

But where their big, major holdings are in this category, then I do have questions—where, out of 60 major holdings, 25 percent of those major holdings are situations in which they have gotten underwriting business. Now, whether or not the investment company was used for that purpose I do not know. In the hearing we held, it was admitted that it was of some help to the investment banker.

I do not think the average investor should be subjected to that risk. It has been disastrous, with a person who is a little bit unscrupulous; and even to the best person it requires the wisdom of Solomon, it seems to me.

In section (g) we say that no registered company shall purchase any security until a year after it has been put out by an investment banker. In other words, they should not buy the product of the investment banker, even though they do not buy directly, to stimulate the market for it, until the security has been seasoned for a year.

Senator TAFT. That applies only when a director is a member of the underwriter?

Mr. SMITH. That is right.

Section (h) is a reciprocal arrangement provision to prevent evasion of the arrangement.

Section (i) applies to a specific type of company. That is an exception just to make these sections applicable to them.

Mr. HEALY. Senator, I have to get back to the Commission to make a quorum.

Senator WAGNER. Yes; I think it is time to stop for today, at any rate. We have been at this all day.

I am glad you came.

Senator TAFT. I have been in the Senate Appropriations Committee meeting all the time.

Senator WAGNER. Yes; I know the Senator is also busy there.

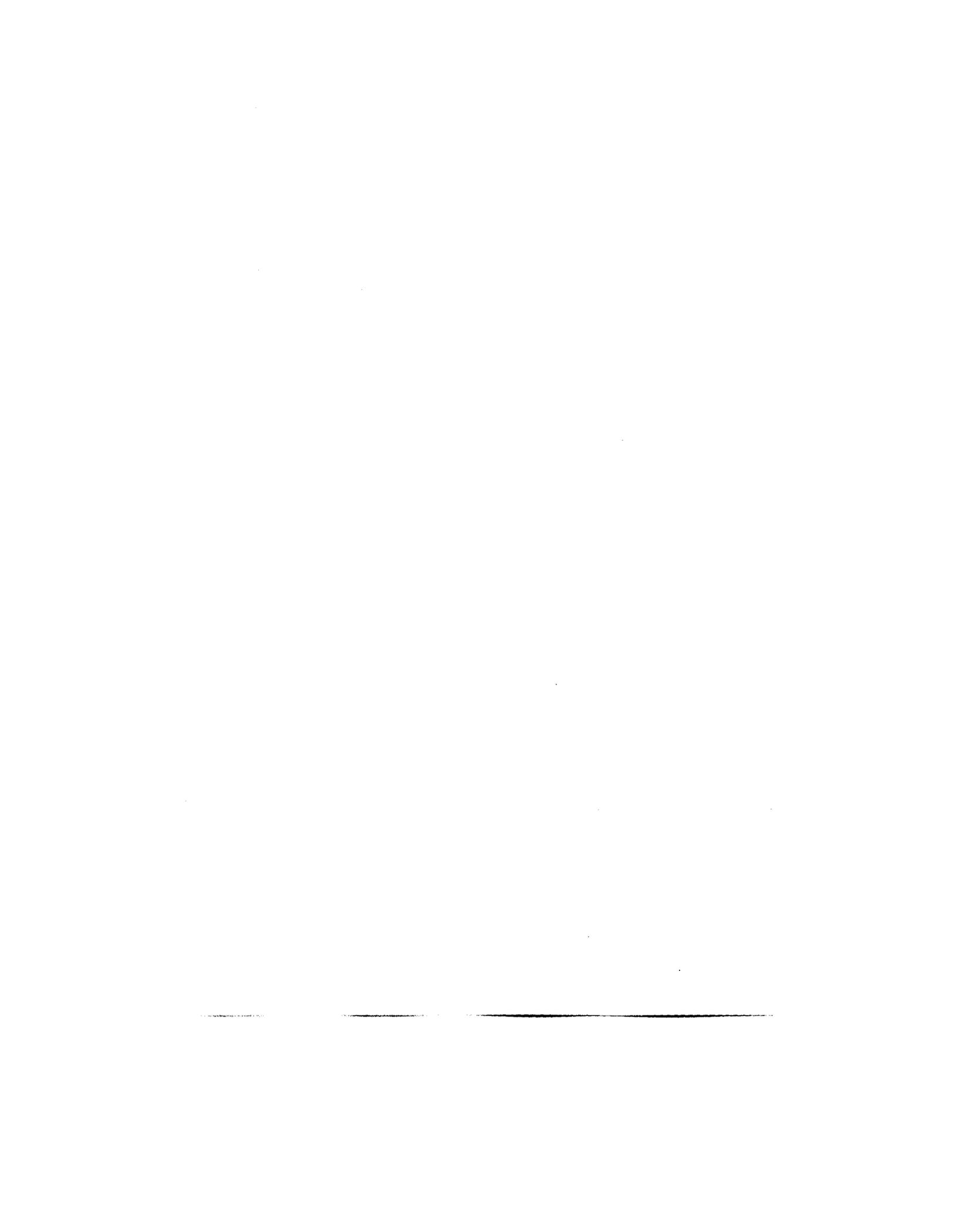
Mr. SMITH. May I say, also in the record, that these trustee activities of mine are wholly family matters. I am not in any other business.

Senator WAGNER. Have you not gotten along without interlocking directors?

Mr. SMITH. I have gotten along very well. As a matter of fact, the standards set up in this act do not come up to the standards I have to carry out and set for myself; and I have some question about that, myself.

Senator WAGNER. Yes. Well, gentlemen, we shall adjourn at this time until tomorrow morning at 10:30, then.

(Thereupon, at 4:50 p. m., an adjournment was taken until tomorrow, Tuesday, April 9, 1940, at 10:30 a. m.)



INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY, APRIL 9, 1940

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

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

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Miller, Frazier, and Taft.

Senator WAGNER. The subcommittee will proceed with its hearing. Mr. Schenker, you may resume your statement.

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

Mr. SCHENKER. We have reached section 11, on page 27 of the bill, which deals with the subject "Recurrent Promotion of Investment Companies."

You will recall Mr. Stern's description of the growth of the Founders System where, in rapid succession they organized investment trust after investment trust. The Founders picture was not a rare or unusual one.

Our study indicates, or at least we have the feeling which, in our opinion, is substantiated by the record, that in a great many instances the formation of investment companies is not predicated upon any inherent belief in the soundness of the particular company which is organized, but rather is generated for the purpose of having merchandise which the distributor can sell.

When you have that close association between an investment company and distributor—and the distributors do engage primarily in the distribution of investment-company securities and have tremendous selling organizations—after a particular company loses its sales appeal it is almost incumbent upon them to start organizing another investment company so they may have more merchandise to sell.

The basic philosophy of section 11 is that the investment-company industry—and "industry" is a most unfortunate word, because it is not an industry but it is like a savings bank—is not a device merely for creating securities which people can peddle.

Now, in connection with that let me just give some indication of the extent to which this practice of recurrent promotion of investment companies can be carried. We find that one of the companies engaged primarily in distribution of investment-company securities, organized

from 1924 to 1932, 12 investment trusts. In one year alone that distributing agency was responsible for the promotion of 1, 2, 3, 4, 5, 6 investment trusts.

Senator WAGNER. Do you mean in 1 year?

Mr. SCHENKER. In 1 year there were six investment trusts, management investment trusts as contradistinguished from the fixed trust, because you may get the argument in the case of the fixed trust that there is no management involved—it is just a package of securities deposited with a bank, and an interest in that fixed trust is sold to the public. But I am now talking about management investment companies.

Senator FRAZIER. Do you mean that was done at one and the same time?

Mr. SCHENKER. Within a year. Practically every 2 months a new investment company was brought out by that distributor.

Senator WAGNER. By the same group, do you mean?

Mr. SCHENKER. By the same—shall I say, individual? He was in the business of distributing investment-company securities.

Senator FRAZIER. If they are doing an honest business what is the excuse for organizing all these different investment companies? Why not one company instead of a dozen companies?

Mr. SCHENKER. That is precisely the attitude of the Commission on that subject. We say that if one is really in the investment company business as an instrumentality of furnishing expert management and advice to the small investor, and is interested in managing the money and in being compensated by management fees, then he ought to be able to form one company, raise money, and devote all of his time and effort to the management of that company; that he should not be in the slightest motivated in the formation of these investment companies by the profits he may make through the sale or peddling of securities.

Now, that is not the only situation. Then you have another company which was in the business of selling investment company securities, and they organized one, two, three, four, five fixed trusts, and then within 2 years organized one, two, three management investment companies.

Don't you see, Senator, at a certain point in the development of these institutions the major portion of the profits may be in the distribution of securities rather than in the management fees one gets, because when they sell those securities they get a sales load, and with these big distributing agencies they have to keep generating merchandise to sell.

Now, let me give you an example: Only recently an individual came to me and said—and he was associated with one of the investment trusts—he wanted to organize another investment trust. I said, "What kind of trust are you going to organize?" He said "Well, my salesmen tell me that the kind of investment company they can sell is the investment company where the investor gets a check regularly." Now, such a man is not interested in where that check comes from, whether that check really represents dividends or earnings. The investor will find it difficult to distinguish between a case where he is getting earnings and where he is getting a part of his money back. This man was going to set up such a trust where an investor would be getting 9 percent on his money. I said to the man, "You know you cannot earn 9 percent; in fact, you cannot earn

6 percent, because our statistical analysis shows that the ordinary income such an institution can earn is usually about 2½ to 3 percent." He said, "I know that, Mr. Schenker." I then said, "Well, why?" He said, "What I will do is this, I will pay it out of earnings if there are earnings, out of capital gains if there are capital gains; and if there are no earnings or capital gains I will pay it out of service." I said, "What will you charge?" He said, "I will have that 9-percent load, and I will have one-half of 1 percent in management fees on the total assets." I said, "It seems to me the only thing you are doing is charging the public a 9-percent load and you have the one-half of 1 percent management fee, and you are giving the investor back his own money in drips and drops."

After we threatened to stop the proceedings he fixed up the prospectus a little bit, and today he is selling the securities of that investment company.

Now, aside from the rapid formation of these companies, one after another—and you can see, Senator, that these people do not make any substantial investment in these investment companies. In an extreme case all one needs, is a lawyer and \$125 to get articles of incorporation in Delaware, a couple of salesmen to start out peddling. He gets money from the public, and he gets management fees and distribution fees.

Now, aside from that you have this problem: They organize one investment trust. The security of that investment trust loses its sales appeal. Thereupon they organize another investment trust, and what do they do? Then they start switching from one investment trust to another, and our record indicates—and if the members of the subcommittee are interested, they will find it on page 214 of our report on fixed and semifixed investment trusts—that there were as many as six switches from one to another.

On page 215 of the report you will find where we had one case where there was an investment trust organized and there was an exchange on November 5, 1931. Then another trust was organized and there was an exchange in 1934; then another one was organized, and they were switched into an open-end company.

We say fundamentally this business is a business of furnishing management advice to small investors. In our opinion the only way you can stop this business of putting the emphasis on distribution and running the whole investment trust with an eye to distribution, is to say that you cannot, any time you want, organize an investment trust.

Senator, one cannot organize bank after bank; one cannot organize insurance company after insurance company, and we feel they should not be allowed to organize investment trust after investment trust.

Now, section 11 of the bill says what? If you organize one investment trust, then within the period of 5 years you should not be allowed to organize another investment trust if you are going to be the manager of the new investment trust.

Now, we concede that the 5-year period is an arbitrary period, but we also have the feeling, from our study, that within 5 years a man ought to be able to get up for himself a sufficient pool to make it pay him to run it. If you have any shorter period, then you are going to get a recurrence of what happened in 1932, 1933, 1934, and 1935; and you are going to get a recurrence of what happened in the case of these fixed trusts with all the switching.

Now, there is nothing arbitrary about this because we say: There may be instances where there may not be any undesirable aspects to a person organizing more than one investment trust. You may get situations because of the tax situation or other circumstances, where an individual may have liquidated one trust, or severed his connection with one trust, and he may want to organize another trust.

Then we say what? In subsection (d) of section 11 we say: In such a situation if he can make out a case that he ought to be permitted to organize another investment trust, then the Commission shall by order, conditionally or unconditionally, exempt the promoter from the prohibitions of this section (d). We try to set forth in some detail the things the Commission should consider in passing upon such an application.

Now, if I may take one more moment on that: You take the Goldman Sachs Trading Corporation. Goldman Sachs was sold to the public in December of 1928, and they raised \$100,000,000. Within a short period of time Goldman Sachs Trading Corporation arranged for a merger with Financial & Industrial Securities Corporation another investment trust, which had \$117,000,000 of assets.

Now, this may be of interest and it is a little aside: The Goldman Sachs Trading Corporation stock was selling on the New York Curb Exchange for \$135 a share, 30 percent above its asset value. Financial & Industrial Corporation stock was selling at \$140 a share although its asset value was \$70 a share. Thus the stock of Financial & Industrial Corporation was selling at a one hundred percent premium. What happened? On February 4, 1929, the Goldman Sachs Trading Corporation started buying in its own stock on the New York Curb, and, Senator, within a period of 4 days what do you think was the dollar amount of stock bought back of the Goldman Sachs Trading Corporation?

Senator WAGNER. Do you mean of its own stock?

Mr. SCHENKER. Yes. It bought back \$46,000,000 of its own stock, pushed the price up from \$135 to \$220, and was buying back its own stock at \$220 when its asset value was \$110, thereby paying \$110 a share premium for its own management. Well, they had to do it to make that exchange. Financial & Industrial Securities Corporation stock had a market of \$222 while Goldman Sachs Trading Corporation stock at a market of a hundred and ten, although their asset values were the same.

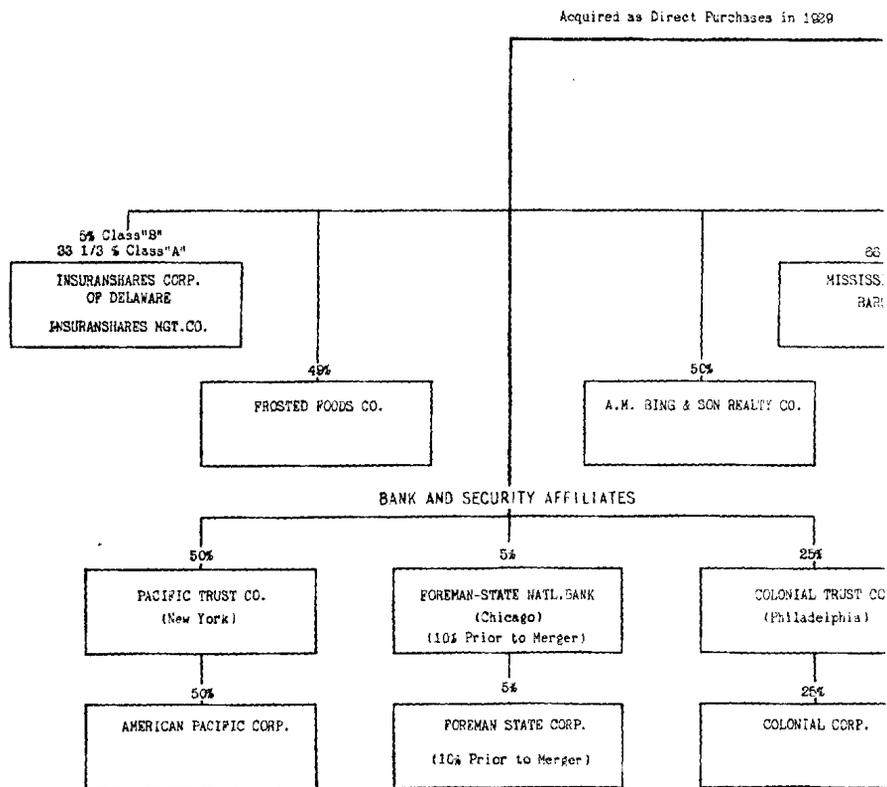
You have the Goldman Sachs Trading Corporation with \$234,000,000. Within a few months, on July 23, 1929, they organized the Shenandoah Corporation and raised \$62,500,000 of the public's money in that corporation; and then, shortly after that, in August of 1929 they organized the Blue Ridge Corporation and got \$81,825,000 from the public.

Senator WAGNER. Is this all the same group?

Mr. SCHENKER. This is Goldman Sachs & Co., organizing the Goldman Sachs Trading Corporation, and then Shenandoah and Blue Ridge. I think there was a joint sponsor in the latter situations. Then they arranged for an exchange of Goldman Sachs Trading Corporation with one of the biggest bank holding companies on the Pacific coast, so that by September of 1929 the Goldman Sachs Trading Corporation had raised \$326,000,000.

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What did they have in 1932? \$33,000,000, and in our opinion, Senator, a good part of that loss was of course attributable to the stock market decline, but another part of that loss was because they had such large funds to invest. What was the result? This was the result: This chart, which I would like to introduce in evidence—

Senator WAGNER (chairman of the subcommittee). That may be made a part of the record.

(The chart entitled "The Goldman Sachs Trading Corporation" is made a part of the record.)

Senator WAGNER (chairman of the subcommittee). You may proceed, Mr. Schenker.

Mr. SCHENKER. This chart is the result. In their prospectus what do you think they said the nature of their business was going to be? To trade in securities. What did they wind up with? They wound up with a 32 percent interest in the Manufacturers Trust Co., upon which they lost in 1932 and 1933 \$70,000,000. They wound up with a 49 percent interest in Frosted Foods, which cost them \$13,000,000 and which they lost almost completely. They wound up with insurance companies and banks and promotional adventures.

If you will take a look at this, and I consider this a matter of some importance, and Mr. Waddill Catchings who was in charge of that corporation denied this; but if you will look at this picture, what do you find? They had the investment trust buy institutions which were big purchasers of securities, banks, and insurance companies.

Now, Goldman, Sachs & Co. had been bankers for a great many industrial companies, but they had never been bankers for any public utilities. Well, we find that suddenly they put up a large sum of money to build a Mississippi barge line. You also find that they accumulated, or had the investment company acquire, some of the largest distributing agencies for securities throughout this country, and one of the largest wire houses throughout this country. You will find that they took a half interest in the company which was going to build properties in New York.

You may say that is fantastic, but you have a case where the Goldman Sachs Trading Corporation may have been using the funds of the public essentially to help Goldman Sachs & Co.'s banking business.

One of the investments they made, or that they had the trust make, was in the Greyhound Corporation, a bus company. In the files we find this letter, which they furnished to us. After the analyst describes the investment as a very speculative one, we find this paragraph:

The connection with the company should prove valuable in other ways. In the first place if the industry develops as it gives promise of doing the contact should prove of material value to Goldman Sachs & Co.

You do not see any statement to the effect that the contacts should be of value to the investment trust:

With the expected stabilizing of the industry, the connection should give rise to financing opportunities. In the future the Motor Transit Corporation [the original name of Greyhound Corporation] may be expected to require capital for additional expansion, the simplification of its present capital structure, and the possible acquisition of a larger interest in the two western holding companies.

Now, that is all that section 11 of the bill says. Section 11 says that these are institutions in which the public puts their savings to receive diversification and expert management. That is the primary

purpose; the distribution aspects should be secondary. The distribution aspect should not be the primary thing that motivates the formation of these companies.

Now, we go on to section 12—

Senator TAFT. I do not see what basis there is for saying that having organized one, he cannot organize another. I can see why we might prohibit an investment banker from having an interest in an investment trust; but after he once promotes it and is through with it, why should he not go on the next year and promote another one? What has Goldman-Sachs got to do with it?

Mr. SCHENKER. That was just an illustration, Senator, of the rapidity with which these things were formed. I asked Mr. Sidney Weinberg, a partner of Goldman, Sachs & Co., "Why do you form them so rapidly?" He said, "Well, the people want them."

You were probably not here, Senator, when I started the discussion in which I said that if we permit this constantly recurring promotion, the thing that might motivate constant promotion of these companies is not any inherent belief in the economic soundness of the set-up generally, but a desire to manufacture merchandise which may have sales appeal at the moment.

Senator TAFT. That is the object of all promotion in this country.

That is the way we got ahead—by promotion. That statement assumes that promotion, in and of itself, is a bad thing. I do not see why, admitting that it is perfectly proper, possibly, to prohibit anybody from promoting a certain kind of investment company, after he promotes it and starts it on its way, I do not see why he could not start another one next year, if he is out of the first one. I do not see what that story has to do with this particular section which you are discussing, except to stir up prejudice.

Mr. SCHENKER. Oh, well, Senator Taft, after all, Congress directed us to make a study—

Senator TAFT. No; I am objecting to your using this to support this section with which it has no relation.

Mr. SCHENKER. The fact of the matter is, Senator, that it appears to me that it has relation, because here you have Goldman-Sachs & Co., bankers—

Senator TAFT. Your whole argument is directed to the one question of an investment company not having an interest in an investment trust, with which I wholly agree; but I do not see what it has to do with section 11 (a) which you are discussing.

Mr. SCHENKER. Well, on section 11 (a), Senator, our study indicates that when an individual has a distributing organization with a tremendous overhead, the impulse may be to create these companies in rapid succession, not with any inherent belief in the economic soundness of the type of company he is creating, but because that particular institution has sales appeal. I illustrated that with an example where a person had one, and his salesmen told him they could sell the type—

Senator TAFT. That has nothing to do with section 11 (a). I want to know why, if a man has promoted an investment trust one year, he should not promote another one next year.

Senator WAGNER. Are they dissociated?

Senator TAFT. They may be.