

The only gentleman that I remember who appeared before your committee and opposed legislation of any kind, also telephoned me last night endorsing this bill.

So, while we have not had time to get everybody in the boat, I think we speak for a very large percentage of the industry, and we feel that this bill is not only a workable bill, but is a bill which is a good thing for the industry. We would like very much to see it passed, and we hope very much that it can be passed at this session. The industry would like to feel that it has regulation behind it; that is, that we may know what the regulation is to be and that we will no longer live in uncertainty as to what the future holds for us. This is the type of regulation under which the industry feels it can work and which it feels will be very beneficial to the industry. We are hopeful that if this legislation passes it will constitute a stimulus to the investment company industry's contributing to venture capital.

I have a hope, and a number of us have discussed this, that out of this cooperation among ourselves and with the Securities and Exchange Commission there will result an association of investment companies which will work with the S. E. C. to improve even further the standards of the industry. We think that that will be helpful to the S. E. C. in administering this bill, to have an association to work with; and we are really very hopeful that we are at the start of something very useful and beneficial to the industry.

We feel also, that the critical period that we are going through now, rather than being a reason for postponing legislation, is, in our opinion, an added reason for passing this legislation. We feel that it would be helpful not only to the industry to have this legislation passed now, but also we feel that it is a very healthy sign that Government and industry can come together and do a constructive job of this kind.

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

Mr. MOTLEY. I shall take but a few moments to express my complete endorsement of everything that has been said, both by Judge Healy and by Mr. Jaretzki.

I appeared at the hearings here as counsel for Massachusetts Investors Trust, primarily. When it became a matter of these negotiations, of trying to work something out, I was asked to act in general for the open-end industry, as Mr. Jaretzki was asked to act in general for the closed-end industry. We have worked very hard, all of us, with Mr. Schenker and his associates, and with Judge Healy's cooperation, for the last 2 weeks, and we have got something that is now presented to you that, as has been said, we can endorse. And while I have not been able actually to reach all of the members of the open-end industry, just as Mr. Jaretzki said, within the short time we have had over the holiday, everyone that I have heard from has endorsed the bill as it was sent to him, and we have not heard any opposition although we have received suggestions as to minor points.

Mr. Griswold is here, representing Massachusetts Investors Trust and Supervised Shares, and Mr. Hugh Bullock, representing the investment companies sponsored by the Calvin Bullock organization, and I talked on the telephone this morning with Mr. Tudor Gardiner, who expressed the regret of himself and Mr. Traylor and Mr. Cabot that the plane did not run this morning, as they all wanted to be here, and they asked me to say for them what they have said in that telegram as to their agreement.

The only other thing that I would like to add is that while we have worked very hard the last 2 weeks over this matter, it has been an extremely interesting experience to find with what cooperation we have been able to work in a thoroughly fair and honest effort on both sides to put into language, necessarily complicated, the principles which we had previously agreed to—which is not always an easy thing to do; misunderstandings can so readily arise. But all the problems have been faced both by ourselves, I think, and I am sure, by the S. E. C. representatives, with the utmost desire to be fair and to work into the bill all the provisions that we could persuade one another ought to be there.

I do not think I can add anything more.

Mr. JARETZKI. I would like the record to show Mr. Arthur H. Bunker, who appeared before you, is present, as are also Mr. Cyril Quinn and Mr. Raymond McGrath, who are members of the closed-end industry.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. Senator, I would like to take a few moments to indicate broadly what are the differences between the revised proposals and the original proposals.

Senator WAGNER. I think I speak on behalf of the entire subcommittee in congratulating you gentlemen on reaching an accord. It shows what can happen when reasonable men sit around a table. It also seems to me that cooperation between Government and industry, as is evidenced by the results here, is the way to secure reasonable, sound legislation. While I cannot speak for the subcommittee as to what ultimately will be adopted, I am sure they were all gratified when they heard that you gentlemen decided to confer with one another. I hope it sets an example for general cooperation.

Senator HERRING. For the Congress, let us say, and especially for the Senate.

Senator WAGNER. Yes.

Mr. SCHENKER. In section 1, "Findings," and in section 2, "Declaration of policy," a few changes have been made in phraseology to conform to the changes in the substantive provisions of the bill and are not of great consequence.

The definition of investment companies contained in section 3 is substantially the same as it was in the previous bill. Similarly, we have in section 3 taken every precaution to grant an exemption to every type of company which might be construed to be within the purview of the legislation but should not be within the legislation.

We have specifically enumerated additional exemptions, so that it will be notice unequivocally to everybody in that category that they are not within the purview of the bill.

Section 4, "classification of investment companies," is substantially the same as it was in the previous bill.

Section 5, "Subclassification of management companies," has been simplified, and two classes of companies have been provided for. One is known as the diversified company and the other as the nondiversified company, besides making the same distinction that we had in the previous bill; namely, you have open-end companies and closed-end companies, but these open-end companies and closed-end companies are further subdivided into two broad categories, depending upon what their investment policy is. If they have the policy of having no more than 75 percent of their assets invested in diversified securities, if they do not have more than 5 percent of their assets invested in not more than 10 percent of the outstanding securities of a company, they are diversified companies. Every other type of company is a nondiversified company.

We have not attempted to distinguish between them on the basis of capital structure, as we attempted in the other bill.

Senator WAGNER. Those are all removed, are they—the capital structure limitations?

Mr. SCHENKER. Those limitations are no longer incorporated in the classification of investment companies, but they are still dealt with in the substantive provisions. We have provisions relating to capital structure.

Senator WAGNER. Perhaps you misunderstood me. You remember that there was a provision putting a limitation on the amount of assets that can go into one security?

Mr. SCHENKER. Yes. That is in there. That is the basis of distinction between companies. The distinction in this draft is, do you diversify your securities and limit yourself with respect to the major portion of your assets, to not putting more than 5 percent of your assets in one company and not owning more than 10 percent of outstanding securities of that company?

You recall in the other draft we had a provision that a diversified company had to have one class of stock; it could not be pyramided, and a specified portfolio turn-over. Those other qualifications have come out of the classification of investment companies section, so that you have a simple classification, diversified and nondiversified companies.

Section 6 is substantially the same as the old section 6.

Section 7 is substantially the same. Subsection (d) on page 18, in essence, is similar to the provisions we had in the other proposed bill, except that now provision had been made that if an investment company that is organized under foreign laws can be subjected to the same policing that a domestic corporation is subject to, and if the Commission, by rules and regulations, can insure effective policing, a foreign company may be permitted to register.

You remember that under the old bill foreign companies could not register because we did not want to give them the sanction of being a registered company without being able to enforce all provisions against them. This carries through the same thought, except that we make provision that in the future, if we work out a system

whereby these foreign companies can be subject to comparable regulation, then the Commission is authorized to permit them to be registered, subject to those regulations.

Section 8, "Registration of Investment Companies," has been modified to include a provision for a detailed statement as to what the investment policy of the company is going to be—whether they are going to be diversified or nondiversified; whether they are going to borrow money; whether they are going to trade in commodities, whether they are going to be a trading company rather than an investment company. The language has been deliberately broad so as not to impede the management in its primary function of managing the portfolio, and yet to put the investor on notice as to the basic type of company that it is going to be. Instead of putting these limitations into the definitions, we have now put them into the registration statement, which will put an investor on notice as to what type of company it is going to be and what activities it is going to engage in.

Also, in order to accommodate another change made in section 9, this registration statement will give the Commission detailed information with respect to the officers, manager, investment adviser, and similar affiliated persons. These affiliated persons will not have to register as they would have had to do under the first draft. The company will furnish the Commission with information with respect to these persons.

Section 9 provides that any person who has been convicted for a securities fraud or has been subject to an injunction for a securities fraud cannot be an officer, director, or investment adviser of an investment company, instead of taking the approach that we did before, namely, that they had to file a registration statement and the Commission could deny them registration, and if such person has been so convicted or enjoined in connection with a securities fraud. In order to provide for the extreme or unusual or harsh situation, the Commission is given authority, in the event that a person has been convicted of a crime or subject to injunction, to still permit him to act if it feels, on the basis of all the facts, that it is not inconsistent with the protection of the investor, to permit him to act. That is to take care of the harsh case.

Senator WAGNER. How does that question arise, now? The company, of course, in filing its registration statement, will set forth these facts. Then does the company ask, notwithstanding the conviction, that he be permitted to act? How does the question arise?

Mr. SCHENKER. The bill says, on page 25, subsection (b) [reading]:

Any person who is ineligible, by reason of subsection (a), to serve or act in the capacities enumerated in that subsection, may file with the Commission an application for an exemption from the provisions of that subsection.

Senator WAGNER. That will come subsequent to the registration?

Mr. SCHENKER. Yes. [Reading further:]

The Commission shall by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of subsection (a), as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application.

Senator WAGNER. It may not be in the registration statement. He simply makes an application?

Mr. SCHENKER. That is correct, Senator.

Senator WAGNER. Which is independent of any registration?

Mr. SCHENKER. Yes, sir; that is correct.

Section 10 has been simplified substantially. You remember it was quite a complicated provision in the previous draft.

Senator WAGNER. We heard a lot about section 10. I thought about it in my sleep.

Mr. SCHENKER. Although, Senator, the fundamental approach in both these bills is similar, you remember the underlying thesis of old section 10 was that if anybody stands to gain or lose from transactions in which he has some element of control, then provision ought to be made for independent representation. This new section 10 provides that 40 percent of the directors have to be independent of the managers, officers, and employees. It is stated the other way. It says, not more than 60 percent shall consist of persons who are managers, officers, or employees. This provision will provide the independent directorships where you have a management contract. In the situation where the directors are the brokers for the investment company or are investment bankers or are the principal distributors of the securities of the investment company, then a majority of the board has to be independent of those individuals. So you have a situation where there is no element of self-dealing—and I do not use that word in any offensive sense. In a situation where the director stands to gain or lose in a particular transaction, either as acting as investment banker for portfolio corporations, or acting as broker for the investment company, or acting as principal distributor for the securities of the investment company, in that case the board of directors has to be independent to the extent of the majority of the board from those individuals—

Senator WAGNER (interposing). That will require some readjustments?

Mr. SCHENKER. Yes; that will require some readjustments; and I think it is a tribute to the industry that they recognize the underlying philosophy of that provision. And be it said also that I do not think they really opposed the underlying philosophy, except that it was a matter of what protection was necessary to safeguard the situation. We feel that this will do it.

We have eliminated the other provisions which had prohibitions against interlocking directors between investment companies and the portfolio corporations which provisions had engendered such opposition. Under this bill today the director of an investment company can be on the board of a portfolio corporation.

Now, coming to section 11. The old section, as you remember, had a prohibition against organizing new companies if within a certain specific period you had organized another company. The major problem in connection with that situation was "switching" the investors from one investment company that you had organized to the new investment company that you organized. The approach that we have taken in the bill is that we have aimed at the abuse that grew out of the recurrent formations. We have provided that these exchanges shall be subject to the approval of the Commission, so that there shall not be any overreaching or imposition of heavy loads, and so forth.

Senator WAGNER. If there is an effort to organize another investment trust, that cannot be done unless it is approved by the Commission? Is that correct?

Mr. SCHENKER. No, Senator. There is no limitation now upon the number of investment companies that one sponsor can organize. However, the abuse in the past used to be that you would organize A Investment Co., and organize B Investment Co., and then go to the A security holders and say, "This trust is not as good as the new one. Why don't you get out of the A company and get into the B company?" There was a "switching," and it is that switching that we regulate rather than the organization.

Senator HUGHES. But you still have the companies?

Mr. SCHENKER. Yes. They cannot "switch" the investors. And, of course, Senator, the new companies will be subject to all the provisions in the bill. I think the fact that they are to be subject to all these provisions will tend to discourage the practice. It is not a simple matter any more to sponsor a new investment company. That combined with the fact that we still retain the minimum size requirement will certainly cut down very substantially the number of companies that an individual will organize.

Now, coming to section 12, that is the same as the old section 12 except in one respect. You remember that old section 12 said that under no circumstances can one investment company buy the securities of another investment company. The industry had some difficulty with that absolute prohibition under all circumstances. As a matter of principle they felt that if one investment company's securities happened to be a good buy, another investment company should be able to acquire such securities although they were conscious of the fact that pyramiding should not be any longer permitted. The compromise we worked out is that one investment company may own the securities of any investment company to the extent of 3 percent of the outstanding voting securities of the investment company, which means that in reality the acquiring company has no effective voice in the other investment company.

There is one exception for which we made provision, and that is this. If one company already owns a substantial block of stock of another investment company and, therefore, really controls it, then we felt that it did not make sense to prohibit that company from increasing its position in the company which it already controls. If it controls the company—already has got 30 or 35 percent of its outstanding voting securities—it ought to be able to get as much as it wants. That is a very salutary thing, in our opinion, because there may be situations where, if the contracting block can be built up to 66⅔, those companies may be consolidated in one structure.

At the suggestion of some insurance companies we have incorporated a provision, which has approval of the industry, to the effect that hereafter investment companies shall not buy a controlling interest in insurance companies. We think that is a salutary provision, because of the possible effect upon the insurance companies through the ownership by investment companies whose business it is to trade in securities, and so forth.

The provision we have is not unlike the one dealing with one investment company buying securities of another investment company, except that if it does not have any interest in the insurance

company at the present time it can buy up to 10 percent of the outstanding voting securities, but not more. So, in the future, no investment company can acquire more than 10 percent of the outstanding voting stock of an insurance company. The status quo is maintained. There are investment companies who have a controlling interest in insurance companies. We are not disturbing those situations.

Senator WAGNER. That is fixed now, is it? When you say you are not disturbing those situations, how do you provide for that?

Mr. SCHENKER. The bill says, after the effective date of this act no company shall purchase the voting stock of an insurance company if, as a result of the purchase, the investment company will have 10 percent of such company's voting securities.

The motivation for the inclusion of another provision which I am going to discuss is as much attributable to the industry, particularly to the suggestion of Dr. Sprague, as it is to the Commission. That is a provision which permits the formation of venture capital companies to participate in underwritings, furnish capital to industry, and make small loans to industry.

Senator WAGNER. Where is that in the bill?

Mr. SCHENKER. That is on pages 35 and 36. That provision states that a group of investment companies can buy an interest in a company to be formed where the primary business of this company shall be to promote industry, finance industry, underwrite, and make loans. The only participants in that type of company will be registered investment companies; and these registered investment companies cannot put more than 5 percent of their total assets into it, and there is a size limit of \$100,000,000 for such venture capital companies.

Senator WAGNER. That is new, is it not?

Mr. SCHENKER. Yes, sir. We feel that it is a very salutary provision which may encourage the opening up of the capital markets. This is one of the things that we feel ought to impel the passage of the bill as soon as possible, so that we can get that type of thing working. This does not depend so much upon public participation. It depends upon investment companies who can take care of this company. There is no reason why an institution like that cannot function immediately after the passage of this bill.

Senator WAGNER. Five percent of the portfolio, did you say?

Mr. SCHENKER. No. No company can put more than 5 percent of its own assets in that type of company.

Section 13 is not unlike the original section 13, in that it says in substance that an investment company cannot change its investment policy as recited in its registration statement without getting the approval of the majority of its outstanding voting stock.

Senator WAGNER. Is that policy defined at all?

Mr. SCHENKER. In the registration statement, Senator, they are required to set forth what their investment policy is going to be with regard to specific items.

If you will look on page 20, these are some of the things we consider fundamental to investment policy. Starting with line 8:

(1) a statement in respect of the policy of the registrant in respect of—
whether you are going to be diversified or nondiversified; do you expect to issue senior securities; do you expect to engage in the underwriting business; do you expect to have concentration of investments

in a particular industry or group of industries—like a chemical fund or an aviation fund; do you expect to deal in real estate and commodities, or either of them, or loans to other persons; what is your policy with respect to portfolio turnover; do you expect to have a rapid or slow turnover, and so forth? In order to give a little rubber, we say that the company should not be hamstrung by those recitals but should have some freedom of action. However, the statement of policy will indicate to all persons what general type the company is going to be. As the company enumerates these policies in its registration statement, it will not be able to change them without a majority vote.

Senator WAGNER. You do not limit the type of securities? I see they may issue senior securities.

Mr. SCHENKER. That is right. I will come to that very soon.

Senator WAGNER. Yes.

Mr. SCHENKER. Section 14 relates to the size of investment companies: We have the minimum size of \$100,000; but, instead of having a maximum size, we have made it a subject of study by the S. E. C., and a report to Congress.

The next, "Investment advisory and underwriting contracts," is substantially the same as it was in the other bill.

The "Changes in board of directors: provisions relative to strict trusts," is substantially the same as in the old bill, except we have put in a special provision for dealing with the Massachusetts type of trust.

Section 17, "Transactions of certain affiliated persons and underwriters," is substantially the same provision as in the old bill. These provisions prohibit self-dealing between the officers and directors and the investment trust. They cannot knowingly purchase from such registered company or from any company controlled by such registered company, any security or other property, except securities of which the seller is the issuer, and so forth. They cannot borrow money, and those other provisions are substantially the same.

Section 18, "Capital structure": Instead of having the provision that we had in the old bill—that in the future you can issue only one class of stock—we have agreed upon this recommendation to the committee that you could have as a maximum three different types of securities—debentures, preferred stock, and common stock. That is for the closed-end companies in the future.

With respect to the open-end companies, they can have only one class of stock. However, we have made provision to enable them to borrow from a bank, provided that at all times they maintain the ratio that we prescribe with respect to such bank borrowing by an open-end company.

With respect to the closed-end company in the future, the maximum number of securities they can issue is three different types—debentures, preferred stock, and common stock. They cannot issue debentures unless at the time they issue the debentures they have a 300 percent coverage for the debentures. That means they can issue debentures only to the extent of one-third of their total assets.

With respect to preferred stock, they cannot issue such stock unless it is covered 200 percent. They can issue preferred stock up to the extent of 50 percent of their total assets.

Debentures have to be covered 300 percent; preferred stock has to be covered 200 percent.

The total senior securities including bonds and preferred stock that can be issued is 50 percent of their total assets.

Senator WAGNER. What is the difference between the debentures and preferred stock? I know generally what the difference is, but what is the debenture in the sense in which you use the term?

Mr. SCHENKER. Well, the difference, Senator, is that the debenture is a debt which is a fixed charge. They have to pay the interest or they are in default.

Senator WAGNER. I see.

Mr. SCHENKER. In the case of preferred stock, they promise to pay them a fixed dividend, if earned; but if they do not earn it, the preferred stockholder does not get it.

Since the debenture holder gets a smaller return than the preferred-stockholder, and since he is a creditor of the company, rather than having an equity interest in the company, as the preferred-stockholder holds, he ought to have more security than the person who is a preferred-stock holder. That is the reason for distinguishing between those two situations.

Senator WAGNER. I understood you to say the debenture income is lower. It may be lower or it may be higher, depending on the earnings?

Mr. SCHENKER. Well, not depending on the earnings; because if a debenture holder is promised 4 or 5 percent return, that is all he can get. The preferred-stock holder usually gets the same, except he usually gets a little higher return. But if they do not earn it, the preferred-stock holder may not get anything.

Senator WAGNER. That is what I was talking about. You said the debentures usually had a lower income than the other securities, including preferred stock. However, it really is variable, and may or may not be?

Mr. SCHENKER. I meant they promise them a smaller return than they promise the preferred-stock holder, if they earn it.

Senator WAGNER. I see.

Mr. SCHENKER. With respect to dividends we have the provision that in the future, with respect to senior securities, not only must they have the requisite coverage of 300 percent for debentures and 200 percent for preferred stock, but they cannot pay dividends on the common stock unless the debentures are covered 300 percent; they cannot pay dividends on the common stock unless the preferred is covered 200 percent; and they cannot pay dividends on the preferred stock unless the debentures are covered 200 percent.

The theory of that is that the common-stock holder has no limit on what he may get, depending on what the earnings of the company are. He cannot get any dividends and draw off the earnings of the company, to the detriment of the preferred-stock holder and the debenture holder; he cannot get dividends unless the debentures are covered 300 percent and the preferred stock is covered 200 percent.

The distinction is made between the debentures and the preferred stock. He cannot get a dividend unless the preferred stock is covered 200 percent. You have to make a distinction between the common and the preferred, because the slightest decline in the assets