intricate rules of section 10 are enacted we shall have a very

serious problem with respect to the personnel of our board of trustees. The type of men we want on our board, whether they be present incumbents or replacements, will have to sacrifice other connections, and I don't see how we can expect them to do that without substantially increasing the extremely modest compensation which they are now willing to acept.

Section 17 (g) (2) gives the Commission authority by rules and regulations or order to require that any person be bonded in such minimum amount as the Commission may prescribe. It is obvious that the recurrent cost of any such bonds would ultimately have to be borne by the security holders. It is entirely conjectural how much such bonds would cost, but it might well be very considerable. Moreover, in general it is likely that such bonds will be proportionately more expensive in the case of smaller investment companies than it is of large ones.

I estimate that the annual expense of operating the trust, if the above-mentioned provisions are adopted, will be increased from 25 to 30 percent in our case.

As to the effect of the bill upon financing of small companies and underwriting other securities by investment companies, members of the Commission and of the staff have stated a number of times in the press that they consider that American investment companies, or at least some American investment companies, ought to supply equity capital to industrial concerns by way of underwriting or sales of the securities of such concerns and by way of purchasing such securities for investment. They have adverted to the fact that some of the British investment trusts perform these functions.

As I have already indicated, I believe that there is a place in the national economy for investment companies performing these functions. The four corporations which were the predecessors of Consolidated Investment Trust participated in underwritings and invested equity capital in industrial concerns. Our indenture of trust authorizes the trustees to do both and, as I have shown, we have taken considerable interest in the so-called "special situations" which I have discussed before. Although we have never participated in underwritings, we have given considerable thought to that subject.

The proposed law, despite the Commission's stated views, does not encourage an investment company to engage in financing special situations or to engage in underwritings. I have already indicated the serious problems raised by section 10 (e) so far as investments in special situations are concerned. I do not believe that we would start or that we ought to start making any investment of our shareholders' money in any special situation unless we were able to have one of our trustees go onto the board of directors of the special situations company. If we should decide to go into any underwriting it would probably be in relation to some company of relatively small size. I think we would generally be unwilling to participate in such an underwriting unless in connection therewith we would be able to have our nominee on the board of such company and generally we would wish such nominee to be one of the trustees. Such supervision of the management would be desirable from the viewpoint of persons who might purchase the securities which we underwrote or sold. And yet, under section 10 (e), if we own securities in any

company but do not have 5 percent of the voting securities, one of our trustees cannot go on the board of that company.

Moreover, it seems clear from section 15 (a) and section 19 (a) that the draftsman did not expect any investment company to engage in underwriting. Underwriting profits are apparently excluded from ordinary income and dividends from underwriting profits must be treated as if they were distributions of capital. This is clearly unsound.

The four points which I have touched upon set forth the principal specific points in the bill which will adversely affect our shareholders.

I would fail in my duties to my shareholders if I allowed this committee to think that if these foregoing points were properly dealt with this bill would be suitable for enactment. The general objections to the bill have been very ably indicated by Mr. Bunker, Mr. Quinn, and others, and it does not seem appropriate for me to take up more of your time to go over this ground again.

If I or my associates can in any way serve a constructive purpose to this committee in any problems which may confront you in determining the final disposition of this bill, you will find us anxious to cooperate and be useful and our efforts will be honest and sincere.

Senator HUGHES. Thank you, Mr. Anderson.

How many more witnesses are there to be heard?

Mr. GRISWOLD. I think we are about through, Senator.

Senator HUGHES. Mr. Motley will want to go on on Monday morning.

Senator HERRING. I wonder if the brief of the last one on the list could not be placed in the record. There is nothing to be gained by reading it to only two members of the committee.

Senator HUGHES (presiding). When we take a recess today it will be until 10:30 next Monday morning.

Senator HERRING. I suggest that we do that at this time.

Mr. GRISWOLD. That is very satisfactory.

(Whereupon, at 12:30 p. m., a recess was taken until Monday, April 22, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

MONDAY, APRIL 22, 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 Friday, April 19, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner, presiding.

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

Senator WAGNER. The subcommittee will come to order. Mr. Warren Motley is the first witness, I believe.

Mr. MOTLEY. Yes, Mr. Chairman. Shall I sit here and go ahead?

Senator WAGNER. Yes, we will now proceed.

STATEMENT OF WARREN MOTLEY, COUNSEL, MASSACHUSETTS INVESTORS TRUST, BOSTON, MASS.

Mr. MOTLEY. My name is Warren Motley. I come from Boston. I appear here as counsel for the Massachusetts Investors Trust and Supervised Shares, Inc., the latter company under the same management.

I think I ought to mention that I and my firm are also counsel for several other investment companies in Boston, both open-end and closed-end, although I am not appearing for them today.

I am not going to take long to present what I have to say, and will confine myself almost entirely to section 10 of the proposed bill. I had intended to make a rather exhaustive discussion of section 10, but so much has been said on the different phases of it that I am going to limit myself, first, to bringing out one more concrete actual example of what it would do in a certain situation, as a supplement to the examples which have been brought out by the witnesses who have heretofore appeared before you; and then, after that, I propose to make a brief analysis of the different types of control which it seems to me that section seeks to cure—or I will correct that word "control" and say, different types of conflicts.

Now, before getting into that I am going to ask you to forgive me if I take up a little point which came up in Mr. Anderson's testimony on Friday, when you, Senator Wagner, were not here.

Mr. Anderson, president of the Consolidated Investment Trust, was testifying on Friday and he pointed out that in the case of his company he had an executive committee of three, and that it would be unlawful if he should at any particular time have on that executive

committee of three, two of his directors who happened to be wardens of the same church.

I do not wonder that Senator Hughes, who was presiding, expressed a little incredulity and very courteously suggested to Mr. Anderson that he thought he was going a little far. I think it is really worth while to take just a moment to point out that Mr. Anderson was absolutely right.

Section 10 (a) says that no company shall have a board of directors or executive committee more than a minority of the members of which consist of affiliated persons of any one company other than the investment company in question.

Now, Mr. Anderson's remark did sound a little bit far-fetched. But if you will look at the definitions in the bill you will find, on page 85, that a company means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons whether incorporated or not; and affiliated persons are defined in the bill so as to clearly include directors of any company. And then in order to know what directors are you are referred to the provision on page 86 of the bill that "director" has the same meaning as in the Securities Exchange Act of 1934.

Now, if you will look at the Securities Exchange Act of 1934 you will find that the term "director" means "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

Now, certainly the wardens of a church are directors under that definition in the Securities Exchange Act of 1934. A church is certainly a company within the definition of "company" in this bill.

So I think I am perfectly safe in saying that Mr. Anderson's statement was entirely correct, that it would be unlawful for him to have two wardens of the same church on his executive committee of three.

Now, I do not want you for a moment to think that I would take this much time merely to be facetious or to bring out an absurd situation. I take the time because it seems to me a good example of two things.

1. How very far this bill goes in all sorts of unexpected ways as well as those which are clearly obvious; and

2. What a meticulous analysis of every word and section of this bill is necessary for anyone to understand what it means or how it will affect a particular situation. And it is simply for that purpose that I bring out that that particular point, not because it is particularly likely that anyone is going to be embarrassed by that actual situation.

I think the very intricacy of this bill is sufficient in itself to condemn it as a piece of legislation.

Now, gentlemen of the subcommittee, if I may I will take up the particular concrete example which I mentioned, which is just one more example supplementing those that have been given you by others. It relates to the situation of the two clients whom I represent here, Massachusetts Investors Trust, and Supervised Shares, Inc.

Massachusetts Investors Trust has a board of five trustees. They have no management or advisory contract with themselves or anyone else. These five men also constitute the board of directors of Supervised Shares, Inc., a Delaware corporation, which also has no advisory or management contract. These five men give practically their

whole time to the management of these two companies. They have quite a substantial research and statistical organization, which is shared by the two companies so that only a small proportion of the expenses falls on the little company. The Massachusetts Investors Trust has assets of $120,000,000, and Supervised Shares, Inc., has assets of only $8,000,000.

Each company also has an advisory board of five men, completely independent of the trustees. The same five men serve on the advisory board of each company. In fact, I think three of these men have appeared before you already.

Senator WAGNER. Mr. Motley, might I ask you a question right there in order that I may understand the situation?

Mr. MOTLEY. Yes, sir.

Senator WAGNER. You spoke about your company and then said it has five trustees. Just what is the organization there? Are the trustees appointed by the corporation, or did you mean to say that they were to be the directors of the corporation, or what is the structure?

Mr. MOTLEY. Let me make that clear. I am speaking of two companies as defined in the bill. One of these companies is in fact a strict trust, the Massachusetts Investors Trust, which has five trustees, who are self-perpetuating. The other company is a Delaware corporation, which has five directors, who are the same individuals and who are annually elected by the shareholders.

Senator WAGNER. I wanted to get your view of the situation.

Mr. MOTLEY. The advisory board of five men acts in that capacity both for the trust and for the corporation.

Senator WAGNER. They are other individuals again.

Mr. MOTLEY. They are five other individuals.

Senator TOWNSEND. What authority has the advisory board?

Mr. MOTLEY. The advisory board has no authority to determine that any investment shall be bought or sold. In the case of the Massachusetts Investors Trust the advisory board has some veto power; they can veto the placing of a new security on the approved list, but the approved list is a much larger list than the actual list of investments.

Senator TOWNSEND. What are their real duties?

Mr. MOTLEY. Their real duties are purely advisory and consultative

Senator WAGNER. Do you pay them by their attendance at meetings?

Mr. MOTLEY. I might add this, that in the case of Supervised Shares, Inc., the little company, the set-up is such that the advisory board has no authority whatever.

Senator TOWNSEND. What I am trying to find out is this: Of what benefit are they if they have no authority?

Mr. MOTLEY. They are purely advisers.

Senator TOWNSEND. I know, but if they have no authority what is their benefit to the company?

Mr. MOTLEY. The board of trustees, or I mean the board of directors gets the benefit of the advice and experience of these men to guide them in their actions.

Senator TOWNSEND. Are they paid anything for their advice?

Mr. MOTLEY. They are paid a portion of the percentage which goes to management. That is, a portion of what would otherwise go to the trustees is paid to this advisory board.

Senator WAGNER (chairman of the subcommittee). All right. You may proceed.

Mr. MOTLEY. Now, that is the set-up of the two companies. This advisory board has no authority to determine that any investment shall be bought or sold. In the case of Massachusetts Investors Trust, it has some veto powers. In the case of Supervised Shares, it is wholly advisory. This seems to me a good set-up. The little company gets a type of management which it could not command if it stood alone, and the same is true of the research and statistical facilities.

Now, we don't really know the status of the advisory board under this bill, so for the moment I am going to ignore them and assume that the five trustees of Massachusetts Investors Trust constitute the board of directors of each company.

Now, in speaking of the effect of section 10 here I am first going to ignore the advisory committee, because frankly we do not know what constitutes an advisory committee under this bill; and I will come back to that a little later. So we will assume that the five trustees of Massachusetts Investors Trust, these five individuals, constitute the board of directors of each company for the purposes of this bill. That, of course, is clearly forbidden by section 10 (a) of the bill. Even if they added six independent directors to the board of Supervised Shares, it would be forbidden. They must either add six independent directors to both boards or else three of the five must resign from Supervised Shares and three new men be substituted for them. Neither of these arrangements would offer much incentive to a continuation of the existing cooperation, and it is more likely that the five trustees would eliminate themselves from Supervised Shares, leaving it to find a new management.

We have also considered whether anything could be worked out through an investment advisory contract. If the five trustees of Massachusetts Investors Trust formed an investment advisory company in order to enter into an advisory contract with Supervised Shares, that again would be forbidden even though Supervised Shares had a wholly independent board of directors. If they undertook to form a management company which should act as investment adviser to both companies, this would be permissible only if they installed an independent majority of directors in both companies, and even then the combined assets of the two companies would be so close to $150,000,000 that they might run over that figure at any time, and so even that arrangement would become illegal. Moreover, Supervised Shares should have scope to grow, in the interests of its own shareholders. For, although now with assets of $8,000,000 it has an expense ratio which compares very favorably with the averages of other similar small companies, it would have to be considerably larger to get its expense ratio down to a point at all comparable to that of Massachusetts Investors Trust.

Now, of course, we could offer an amendment by way of a further exception in section 10 (b) which would permit some one of these arrangements, but, frankly, I hesitate to suggest any further complication of section 10. The whole trouble goes back to the particular prohibition of section 10 (a), which I believe to be wholly unjustified.

And yet, it would be most unfortunate if Supervised Shares should be cast adrift. It was orphaned once before and the trustees of