Senator WAGNER. Exactly. That is what I want to know. You go back to the registration?

Mr. SCHENKER. That is right.

Senator WAGNER. To ascertain what the fundamental policy was.

Mr. SCHENKER. But in determining whether there is a change in fundamental policy, the Commission has to give consideration—it cannot be arbitrary—to these specific things which are enumerated in section 13 (b).

Now, we come to section 14——

Senator WAGNER (interposing). You say if the Commission feels that there should be any question about the discretionary power given therein, you would just as soon leave that out, so that it will just require an approval by the vote of the common stock?

Mr. SCHENKER. That is right, and I am no gambling man, Senator, but I will bet——

Senator MILLER (interposing). I would not want that change at all in the last sentence in section (b).

Senator WAGNER. What is that, Senator?

Senator MILLER. I say, I would not see any reason for striking out that last sentence in subsection (b) of section 13. I think it is the meat of that whole section, because it is very easy for a company to high pressure stockholders into a fundamental change. We have just got to do it. That ties it up with the representations made by the salesmen of their secuties when they organized the company and said, "We organized it for this purpose and we organized it for that purpose. That is a very good safeguard.

Mr. SCHENKER. We felt so, Senator.

Senator MILLER. I do not see how any legitimate industry would kick on that.

Mr. SCHENKER. Section 14 deals with sizes of investment companies, which is not an easy problem. You may ask, "Well, where did you get the figure that a diversified investment company should not have assets of more than $150,000,000 at the time it wants to sell securities?"

Senator WAGNER. We will recess now until 2:30 this afternoon.

(Thereupon at 12:10 p. m. a recess was taken until 2:30 p. m. of the same day.)

AFTERNOON SESSION

The committee reconvened at 2:30 p. m., upon the expiration of the recess.

Senator WAGNER (chairman of the subcommittee). Mr. Schenker, will you continue, please?

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

Mr. SCHENKER. We were discussing section 14 which relates to size of investment companies; the section provides that the diversified investment company or the fixed trust should not exceed $150,000,000 of total assets; the securities trading or securities finance company, $75,000,000; and those face-amount certificate companies, which sell securities which are really unsecured promissory notes, $200,000,000.

The question might be asked, Why did we impose or recommend the imposition of any size limitation on these companies? We are not unmindful of the fact that it presents some problems. I think you must recognize that investment companies are a different type of institution than any other type of financial institution in existence today. You may say to me, "Mr. Schenker, they do not impose any size on insurance companies and they do not impose any size on savings banks. Your whole legislation is predicated at least in part on the fact that there is a kinship on the part of those institutions. Why do you impose a limitation on an investment company and why, if you do, don't you do it in connection with a bank?"

In connection with a bank the type of supervision they get is not even remotely comparable to the supervision they get here. In a bank the bank examiners examine every investment; they have a right to tell the bank's officers to mark the investments down to get rid of bad loans, and so forth. There is nothing that even approximates that in this bill.

Senator WAGNER. And they are limited in the character of the loans in which they can invest their money, too?

Mr. SCHENKER. They are limited in the character of the investments they can make.

Senator WAGNER. That is what I mean, too.

Mr. SCHENKER. The fact is, Senator, that you know the average large-size investment company constitutes today a bigger common-stock pool than any bank or insurance company in this country. You take an investment company that has $150,000,000 which it can invest in any and all common stocks: That is more than all the common-stock portfolios of all the life insurance companies in this country.

I have some figures on that which I whould like to give you: At the end of 1939 the common-stock holdings of one of the largest investment trusts in this country amounted to nearly $120,000,000; and the common stock holdings of four other investment companies amounted to $50,000,000 each. In comparison with that, the common-stock holdings of the largest life insurance companies were entirely negligible. The Metropolitan Life Insurance Co., for instance, reported only $25,000 in common stocks at the end of 1938; the Prudential Life Insurance Co. had $234,000 in common stocks; and the Equitable Life Insurance Co., $18,000 in common stocks.

As a matter of fact, the 49 largest life insurance companies together, according to the Association of Insurance Presidents, held only about $115,000,000 of common stock. So that you have a situation where the investment company is a bigger common stock pool than all the 49 largest life insurance companies in this country.

Now take that in conjunction with the fact that there is no limitation with respect to the extent to which they can turn over their portfolio and with respect to what common stocks they can go into. We shall develop in a moment, what the effect of no limitation upon size can be.

Now let me go on: The smallness of the holdings of these life insurance companies, of course, is attributable to the fact that they have got to invest in legals; and that is true of banks.

Let us take the fire insurance companies which do invest in common stock. None of the fire insurance or casualty insurance companies which are permitted to own common stock, and which do considerable amounts of common stock purchasing, had a portfolio valued at anything like $100,000,000. The Home Insurance Co. had a portfolio of common stock at the end of 1938 of nearly $60,000,000—probably the largest of any fire insurance company; yet we say an investment company can have up to $150,000,000. The Hartford group, with total assets of $172,000,000, held only $17,000,000 of common stocks; the Great American group, with assets of $71,000,000, had only $19,000,000 in common stocks; the Aetna group, with $67,000,000 of assets, had only $7,000,000 in common stocks.

Senator TOWNSEND. Is the question of supervision the dominating influence over the thought of fixing the size of the investment trusts?

Mr. SCHENKER. No, Senator. The only reason I brought up the point of supervision is that I do not think you can analogize to a savings bank or a commercial bank, because the investments are closely supervised. More fundamentally, the nature of the investments of the savings banks is so different from the nature of the investments of investment companies.

I am not being disparaging when I say this, Senator; but in essence an investment company is a blind pool; you turn over $150,000,000 to them, and they can invest in any common stock and they can invest in small blocks, large blocks, highly liquid securities in which they can get in and out fast, and so forth. I shall discuss in a moment the possible effect of a large common stock pool which is managed by one interest and what may be some of the consequences on the stock market and what may be some of the consequences on the investor.

Senator, we have no interest in size per se. But in the open-end company, the stockholder has the right at any time to tender his stock and get his asset value: If you were to have a run on that type of company—and it is no different from a run on a bank, Senator—you can see that if you had $150,000,000 invested in large blocks of stocks, if the time comes when for some reason or other the stockholders in the company are dissatisfied with the management and they decide to tender their stocks for redemption, you will get a program of liquidation which may result in two things: In the first place, an undesirable effect upon the stock market in general. In the second place the stockholder who tenders his stock for redemption a little later may find himself with an illiquid stock and who may not be able to get his asset value.

Senator TOWNSEND. Have you any standards set up in this bill with respect to the kind of stocks in which they can invest?

Mr. SCHENKER. I beg your pardon, Senator?

Senator TOWNSEND. Do you have any standards set up in this bill with respect to the kinds of stocks in which they can invest?

Mr. SCHENKER. No.

Senator TOWNSEND. Do you think that would be practicable?

Mr. SCHENKER. That in my opinion, Senator, would be an attempt to influence or dominate management. This bill has taken meticulous care, in my opinion, not to tell these fellows how to run their business. After all, the persons who are buying it are buying it on the reliance that Mr. A. who is supposed to be an expert, is running it. This bill gives him absolute and unlimited discretion and power to invest in any stock, in any industry, and in any situation he wants. However, we say there comes a time, when you reach $150,000,000, particularly in the open-end companies, where there may be undesirable consequences to the investor and to the public interest.

Senator TOWNSEND. Will you give an illustration of why you think $150,000,000 might be more dangerous than $300,000,000 or less dangerous than $300,000,000?

Mr. SCHENKER. Well, Senator, the answer to that is that there comes a point where you must draw an arbitrary line. Why did we take $150,000,000? Because the people whom we examined almost unanimously agreed that $100,000,000 is enough. The things that persuaded us to recommend to the committee that $150,000,000 be taken as the top figure are several: In the first place, all the witnesses whom we questioned said that $100,000,000 is enough for anybody to manage. With respect to one company in particular, which is run in a high-class manner and by one of the finest and most reputable persons in this industry, we were told by its manager, "When we reach $50,000,000, I have got enough to manage." There was almost a unanimous consensus of opinion that $100,000,000 ought to be enough.

In the second place, when we look at the records in this country of the investment companies, we find that the companies that had over $100,000,000 were the ones that took the worst lickings. For instance, the Pacific Eastern Corporation, which is the new name for Goldman Sachs Trading Corporation, had $326,000,000 contributed. When the company was turned over to the Atlas Corporation they had about $40,000,000. The United Founders group, the one Mr. Carl Stern described, had $500,000,000, and they wound up with $40,000,000. The Blue Ridge Corporation received contributions from the public of $137,000,000. They had at the end of 1939, $36,000,000. The Shenandoah Corporation had a total invested amount of $169,000,000, and they finished up with $28,000,000.

Then you have the Central States Electric Corporation, which we described somewhat this morning. It raised $134,000,000. Today it has $15,000,000. The Insull Utilities Investment Co. started with $250,000,000 and then wound up with $33,000,000. Continental Shares, Inc., of Ohio had $111,000,000, and when they went into receivership they had $3,000,000.

You may say, Senator, that that is a matter of coincidence; but the fact of the matter is, as we learn from our study of every investment trust in this country, that there seems to be some correlation between the amount of losses that were sustained and the size.

The fact is also, Senator, that even in the British investment trusts the average size is from $20,000.000 to $30,000,000. Some of them are in groups. But even when you consider the groups, we do not know of a case of an investment trust group in Great Britain which has exceeded $100,000,000.

It is very difficult to put your finger on the precise reasons why we take $150,000,000 as the limit, and not $200,000,000. Our selection of that figure of $150,0000,00 as the maximum was based on the record, it was based on their past experience, it was based on what we have been told, it was based on the nature of the companies, it was based on the potentialities, and upon our conclusion that in this type of company there ought to be a maximum size. Although we felt in the first instance that we ought to recommend $100,000,000, we increased it to $150,000,000 in order to cover all existing situations.

You also must be conscious of the fact that we do not say that if an investment trust reaches the size of $150,000,000 it has to cut itself down. If a fellow starts with $100,000,000 and runs it up to $3,000,-

000,000, this bill does not say that when he reaches $150,000,000 he cannot make any more money for his stockholders and has to quit.

The only thing we say in this bill is that if you have total assets of $150,000,000, then you cannot go out and sell new securities to raise new capital. In other words, when you have reached that point, then we say you have enough capital to work on; but if you can run $150,-000,000 up to $3,000,000,000, this bill does not stop you. We simply say that if you have $150,000,000 of assets, then you cannot start selling new securities, to get new money as capital.

We made some exceptions for the so-called open-end companies. We said, "Well, you can sell an amount equal to the amount of securities which people redeem. In my opinion that will not compel them to cut down the size. The fact of the matter is that at the present time the largest open-end company has assets of $120,000,000. They still have a ceiling of $30,000,000 additional. We say that in our opinion the protection of the investor, particularly in the open-end company, requires some limitation on size. We think $150,000,000 is a reasonable figure at which to cut off that limit. That is this whole size section.

You will notice that we differentiated between diversified investment companies and securities trading corporations. The reason that impelled us to do that is that it was practically conceded that a distinction should be made between those two types of companies. The securities trading company or securities finance company gets into control situations, and with $75,000,000, if you want to go out and buy control of corporations in this country, you can get control of a tremendous number of corporations.

The fact of the matter is that the Phoenix Securities Corporation, with total assets, the last time I looked at it—and perhaps a little more today, because of their Pepsi-Cola holdings—of about $16,000,000, were able to exercise a great deal of control. With that $16,000,000, Senator, as I said before, they controlled the United Cigar Stores, they controlled Loft, Inc., which in turn controls Pepsi-Cola; they controlled Celotex, and through Celotex they have a controlling influence in Certain-teed Products. They control the Southwest Corporation and have a controlling interest in Autocar. At one time they had a controlling interest in the Lincoln Hotel. You have such situations where you can get a tremendous concentration of wealth in an investment company.

It is quite true that when you get into controlling investment corporations, the amount of their assets should be less. Thus you see Goldman Sachs Trading Corporation with its $360,000,000 of assets controlled, and by "controlled", I mean 50 percent or almost anywhere over 20 percent—about $1,600,000,000 of assets owned by banks, insurance companies, and industries in this country. That is the reason why we fix that limitation.

We fix $200,000,000 for the so-called face-amount certificate companies because this bill requires, for the protection of investors, that their assets should be comparable to those of a life insurance company. Under those circumstances we feel that since they do not invest in common stocks with all this trading and fluctuation in values, $200,000,000 may be sufficient. Perhaps it ought to be a little higher; I do not know.

However, there is no magic about this; there is no ulterior motive about this. We have come to the definite conclusion that an individual who manages $150,000,000 has a man-sized job on his hands, to look after that amount of money. That is particularly true in view of the fact that this bill lets him manage one company and act as investment adviser to others. In the aggregate, he can manage $150,000,000.

Senator WAGNER. Mr. Schenker, may I ask you a question right at that point?

Mr. SCHENKER. Yes, Senator.

Senator WAGNER. When do you ascertain the value of the assets—that is, to determine whether the total assets are above or below $150,000,000?

Mr. SCHENKER. If he wants to issue securities, Senator, he must come to us and file a registration statement. At that time we ask him, "What are your total assets?"

If he says they are $150,000,000, that is ground for denying his registration and application for a new issue of securities. So, Senator, at the time when he makes that application, if he wants to issue new stock to raise money for his company, that is the time when we look at the assets of the company.

Senator WAGNER. So it is the assets as of that day?

Mr. SCHENKER. That is right. Senator, if there are any further questions, I should be glad to answer them as best I can.

Senator WAGNER. Of course, the fixing of that particular limitation is to a considerable extent a matter of judgment, is it not? It is one of those flexible matters? Of course, you have given a basis for the conclusions which you have reached.

Mr. SCHENKER. Yes, Senator; you could have set it at $125,000,000 or $175,000,000.

Senator WAGNER. Yes.

Mr. SCHENKER. When we get around $150,000,000, for this type of institution, then we feel that it requires the entire time of the individual.

Judge Healy calls my attention to the fact—and I thought that was inherent in my statement—about an open-end company that had $120,000,000 of assets. As I remember, there is not a company in existence today which is touched by this provision. Every single one of them could issue more securities to raise more money.

Senator WAGNER. Yes.

Mr. SCHENKER. The one that is nearest to it has about $120,000,000 or $130,000,000, so it still has $20,000,000 to go.

The next subject which is covered by the bill is section 15 which relates to management contracts. May I make this observation: When we concluded that we ought to recommend $150,000,000 as the maximum, we were not unmindful of the fact that the bigger the size of the trust gets, the possibility exists that they may cut down a little in their operating expenses. However, I think that cut-down in their operating expenses does not compensate in any way whatever the disadvantage to the investor, when the size of the fund is over $150,000,000. In the case of the open-end company it does not compensate for the possibilities of risk if there should be a run on that particular company.

You talk about diversification of risk by investing in an investment company: What greater safety do you have with respect to diversification of risks and in connection with runs upon these companies, by keeping them to a fairly reasonable size? Suppose you had a company with $300,000,000 or $400,000,000, and suppose for some reason or other, whether justified or not, that company's management was suspect. If you got a run on that $300,000,000 corporation, you can see the havoc that could result. If that three or four hunderd million dollars were spread over five or six companies, you might not get the same situation.

In a savings bank they attempt to get some protection against runs, because they limit the amount that a single depositor can have. This is an added reason, we think, why there ought to be some limitation on size.

If I may take a moment to discuss these management contracts, Senator, I should like to say—I may be wrong about this—but I believe that investment companies are the only type of companies where you have this institution of management contracts. That, to our mind, presents an anomalous situation.

Judge Healy called my attention to the fact that you may have an analogous situation in public utility holding company systems, where you have service companies which may have the management contracts and operating contracts. However, aside from that possibility, I do not know of any other industry, financial institution, or any organization that has this system of management contracts. As I said before, in some respects to my mind, at least, it presents an anomalous situation. Here you invest your money in a corporation. Ordinarily in a corporation the managerial functions are performed by the officers and directors. After all, that is what the corporation is. The corporation is really the officers and directors.

However, when we come to investment companies, we find the situation existing where the officers and directors, if they have not done it in toto, have delegated a substantial part of their managerial functions. You find a situation where the persons who are supposed to be vested by the stockholders with the managerial discretion or function have delegated that managerial function to someone else.

That may be almost a complete delegation of function. The only thing that makes it incomplete is that the board of directors may at some subsequent time ratify the action of the managers; or it may be a partial ratification of the delegation of function. In any event, you have the situation where the very purpose for which the company was formed and the very powers which were supposed to be vested in the officers and directors are delegated to other individuals, who may or may not be the same individuals as the officers and directors.

During the course of our investigation there were quite a few people who said, "David, you will just make yourself a laughingstock down on the Street if you permit management contracts." They said, "Who ever heard of a management contract in a bank? Who ever heard of a management contract in an insurance company? Who ever heard of a management contract in any industrial corporation?"

Senators, you must realize that the management contract I am talking about is not the same thing as a bonus arrangement made with an officer who does a particular job. These are formal contracts by which these individuals are given the power to give investment advice and in many instances manage the portfolio. Sometimes that contract runs for 10 years. And, curiously enough, although I know of no other trustee relationship where the trustee can do that, he has the power to transfer that management contract to someone else.

People down in the Street have told me—people who control investment trusts—"Why should this be any different from any other financial institution? They ought to have paid officers and paid directors." If they want to pay themselves a million dollars, why, that is all right; we do not fix the amount.

Well, that presented, theoretically at least, a potent argument. However, we made a detailed study of the industry. We found that although when you get into the large companies, they could afford to pay salaries of such size as to attract competent people and people with ability, on the other hand, when you get down to the smaller companies, in their cases if you started paying salaries, those salaries would eat up all the ordinary income and all the profits.

So you had this situation: Should you abolish management contracts and say "Paid officers and directors"? Should you try to differentiate between large-sized companies and small-sized companies?

Well, the Commission felt that under the circumstances if there were a few elementary safeguards set up with respect to management contracts, they could see no difficulty with that situation.

I know that this is not in accord with the views of many people in the Street, and the fact is that there are many investment trusts that have paid officers and directors, just like any bank or insurance company. However, we said, "If the industry feels that the practice is indigenous to that type of institution, we may have some difficulty with it, but we would not recommend to this committee that the status be disturbed."

What have we done with respect to management contracts? There is not a single provision in section 15 which even remotely assumes to fix what they should be paid as compensation.

As a matter of fact, in Senator Taft's State the "blue sky" laws were recently amended, and they have a provision that investment company securities could not be sold in that State if the management and operating expenses exceeded 1½ percent of the average total assets.

We do not have that. We feel that is a question for the stockholders to decide. If they want to pay a man a million dollars to manage the fund and if they know they are paying him a million dollars and if they have the right to approve the payment of a million dollars, this bill says that is perfectly all right.

Section 15 (a) virtually says that you cannot act as a manager unless you are paid in one of three methods. One of those is where you get a definite sum per month or per year; that would be a salary basis. Another is a percentage of the income. The third method is a definite percentage of total assets—or any combination of these three.

What we aim at really is to kill profit-sharing arrangements, where a man makes an arrangement to the effect that he will take a cut of the profits but he does not take any cut of the losses. It is one of these "heads I win and tails you lose" propositions. By and large, I do not think the industry finds any difficulty with this provision.

Subsection (b) provides in substance that the contract has to be in writing. We felt that that was necessary because we saw some arrangements, and we have studied hundreds of management contracts where sometimes the contract was oral and sometimes it was just a slight reference in the minutes. Sometimes it was an elaborate contract.

We say that it ought to be a formal agreement between the corporation and the managers, setting forth—what? The compensation to be paid. We say that in the first instance it cannot last more than 2 years and that the board of directors shall have the right to terminate it on not more than 60 days' written notice. The fourth provision is that you cannot assign the contract.

Let me discuss that last provision at this point, because I think that presents the simplest situation. Here you have a situation where a person assumes a fiduciary obligation; he is the manager of other people's money. If he is through with the job, he ought to go home. However, instead of that they take these 10-year contracts which they have the right to assign to someone else.

This provision says that the management contract is personal, that it cannot be assigned, and that you cannot turn over the management of other people's money to someone else.

The third part is a provision for termination on not more than 60 days' written notice. We have made an analysis of a great many management contracts, and many of them contain the provision that the manager can terminate on 60 days' notice. The company should also have the right to terminate on 60 days' notice. We feel that the relationship is really a personal one and that if the stockholders or the board of directors are displeased with the management, they ought to have a right to terminate the contract.

The other provision, with respect to the 2 years, is to take care of situations where a 10-year management contract or a 5-year management contract is voted the managers and there comes a time—and I shall illustrate that in a moment, with an example—where the stockholders are dissatisfied with the management, and the only way they can get rid of the management is to pay these people a substantial sum of money, in order to get a termination of the contract.

So we say the management contract can be for 2 years, if it is approved. Thereafter it is renewable yearly. We say that annually it has to be approved by the directors or the stockholders. If it is for 2 years, it has to be approved by the stockholders. Thereafter it can be year after year approved either by the directors or the stockholders.

Now coming to subsection (c), that is an analogous provision for the person who has the distribution contract with an open-end investment trust. I think the difference in this situation is that we say it does not have to be approved by the stockholders, because in that instance the stockholder, after he buys the security, has no more interest in the distributor. The manager manages his funds. Once he has purchased the security, he should have no control over who the distributor should be. It is the function of the directors to select the person to distribute the securities and to determine what his compensation should be.

In subsection (d) it is simply stated in substance that the management contract, if approved by the board of directors, should be approved by independent members of the board of directors, and that