

to the public. Then technically the investment trust has only one stockholder, the corporation—but the corporation has public stockholders. These stockholders are then counted as the security holders of the investment trust.

Now, then, paragraph (2) of section 3 excludes people who are engaged in investment banking business.

Paragraph (3) excludes banks, insurance companies, and savings and loan associations. A common trust fund which is the trust funds which are operated by banks—

Now, then (4)——

Mr. COLE. Is it necessary to mention Federal loan associations? Are they excluded in another section?

Mr. SCHENKER. There is a specific section, Mr. Cole, that excludes all Government agencies.

Mr. COLE. That would take care of the Federal loan associations.

Mr. SCHENKER. That is right.

Now, paragraph (4) exempts the so-called bank-holding-company affiliates. That covers the situation where a company owns either a majority or the outstanding stock of a bank or a controlling interest in the bank. In that case, the company has to get a voting permit from the Federal Reserve Board. In order to get that voting permit it has to agree to comply with certain conditions imposed by the Federal Reserve Board.

There is one provision in that paragraph which says that the Commission must be afforded an opportunity to be heard, and why is that?

We have one situation today, for instance, where 80 percent of the assets of a company consists of diversified securities and yet has a controlling interest of a couple of banks. That company is a bank holding company. But, in order to avoid circumvention by a person organizing a large investment trust and using a small part of its assets to buy control of a couple of banks and therefore make it a bank holding company, the Federal Reserve Board said, "We would like to hear you people and see if this is not circumvention of a person trying to get away from the provisions of this act." We worked that out with the Federal Reserve Board.

Now, paragraph (5) excludes small loan companies.

Subparagraph (6) excludes people engaged in discounting automobile paper, refrigerator paper, and paragraphs (7) and (8) are to cover subsidiary and controlled company situations of these discount companies.

Paragraph (9) excludes any company which is subject to regulation by the Interstate Commerce Commission or any company which is controlled by a company regulated by the Interstate Commerce Act, provided substantially all of the assets of the controlled company consist of securities of companies which themselves are regulated by the Interstate Commerce Commission.

Mr. COLE. That is the provision of the Transportation Act.

Mr. SCHENKER. That is right. Now, we put that in because of the Wheeler-Lea bill. If that bill passes, then those companies will be under the jurisdiction of the Interstate Commerce Commission.

Paragraph (10) excludes any holding company under the Public Utility Holding Company Act of 1935.

Paragraph (11) excludes oil royalties.

Paragraph (12) excludes eleemosynary institutions.

Paragraph (13) excludes pension trusts under the Internal Revenue Code.

Paragraph (14) excludes voting trusts other than voting trusts involving investment-company securities.

Paragraph (15) excludes protective committees.

Now, we come to the classification of investment companies. Section 3 defines an investment company.

Section 4 divides these investment companies into the basic classes. You have the face-amount companies. Those are companies which, in essence, sell promissory notes on the installment plan.

You have the unit trusts, which include the trusts more popularly known as fixed trusts. They also include what we call the periodic payment plans. As Judge Healy indicated yesterday, the fixed trust is nothing but a deposit of a bundle of securities with a trustee who issues certificates of beneficial interest, and these certificates of beneficial interest are sold to the public. There is no management. The list of securities is specified. Those are securities that are deposited, and eliminations and substitutions can only be made on the happening prescribed express contingencies.

The third type, which is the principal subject of this legislation, is the management companies. The management companies are the companies which raise public funds, and usually they have no limitation or restriction upon the management. They can invest in any type of security, in any industry, in any amounts, and that is how that type gets its name "management."

The bill subclassifies the management companies into the open-end company and the closed-end company.

The open-end company is the company which issues what we call redeemable shares. That means the holder, as counter-distinguished from the company, has the right to compel redemption or repurchase of the shares. The holder can go to the investment company and say, "Here is my certificate. Give me the value of my certificate, based upon the market value of the securities in your portfolio."

Ordinarily, when you have a callable security, it is callable at the option of the company. Here the stockholder has a right to go to the company and say, "You give me the asset value of my certificate." That type of company is a recent development.

Management companies have been divided into open-end companies and any other type of management company which are designated closed-end companies. In the closed end type, the stockholder has no right to compel the company to buy back his stock. If he wants to sell his interest in the company he has to sell his shares in the open market.

Now, it is true the company itself may go out into the open market and buy in its own stock, but the stockholder does not have any contract right to compel the company to buy the shares directly from him. In the open-end company he has that right. That is the distinction between those two types of companies. The distinction is based upon the right of the stockholder to compel redemption.

We have also classified these companies into two classes on the basis of the nature of their investment policy.

One class is the diversified company—the type which diversifies its investments. That type cannot invest more than 5 percent of its assets in the securities of any one company, nor can it control more than 10 percent of the outstanding voting securities of that company.

The bill, in order to stimulate the operations of the capital markets, provides that with respect to 75 percent of the company's assets it is subject to the 5- and 10-percent rule. With respect to the reservoir of 25 percent of its assets, the company is not subject to the 10 percent limitation. That is, for the major portion, three quarters of its assets, the company cannot put more than 5 percent of its assets in one company or own more than 10 percent of the outstanding voting securities of one company. With respect to 25 percent of its assets the company may buy more than 10 percent of the outstanding voting stock of one company.

And, why is that? If you have a small company that wants to borrow money from an investment company, or wants to sell an issue of its securities to an investment company, the only way the investment company can really do it is by buying a controlling interest in that company. An investment company will not make a substantial investment in a small company which has no market for its securities and yet have nothing to say about management.

In order to stimulate those loans to small companies, we have said, "With respect to 25 percent of your assets, you are not subject to the 10-percent limitation."

A nondiversified company means any investment company which is not subject to this 5- and 10-percent limitation.

These are classifications and not prohibitions. A company can become a nondiversified company if it wants to, and it is not subject to any of the limitations of a diversified company. The bill does not prescribe in what securities a company may invest or when to invest. The bill merely provides that if the company is a diversified company that with respect to 75 percent of its assets, it shall not invest more than 5 percent of its assets in one company or own more than 10 percent of its outstanding stock.

Now, (c) is a technical paragraph which provides that if a company has invested only 5 percent of its money in one company and if the market value of that investment goes up so its value is more than 5 percent of the investment company's assets, it does not lose its status of a diversified company. You can visualize that situation. If an investment company puts 5 percent of its assets in the securities of one company, and suppose that the rest of the portfolio securities of the investment company declined, and the market value of this block went up, then, at that time, the company would have more than 5 percent of its assets in one company. Since the company did not invest more than the prescribed portion by virtue of any purchase it made, but just because it selected a good stock which went out, and if you do not have this provision then he would be compelled to liquidate part of that stock to bring it back to 5 percent. This is a proviso we worked out with the industry. That company should not be compelled to liquidate a part of its holding just because it bought a good stock.

Section 6 covers exemptions. Paragraph (1) exempts investment companies in Alaska, Hawaii, Puerto Rico, the Philippine Islands, the Canal Zone, and the Virgin Islands.

Paragraph (2) exempts any company which is in receivership while under the supervision of a court.

Paragraph (3) exempts face-amount certificate companies which were organized under insurance laws of a particular State and are subject

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to the supervision of an insurance commissioner, and all of the stock has been sold in that State. It is a technical exemption.

We have one other section, Mr. Cole, which does not appear in your draft, but which we have prepared. That is an exemption covering situations like the Munson Steamship Line. You remember the Munson Steamship Line went into reorganization under section 77B, and came out with a great deal of cash.

Now, that is a peculiar situation in this sense, that it may really be a transitory investment company. The situation was really created by the liquidation of the Munson Line which got into cash and in the interim is investing its funds in some marketable securities.

Now, we have worked out a precise exemption for that company. If I may make this suggestion, Congressman, I would like to make available to you at this time a copy of the bill which has these additional typographical changes and amendments, so that you can follow the suggested amendments. May I do that?

Mr. COLE. That amendment comes in here between (a) and (b).

Mr. SCHENKER. We suggest, Mr. Cole, that it be under 6 (a) (3) on page 31, following "Any company which prior to March 15, 1940, is in receivership." This really is a company which has come out of receivership, so logically it belongs under (2). Then the present (3) will become (4), and (4) will read, "Any company which prior to March 15, 1940" and so forth.

Mr. COLE. Now, you do not mean because of this proposed amendment that (b), (c), and (d) will be moved up. Let me see just what you have in mind, Mr. Schenker.

Mr. SCHENKER. Yes, sir.

(After informal discussion off the record at the bench, the following proceedings were had:)

Mr. BOREN. What page are you on now?

Mr. SCHENKER. Thirty-one.

Mr. BOREN. I might ask one question. I do not know just where in the bill it will fall. I have not had time to check it this morning, but this more or less "grandfather clause" you have put in here is a provision to let these companies operate that are already established, that might not meet the requirements which you lay down, and yet set up far more intricate and stringent requirements for any company that comes in. When we get to that situation, will you bring that to my attention. You have not discussed that yet?

Mr. SCHENKER. No.

Mr. BOREN. When we get to those sections, I want you to give me some information.

Mr. SCHENKER. We have made provision for exempting employees' security companies. Then as to the general exemptive power of the Commission, section 6 (c) empowers the Commission to exempt any person or transaction if it is not inconsistent with the purpose of the title. Subsection (d) of section 6 gives the Commission the power to subject a company to some of the provisions of this bill even though it is not a registered investment company.

Mr. BOREN. Now, your exempting through section 1 there confused me a little. You say that if they sell a certificate to a nonresident, not a resident of the State in which such company is organized, and yet, of course, you do not even name the State, and in the earlier part of the exemption clause, you name the various Territories. That is a little confusing to me.

Mr. SCHENKER. "State" is defined to include Territories. Just as a convenience, any Territory or possession is defined as a State.

Mr. BOREN. I see; but that makes a peculiar situation.

Mr. SCHENKER. You see, our experience under the 1934 act almost convinced us of the impossibility of enforcing the provisions in these outlying peninsulas and Territories.

Mr. BOREN. I cannot understand why it would be difficult to enforce it in Hawaii, for example. Hawaii is no farther away from Washington certainly in a material sense than Oklahoma, and its people are so much the same that quite frankly, I cannot see any difference between Honolulu and my home town, or not sufficient difference to walk across the street for.

Mr. SCHENKER. I think Judge Healy can be of some help on that problem based on the Commission's experience with the 1934 act.

Mr. HEALY. Well, there is a stock exchange there, a small one.

We have the problem of sending people out there—I have no particular objection to including Hawaii, if Congress would like to have us undertake to regulate investment trusts there.

Mr. BOREN. I do not know; I am just asking for information.

Mr. HEALY. We can send men out to those islands, but it does run into money. You have to make provision for travel expense or else you have got to open an office there, and keep a permanent force there. I mean, it is not so much a question of principle as it is a question of convenience, and if the Congress feels that it would like to have the Commission undertake this regulation in those islands, why, I see no reason why we should offer any objection. We may have to ask for a little extra money to do it with.

Mr. BOREN. The only point that I make with respect to the application to Hawaii is that it is so much an integral part of the United States that many citizens there are clamoring for statehood, as you know.

Now, how are you going to take them under when they do sell a security to a resident of a State? Suppose I were in Hawaii and they sell me some securities. How are you going to take them under without such expense as you refer to? You cannot take them under in the ordinary instance. You understand what I am driving at?

Mr. HEALY. Yes. I think you have a good point there. As I understand it, you think that even though we would be under some expense to enforce the existing provisions, even with Hawaii exempted.

Mr. BOREN (interposing). That is right.

Mr. HEALY. That is, if a person in Hawaii sells this kind of stock to a resident of California and the exemption would be lost and it would be up to us to find out whether such a sale had been made.

Mr. BOREN. That is right.

Mr. HEALY. I admit that presents a problem in enforcement. I have not got a ready answer for it. Perhaps the fact that they would lose their exemption will act as a deterrent.

We have had an occasion when we had to send men out to Hawaii. We found a few months ago that some Japanese residents were selling Japanese Government bonds without registration. We sent men out there and got an injunction from the courts which seems to have stopped it. They sold without registration and therefore were in violation of the Securities Act.

Mr. BOREN. I will pass this section over with the suggestion that before we finally complete the study of the bill that we give a little thought to that point, and see what the answer to it is.

Mr. COLE. All right, gentlemen, proceed.

Mr. SCHENKER. Now, section 7 is the usual provision to the effect that unless the company is registered it cannot use the mails and instrumentalities of interstate commerce.

Mr. COLE. May I ask, Mr. Schenker, just about this section 6 (a) (2), so far as proceeding in court is concerned. Let me see now, is that language as broad as other legislation which permits the Commission to advise with the court. Do you think that that is necessary?

Mr. SCHENKER. This section says that as long as they are under the supervision of the court and do not sell such securities, they are completely exempt.

Mr. HOLLANDS. Mr. Chairman, with regard to section 6 (a) (2), there is this feeling. Generally, if you have an investment company already registered and it goes through the reorganization processes, there is no reason why it should cease to be registered as an investment company, merely because it is in reorganization. There was the feeling, however, that if on the effective date of the title a company is already in reorganization and the trustee or receiver is in there, it is liable to inconvenience the reorganization proceedings rather considerably if they have to be held up for registration.

So, this exemption says if on effective date of the title a company is in reorganization it is exempted until it emerges from reorganization. It is just to take care of those intermediate situations that might happen to exist on the effective date of the title.

Mr. COLE. Does the clearance through the court automatically entitle it to registration?

Mr. HOLLANDS. There is no question, Mr. Chairman, about being entitled to registration. The company, if it files proper information, is entitled to register, with one exception relating to foreign companies.

Mr. COLE. Is it tantamount to automatic registration?

Mr. SCHENKER. No.

Mr. HOLLANDS. No; it does not.

Mr. COLE. Then, you do not participate in the manner similar to that provided for in some reorganizations under section 77 (b)?

Mr. SCHENKER. Except as the Chandler Act is applicable to this present situation and that is the only way the Commission participates.

Mr. COLE. All right.

Mr. SCHENKER. Now, subsection (b) on page 35, covers the fixed trusts, open-end trusts, and the periodic-payment certificates. It is a subsection which covers the use of the mails by these types of investment companies. The only other significant provision in section 7 is that a foreign investment company cannot register, except if the Commission can formulate rules and regulations to insure that the company will be subject to the same regulations that a domestic company would be.

You can see what would happen. A foreign company registers, gets the benefit of being registered, and yet when it comes to enforce the provisions against that company the Commission may be helpless, because the investment company is a foreign company.

So, the bill says that the foreign investment company cannot sell its securities in this country and cannot register, except if the Commission can devise effective means to subject the company to the regulations applicable to a domestic company.

Section 8 sets forth the mechanics of registration. The procedure which was adopted is that a company becomes registered merely upon the filing of a simple notice of registration, and then at a subsequent date to be fixed by the Commission, the more detailed registration form is filed. There is a provision for giving notice of deficiency and for public hearings if any difficulty with the registration statement has not been remedied.

The registration statement has to contain a statement of the investment policy of the company information with respect to its officers and directors, and such information as the Commission could require under the 1933 and 1934 acts.

We have worked this out with meticulous care with the industry to make the provisions precise, and definite and there is no overlapping. It will have this advantage, as I will indicate a little more in detail subsequently, a company which filed under the 1933 act or the 1934 act does not have to prepare an elaborate new registration. They can just take the 1933 registration or the 1934 registration and file under this act, and just apply the additional information to make it complete to comply with the provisions of this act. We have simplified the mechanics of registration and eliminated duplication.

Section 9 states that any person who has been convicted within 10 years of a securities crime or has been enjoined for a securities fraud cannot be an officer, or director, an investment adviser, and so forth, of an investment company or investment trust. However, provision is made that if a person who is disqualified because of his having been convicted or enjoined, he can make application to the Commission, and if he proves he has rehabilitated himself, or that the punishment is too severe and the public interests will not be affected, the Commission can remove his disability and permit him to become associated with an investment company.

The next section is section 10, which is a simplified section of our old section 10.

In essence, what does that section provide? The section provides that if you are the manager or investment adviser of an investment company or investment trust, then 40 percent of the board of directors have to be independent of you.

Now, why do we make that provision? You can see that the manager has a pecuniary interest in the method of running the trust, because his management fees may depend upon the performance of the trust. In order to furnish an independent check upon the management, the provision is made that at least 40 percent of the board must be independent of the management, officers and employees. I think that is one of the most salutary provisions in this bill.

Mr. COLE. Was that in the bill as originally introduced?

Mr. SCHENKER. The bill as originally introduced had a different provision. It required that a majority of the board be independent of the management. However, the argument was made that it is difficult for a person or firm to undertake the management of an investment company, give advice, when the majority of the board may repudiate that advice. It was urged that if a person is buying management of a particular person and if the majority of the board can repudiate his advice, then in effect, you are depriving the stockholders of that person's advice.

Now, that made sense to us. If the stockholders want A's management, than A should have the right to impose his investment advice on that company. However we felt that there should be some check on the management and that is why the provision for 40 percent of independents was inserted.

You come to a different situation which is dealt with in subsection (b). However, the bill provides that if you have a pecuniary interest more direct than that of merely a manager who gets a fee; if you have a pecuniary interest in the transactions in which the investment company effects and have the power to make these transactions, then you have to give up control of the board.

What is a classic example of that? The classic example is where an investment trust is controlled by a brokerage firm. The firm gets the brokerage business of the investment trust. The firm may be motivated rapidly to turn over the portfolio of the trust, "churn it," in order to increase its brokerage commissions. Another typical case is where a person distributes the securities of the investment company. Still another example, which is akin to the type of abuse or deficiency prevailing in the broker relationship is where the company is controlled by an investment banker. The investment banker may be impelled to have the investment company make an investment, not based upon investment quality of that investment, but because the particular investment may give him an "in" to get the banking business from the company whose securities the investment company bought. Do I make myself clear? What does this bill here say? Hereafter the broker cannot dominate the board. The investment banker cannot dominate the board; the principal distributor of the securities of the investment company cannot dominate the board. The board of directors in each case must be independent of those individuals. If you want to be the broker for the investment company, and have control of the portfolio turn-over, you have to subject your activity to the independent scrutiny of a board which consists of a majority of the independent directors.

Mr. COLE. Is this in conflict with any provisions of existing law?

Mr. SCHENKER. No. There is a similar provision—I think that is what you are thinking of, Congressman—in the Banking Act of 1933, which provides for a segregation between commercial banking and private banking. There is nothing in our acts which deals with this situation.

The 1933 act merely deals with registration of new issues. The 1934 act merely deals with the trading on exchanges.

Unless you mean section 16 of the 1934 act, which requires an officer and director to report his trading in his company's securities. The Utility Act of 1935 contains a provision prohibiting interlocking directors between utility companies and banks.

Mr. COLE. Well, is not that along this same line?

Mr. SCHENKER. That is right.

Mr. COLE. Yes.

Mr. SCHENKER. Subsection (c) on page 45 was inserted not only on the basis of our study, but after conferences with the Federal Reserve Board. There were very undesirable consequences flowing from interlocking directorships or interlocking relationships between commercial banks and investment companies. Some of the worst examples of abuses we had in the whole study arose out of that relationship and

the Federal Reserve Board, as well as ourselves, felt that in the future, there should not be that close relationship. The adversities of the investment trust may have harmful effects on the bank such as runs on the bank. They are so intimately tied up.

Subsection (c) provides that hereafter the majority of the board of directors of an investment company cannot consist of directors of any one bank; but we permit, in order not to disturb the status quo, the present relationships to continue.

Subsection (d) deals with the special situation, where investment counselors organize investment trusts so that they can make available—

Mr. COLE. Which is that?

Mr. SCHENKER. Subsection (d) on page 46—makes available to people who cannot afford to take their personalized investment services, the same type of services in an investment company. These investment companies are really an adjunct to the investment advisory business. You notice we have the relationship pretty well circumscribed. They cannot have any sales loads, and they cannot have excessive redemption fees, and so forth.

Provision is made to deal with the case of death of a director—how his successor should be elected. In subsection (f) we have this provision. To protect the investment company from being compelled to purchase part of any security issued, of which an officer or director may be the principal underwriter the company may not purchase such securities unless the investment company itself is the principal underwriter for the issuer. Section 11 deals with this type of situation: A promoter will organize one investment company. He will sell the securities of this company until they lose their sales appeal. He then organizes another investment company, and solicits the security holders of the first company to exchange their shares for the shares of the new company and saying, "Well, this new company I have set up is infinitely superior to the original company. I recognized my mistakes which I made in the old company. Why don't you switch from the first company into the new company." And in some instances the promoter then organizes a third investment company, and switches the investor from the second company into the third company. Everytime he switches the investor he takes a 9 or 10 percent sales load.

It was these switching operations which were particularly current in 1930, 1931, and 1932. Section 11 provides that if an open-end investment company makes an exchange offer which is based on any basis other than respective asset values of the securities involved, the investment company has to submit that exchange offer to the Securities and Exchange Commission for scrutiny. Section 11 deals therefore with switching operations. Provision has been made for the exemption of exchange offers in connection with reorganization situations which are really not switching situations.

Mr. COLE. Before you leave exemptions.

Mr. SCHENKER. Yes, sir.

Mr. COLE. I had some correspondence within the last few days with Texas Fund, Inc. I have a telegram that just arrived which urges that a provision similar to section 3 (a) (11) of the Securities Act of 1933 be incorporated in this bill which provision they say exempts securities issued or sold to residents of States by companies