SEPARABILITY OF PROVISIONS

SEC. 219. If any provision of this title or the application of such provision to any person or circumstances shall be held invalid, the remainder of the title and the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

SHORT TITLE

SEC. 220. This title may be cited as the "Investment Advisers Act of 1940".

EFFECTIVE DATE

SEC. 221. This title shall become effective on November 1, 1940.

The CHAIRMAN. Judge Healy, we will be glad to hear you at this time, sir.

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

Mr. HEALY. Mr. Chairman and members of the committee, my name is Robert E. Healy. I am a member of the Securities and Exchange Commission.

I had general supervision of the study of investment trusts and investment companies. I appear here on behalf of the Commission and I am authorized to say that the Commission favors the passage of this bill in its present form and respectfully urges upon the committee a favorable report and the passage of the bill at this session.

Mr. COLE. You refer to "this bill," Judge. Which one are you referring to, S. 4108?

Mr. HEALY. S. 4108 and H. R. 10065.

The study was authorized by the Public Utility Holding Company Act of 1935. It was not only authorized, we were ordered to make it.

We organized the study about as follows: I was given a very general supervision of it. We put a man named Paul Gourrich who had a background of many years' experience, as statistician and analyst, in charge of it. Under him, in charge of the legal side, was David Schenker, and on the financial side was a man named Spratt, who had had many years' experience as an investment banker and who had had some connection with trusts. Unfortunately, Gourrich's health broke down. He resigned. Spratt had to submit to an operation; developed pneumonia and died. The result is that Schenker for some time has carried three loads. That helps to explain the delay of the Commission in getting its report in this matter to Congress.

The first thing that we did was to prepare some questionnaires. Then it was suggested to the various parts of the industry that they get up some informal committees. They did that. I think the organizations were rather loose ones. Their representatives came and talked with us. Finally it got to a point where they found no particular objections to the questionnaires, so we sent them out.

By the end of 1937 the Commission had received replies from about 700 trusts and companies of all types, and from about 400 investment advisers, or investment counselors, as they are sometimes called. In addition, we sent some men into the field. They made field studies of about 60 companies which had been acquired and absorbed by two large investment companies during the period 1927 to 1935. These two were The Equity Corporation, in which David Milton is an outstanding figure, and the Atlas Corporation, in which Mr. Floyd Odlum is the outstanding figure.

In addition, we sent accountants and examiners into the field to study the books and records of about 100 companies. Then we got up a preliminary report on each company and that report, before it was given any publicity whatever, was sent to the representatives of the company concerned.

These representatives came to Washington and talked with the men who wrote the reports, and some of the points that our men thought were pretty serious, on explanation, did not turn out to mean quite so much. On the other hand, at other points it was plainly shown that some bad practices had developed. Some were never satisfactorily explained, and have gone into the record as examples of abuses.

Now, these conferences, as I have tried to indicate, sometimes helped to explain items that turned out to be not so sensational as they seemed to be at first and also to indicate that other items were quite as sensational and undesirable as they at first blush seemed to be.

The conferences also had the virtue of preparing the companies for public hearings and in that way they knew what the topics were to be and what papers they were expected to bring to the hearings.

The next stage was the public examination. That is, a public hearing was called. A trial examiner presided, and members of our staff proceeded to develop the facts by evidence. In these public hearings the companies involved were entitled to cross-examine witnesses. They were represented by counsel and they were also entitled to present evidence, through witnesses of their own choosing, and in many instances they did so.

The record of these public examinations consists of 33,000 pages of transcript and about 4,800 exhibits.

I am sorry to say that the record was not ordered printed by Congress, and as a result it is only available in typewritten form.

Now, from time to time we have sent reports to Congress embodying the results of these studies.

The main part of the report we have referred to, for ease of reference, as the over-all report. Part I thereof was sent to the Congress in June 1938, and it was entitled, "The Nature, Classification, and Origin of Investment Companies."

Part II was entitled "Statistical Analysis of Investment Trusts and Investment Companies." This part, consisting of eight chapters, analyzes the companies on a detailed satistical basis as to performance, earnings, trading in portfolio securities, investors' experience, and so forth.

Part III was entitled "Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies." That part consists of seven chapters. It discusses, as the title indicates, the evils and malpractices of all the investment trusts and companies which we studied, so far as we found them. All of these chapters, except a part of a chapter dealing with accounting abuses, that is, a chapter elaborating and enlarging upon a study that has already been submitted dealing with the same subject—that is, accounting abuses—have been transmitted to the Congress.

Part IV is not yet wholly completed. It deals, or will deal (it is in typewritten form and still needs a little revision) with the economic significance of these trusts and their place in the economic structure, especially from the point of view of the control of industry. I do not think that there will be anything in it that will in any way affect anyone's judgment on the subject of the pending bill.

Mr. COLE. Does each part have the conclusions of the Commission?

Mr. HEALY. Yes, sir; they all have conclusions.

The summing up of all of the Commission's conclusions, however, was embodied in the bill which was presented to the Senate and in the statement which I was authorized to make for the Commission, which forms part of the Senate record, copies of which have been delivered to all of the members of this committee.

Now, the interest of the public in investment trusts and investment companies——

Mr. COLE. Judge, as I understand, you prefer to conclude your statement and then submit to questions. At that point, I would like to have the record disclose that the reports to which you have just referred are the ones we see on the table to the left, a couple of feet high; reports and records from the Commission reflecting the studies made on this subject under authority of section 30 of the Holding Company Act.

Mr. HEALY. Yes, sir. In addition to the so-called over-all report, which I have tried to describe to the committee, the Commission also prepared some supplemental reports that dealt with special subjects and did not fit into the general over-all report. I would like just briefly to name them.

We submitted a report, a supplemental report, on fixed and semi-fixed trusts. We also submitted one on the so-called installment investment plans. I plan to briefly discuss each one of these types before I get through.

We submitted a report that was prepared for us by two economists in London, dealing with British investment trusts, because they are often referred to in connection with discussions of investment trusts in this country.

Then, we had a supplemental report on investment advisers, involving the so-called investment counselors and advisers.

We had another on the so-called common or commingled trust funds that are operated by banks and trust companies. They are permitted to commingle the private trusts that they operate from time to time.

And then there is a report on companies issuing face-amount installment certificates. That is the last of the supplemental reports and is now in page proof at the Government Printing Office. We will be able to lay that on the desks of Congress in a few days.

Now, what is the extent of public interest in investment trusts and investment companies? Our study discloses that it is very large.

In the last 15 years approximately 1,300 such companies have been created. The American public has contributed over $7,000,000,000 to these organizations. The value of their assets at present is approximately $4,000,000,000.

That sum is computed as follows: the $7,000,000,000 was contributed, as I understand it—and our statisticians will correct me if I am wrong—upon the basis of original contributions of capital and does not take into account those instances where members of the public bought these securities on exchanges or in the over-the-counter market, from the original subscriber or his assignee at prices in excess of the original subscription, but the original subscriptions to the corporations and trusts involved in our studies were disclosed to be about $7,000,000,000 in the last 15 years.

Now, some idea of the significance of these companies may be gathered from the fact that that amount is about half of the sum at which the investment in the electric utilities companies in the United States is roughly calculated, $14,000,000,000.

Furthermore, there was one investment corporation, or one group of investment companies, which raised half a billion dollars; a little over $500,000,000—and they raised it from about 90,000 investors in 44 States.

By 1933 the assets of that corporation or that group of corporations had declined in value to less than $50,000,000. These losses, I think the record fairly shows, were not due to mere shrinkage in market values, but were due, the Commission submits, very largely to so-called investments made by those in control whose principal object was to get control of situations from which they could get investment banking business.

I think the record fairly supports that conclusion.

Let us make a few comparisons of these sums with the assets of our financial institutions, having in mind particularly the $500,000,000 that went into this one group of companies.

In 1939, only one of the 564 principal savings banks of this country had assets in excess of $500,000,000. Out of the approximately 15,000 commercial banks and trust companies in the United States only 16 had resources in excess of $500,000,000. Of approximately 300 leading life insurance companies, only 12 showed total assets exceeding $500,000,000. In the 6 southern States of North Carolina, South Carolina, Georgia, Florida, Alabama, and Mississippi, the total savings in savings institutions, including postal savings, savings banks, and commercal banks, were $484,000,000. In the 13 States between the Mississippi River States and the coast, not including Texas, the total similar savings amounted to $560,000,000.

These securities of investment companies are owned by approximately 2,000,000 investors throughout this country, with the majority of the individual investments in such securities having a value of under $500. The number of security holders of investment trusts and companies probably exceeds that of all other industries except utility holding company systems. It is estimated that 1 out of every 10 holders of securities of all types in this country is a holder of investment trust and investment company shares or certificates.

In addition, investment companies at present control, or are in a position to control or influence various industrial, banking, utility, and other enterprises having total assets which, as of the end of 1935, amounted to many billions of dollars. Furthermore, these investment trusts and investment companies, because of their very substantial trading in securities on stock exchanges, are a most substantial factor in our securities markets.

Against that much of a general description, I would like to pass on to a description of the various types of companies, and this helps to explain why this bill is so long.

I think it is very confusing to have witnesses come in and talk about face-amount plans, periodic plans, and open-end companies and closed-end companies.

It is necessary to know what those companies are, in a general way, because it develops that it is not desirable to have the same type of regulation and the same type of requirements as to each kind of company. You have got to make some differences.

That point will be developed at greater length as the hearings go along.

First we have the management investment companies. The distinctive feature of these companies is that no restrictions, or only limited restrictions, are imposed with respect to the nature, type, and amounts of investment which their managements may make, or how they may invest the money that is turned over to management. Management goes ahead and invests the funds and manages them according to its own best judgment.

These management investment companies fall into two broad classes: The open-end and the closed-end type.

The peculiarity of the open-end companies is that they issue so-called redeemable securities—that is, a security which provides that the holder may tender it to the company at any time and receive a sum of money that is roughly approximate to the current market value of his share of the company's assets.

Because of the exercise of this redemption feature, the assets of most of these open-end companies would be constantly shrinking were it not for the fact that they constantly sell new securities to new investors. It is because of this constant sales activity, which is a companion of the redemption feature, that these companies are called open-end companies.

The closed-end companies are also management investment companies, but they do not have this redemption feature. They do not distribute their securities continually, but only from time to time as they need new capital. Up to 1929 nearly all investment companies were of the closed-end type. However, the open-end companies, though a relatively recent development, have expanded rapidly and now have total assets whose value is approximately two-thirds of the value of the closed-end companies' assets.

Then there are also the so-called unit type investment trusts, which include the fixed trusts and the semi-fixed investment trusts. In this type of trust management discretion is almost entirely lacking. That is, the investor is sold an undivided interest in a specified package or unit of securities which are deposited with a trustee. The underlying securities cannot be changed at all, or they can be changed only upon the happening of certain contingencies or events that are specified and spelled out in the trust indenture, for example, upon the passing of a dividend on a security in the package for a prescribed period of time. That is, if the dividend is passed for a certain period of time, then it is the duty of the trustee to eliminate it; or if the investment rating of the security by a prescribed investment manual or statistical service falls below a certain point, then it is the duty of the trustee to eliminate it.

Still another type of investment company is the so-called installment investment or periodic payment plan. This, in essence, is a device to sell investment trust or investment company shares, to the public on the installment plan. These plans were designed to tap the savings of individuals in the lowest economic and income strata of the population for investment in common stocks. Some plans provide for installments as low as $5 a month, but the usual payment is $10 a month, and the period of payment is generally 10 years.

The final variant of investment enterprise that I will speak about, among those studied by the Commission—I think we covered the field pretty well—is the so-called face-amount certificate company. Although the companies of this type have been in existence since 1894, the greater proportion of their certificates were sold to the public after 1929.

In essence, the certificates sold by these companies are contracts between the corporation which issues them and the purchaser. In the contract, in consideration of the payment of certain specified installments, the corporation agrees to pay to the purchaser at maturity a definite specified sum, that is, a face amount, and hence we get the name of "face-amount securities" or "face-amount certificates." They also have a provision, at least most of them have it, that prior to maturity there is a specified surrender value.

These companies have avoided or escaped registration under the Securities Act of 1933, due to an exemption provision that appears in the 1933 act. I am not sure that they were entitled to exemption. I do not mean to intimate that they were not. I think it is somewhat debatable.

Because of the large public interest in these organizations, and because these companies represent unsupervised pools of savings, these institutions have been a matter of concern to representatives of the investment-company industry themselves, to the stock exchanges, the financial writers, and governmental bodies from an early period of their existence in this country. I will not stop to quote them, but there was a reference by Mr. Paul Cabot, in the Atlantic Monthly some years ago, pointing out some of the problems. The New York Stock Exchange did not admit investment companies to listing for a considerable period of time.

And there was an investigation by the Attorney General of the State of New York some years ago. Nothing much came of it. There was a report and a recommendation, but the State legislature did not act on it, as I remember.

In that connection, it is well to point out, I think, that not only do these companies have these large, unsupervised pools of savings, but in the very large majority of instances the investments are of an extremely liquid character. In the case of the open-end trusts, due to the right of the stockholder to come in and demand a redemption, the company has to keep itself in a very liquid position. That is, it has to be able to turn its securities into money on very short notice.

One of the results of that is that the companies, most of them, have by far the major portion of their investments in so-called blue chips, the securities that are readily salable on the exchanges; so that, to steal a line from my friend Schenker, an investment trust is often merely a safe-deposit box, and experience has proved, rather unhappily for some, that it is not too difficult to loot those boxes and to get away with their contents.

There will be some further references to that matter before I get through or before the hearings are concluded.

Our studies indicate that there are various problems with respect to organization and operation of these companies which we submit should be remedied by legislation. That this is so has been definitely recognized by the industry itself.

I would like to briefly summarize the principal ones. As I have stated, the problems enter largely from the nature of assets. The assets usually, as I have said, are cash and securities which are very liquid and readily negotiable. Because of these characteristics the control of these funds offers manifold opportunities for exploitation by unscrupulous managements wherever they have existed. Happily they have been in a minority. These assets can be and have been misappropriated and diverted by management of that kind. They have been employed to promote the personal interest of the management rather than the interest of the public security holders.

It seems obvious that in the absence of regulatory legislation, individuals who lack integrity will continue to be attracted by the opportunities for personal profit available in the control of the liquid assets of investment companies, and that deficiencies which have occurred in the past will continue to occur in the future, unless measures are taken to prevent them.

The wide appeal to the public which has been made by investment companies in the past has been indicated by the testimony before the Commission.

It is evident that companies honestly and efficiently managed—and there are a number of them—can serve a most useful purpose in extending to the public an opportunity to participate financially in the economic enterprise of the country.

This bill will provide safeguards without undue restrictions so that those who desire to put their savings to work in this manner may do so with greater confidence.

In the past, since no specified amount of capital was required to organize investment trusts and companies, they could be created and were created by, and in many instances their securities sold to the public by irresponsible individuals. Persons convicted or enjoined by the courts because of perpetration of securities frauds were able to organize and operate investment companies. There were a few instances of that character. Brokers, security dealers, investment bankers, and commercial banks are sometimes in a position to dominate a board of directors and control the management of investment companies, and thus, where they were not strictly scrupulous, to advance their own pecuniary interests at the expense of the investment companies and their security holders.

The capital structures of management investment companies have often been inordinately complex, and the rights, preferences, and dividend claims of senior securities have in many instances been inadequately safeguarded. By various devices of control, such as special voting stocks issued to distributors and managements, voting trusts, long-term management contracts, control of the proxy machinery, and pyramiding of companies, public investors are effectively denied, in many instances, any real participation in the management of their companies.

The distribution and repurchase of securities issued by investment companies have, on occasion, resulted in discrimination in favor of the management or other insiders who have been able to acquire the securities and to have the companies repurchase them on a basis more favorable than that accorded public stockholders. In the open-end companies the method of pricing their securities, which they are continually selling and redeeming, may lead at times to substantial dilution of the investors' equity in the companies, and in some instances has even been used by persons closely connected with the companies to realize riskless trading profits. They are able to trade in such a manner as to make profits involving no risk on their part.

A major problem in the case of management companies is created by the absence of any legal requirement for adherence to any announced investment policies or purposes. Such policies have often been radically changed without the knowledge or prior consent of stockholders. Similarly, after investors have invested in companies on their faith in the reputation and standing of the existing managements, control of the public's funds has frequently been transferred without the prior knowledge or consent of stockholders to other persons who were subsequently guilty of gross mismanagement of the companies.

The representatives of the investment-trust industry were of the unanimous opinion that self-dealing—that is, transactions between officers, directors, and similar persons on the one side, and investment companies with which they were associated on the other—presented an opportunity for gross abuse by unscrupulous persons through unloading of securities upon the companies; through unfair purchases from the companies; and from obtaining of unsecured or inadequately secured loans from those companies. The industry seems to recognize that even for the most conscientious management, transactions between these affiliated persons and the investment companies present many difficulties. Many investment companies have voluntarily barred this type of transaction—but not all of them.

The small investors in certain investment companies, particularly in unit investment trusts and open-end management companies, have been subjected to so-called switching operations from one investment company to another, often controlled by those who controlled the first company, to the disadvantage of the investors. Similarly investors have been often powerless to protect themselves against plans of reorganization which have been grossly unfair or which have constituted gross abuses of trust on the part of their sponsors.

Finally, particularly with respect to those companies which have not registered their securities under the Securities Act of 1933 or the Securities and Exchange Act of 1934—and only a small number have so registered their securities—the investor has been unable to obtain adequate information as to their operations. The accounting practices and financial reports to stockholders of management investment companies frequently are deficient and inadequate in many respects and oftentimes misleading. In many cases dividends have been declared and paid without informing the stockholders that such dividends represented not earnings but a return of capital to stockholders.

Turning to the unit investments, or fixed trusts, they have been characterized by certain abuses and deficiencies. These abuses are traceable to the fact that the most important emolument to the promoters of such trusts was the profits to be derived from methods of pricing and selling the securities of such trusts to the public, inequitable pricing of shares, excessive sales loads, hidden loads and such loads and charges have not been infrequent.

I would like to deal for a few moments now with the periodic payment plans.