anywhere in that necessary revision until someone has winnowed out those portions of the bill which have nothing to do with and nothing to contribute to reasonable and workable legislation.

Senator WAGNER. Are you going to enumerate those?

Mr. QUINN. I am going to take up specifically those sections that I think ought to be out of here.

Senator WAGNER. All right.

Mr. QUINN. I understand the approach of the S. E. C. to this problem, even though I cannot say I sympathize with it. They have seen wicked things happen, and they want to prevent their recurrence. This is very understandable. I doubt if anybody has ever gone down to see them and has said a kind word about investment companies, on a voluntary basis. They have seen only the one side of the picture, and they probably have been too busy chasing troubles to familiarize themselves with day-by-day, technical details of operation of investment companies, as run by decent and reasonable people.

We are just as anxious as they are to see the wrongs stopped; but I think it is only more natural for us to be conscious of the fact that in trying to cure a wrong, you may be doing a great deal of unnecessary harm.

May I reiterate my statement that I believe that if you will write a bill containing the prohibitions and requirements I have mentioned, and requiring the fullest publicity of any company's affairs, you will have gone as far as it is feasible to go toward according protection to the investor.

Of course, you can go at it and you can iron out every possibility of evil and every possibility of wrongdoing in this business, just as you can in any other business; but I think that when you get through such a process as that you will have rather effectively destroyed the business, in doing so.

I know you gentlemen are too experienced to think that you can set up a bill which will stop wrongdoing. Certainly, one wonders, in considering the cases that have been cited in these hearings, if the enactment of one more law will deter people from doing what they should not do. They certainly did not show very much compunction about breaking the existing laws in these cases. I know also that you gentlemen are too experienced to think that laws are going to prevent people from losing money; because you cannot do that; you cannot endow them with good judgment and foresight.

I do feel, however, that a bill such as I have suggested will go a long way toward curing all the revealed abuses, insofar as proper legislation can cure them. If you will review in your mind the abuses that have been presented to you by the statements here, I think that you will agree that, to the extent that it is legislatively feasible, you will have met the problem.

It will not go the length of this bill; but this bill attempts, on the basis of a short experience of 10 years, to legislate for all times and to legislate for all contingencies. That is just too big a job. Would it not be wiser to restrict the present legislation to those things on which the case is clear—those things which should be stopped, things the recurrence of which should be prevented?

But do not try in an unrealistic zeal for perfection to cure in one omnibus bill all the faults which have been revealed and to prevent all the abuses which might happen. That is bound to freeze

into the form of law one single solution of these problems, many of which are not solved.

I come now to those portions of the bill which in my opinion go far beyond the proper limits of sound regulatory legislation.

For instance, the present bill prohibits interested transactions between investment companies and persons closely associated with investment companies. That is sound. That will stop the cases you have heard of—cases of dumping and of improper transactions among the interested parties.

It then provides for independent directors to review and scan all transactions. I think that is sound. But having set up these two cures of a possible evil, the bill then proceeds to isolate those who might conceivably be affected by those evils. In effect, the bill dictates who can be directors of investment companies and under what circumstances and conditions they can act.

Now, Mr. Chairman, we have heard a good deal of talk about pyramiding; but isn't this thing in effect a type of pyramiding.? You put one prohibition on, and then put a second prohibition on, and then you put a third on top of those two. I think that the first two are sound; I think the third is unsound.

This bill subjects directors of investment companies to a degree of bureaucratic control which is demanded of the directors of no other form of business. It changes the management of certain companies without consulting stockholders as to their wishes. This is discriminatory, and, I think, unfair to certain classes of persons.

The real difficulty is that it attempts to solve a possible conflict of interests by making it virtually impossible—and we say that advisedly—for investment companies to retain or replace competent and experienced directors.

This is so important a part of this bill and so vital to the future operation of investment companies that, with your permission, our group proposes to deal with that specific item in more detail a little later on, Senator.

Now, I come to another provision of the bill which I think is a unique one. It was discussed in the committee the other day. It practically prohibits, by this section, any person from starting an investment company if within 5 years he has started another investment company. Now, this seems to me to put the cart before the horse, with a vengeance. The evils which it is designed to cure are covered by other provisions of this bill and also by the proper enforcement of the disclosure provisions of the Securities Act.

Now, Mr. Chairman, I don't want to be thought facetious, but it seems to me that the insertion of this provision shows a most lamentable lack of confidence in the rest of the bill. The bill is designed to prevent recurrences of abuses; but the authors are so uncertain of its effects that they say, "At least we will see that these abuses can recur only once every 5 years."

No matter how conpetent and successful a man is in handling other people's funds, he cannot set up another company, even though it may be designed to meet the wishes and needs of a particular group of investors, unless the Commission permits him to do so. This seems to me very questionable, indeed; I certainly question the propriety of including this kind of a provision in this bill.

I should like to refer next to certain prohibitions of the bill dealing with the formation of investment company systems. In relation to this subject you also have to think of those sections of the bill which are designed to prevent what might be called system operations through affiliations. Other sections of the bill prohibit cross-ownership and circular ownership. The declared purpose of the bill is to prevent unlimited pyramiding, but its direct effect is to limit even first-degree ownership in the future. Why would it not be possible to permit first-degree ownership, prohibit pyramiding—which is not involved very largely in first-degree ownership—and subject dealings between companies in the same system to the same type of prohibitions applying to self-dealings? If this were done, I think the possibilities of abuses which might be found in investment-company systems could be eliminated without destroying the possibility of system operation in much the same manner as the system operation of fire insurance companies.

There may be many reasons, primarily that of economy of operation, why joint management of a group of companies is desirable.

In fact, I am inclined to feel that if you thus destroy the possibility in the future of investment company system operations, you may well wash out one of the only feasible methods of providing good management for a company with small resources, at a reasonable cost. That is the second thing which I think should be vitally changed before it should be included in this bill.

I now come to another provision which seems to me to have no place in this bill: That is the section imposing a limitation on the size of investment companies.

Now, Mr. Chairman and Senators, any limitation on size is a very novel idea as far as legislation is concerned.

Senator HUGHES. A limit to $150,000,000?

Mr. QUINN. Well, I want to point out, Senator, that that $150,000,000 limitation does not mean exactly what it says: because not only is there a limitation on size but there is rank discrimination between the size permitted of various types of companies. A diversified investment company, as defined in this bill, is restricted to $150,000,000; a securities trading or securities finance company is restricted to $75,000,000.

Now, sir, the argument that was advanced in favor of that differentiation was diversification; but the only distinction which there may be, under that definition, between a diversified investment company and a securities trading company may be that the securities trading company has a small amount of preferred stock or bonds outstanding. That has nothing to do with diversification. The only difference may also be that one company holds $10,000 of the securities of another investment company. That has nothing to do with diversification.

Not only is there no justifiable reason for this discrimination, but the whole idea of limitation of size is a novel departure in lawmaking. I shall not go into this matter any more fully, because in the further discussion of the details of the bill we should like to take this up again.

Senator WAGNER. Of course, I have always had doubts about that, myself; but I am not an expert on this question, by any means.

Mr. QUINN. Senator, I think there is——

Senator WAGNER. I may want to go further than you do. I do not know; that is a matter of future determination.

However, with the other regulations, I do not particularly see the necessity of that; although, as I say, I want to hear from those more expert on the subject than I.

Mr. QUINN. I should like to go next to another subject which I think has no place in the bill. The bill before you has in section 18 a provision regarding the future capital structure of investment companies. It provides that in the future an investment company can have one, and only one, type of security—common stock. Bonds, debentures, preferred stock are all to be legislated out of future existence.

The prospective purchaser, in the future, is therefore going to be dictated to by the Government, in his choice of the type of security he wishes to buy. He is to be told that he can have one thing and one thing only.

I do not think that even the Public Utility Holding Company Act went that far; but this is so important and serious a matter that I should like to deal with it later at greater length.

Senator HUGHES. I am very much interested in that.

Mr. QUINN. Well, Senator, it is a rather complicated subject; it is a rather difficult subject; it is a very extensive subject. If you do not mind, Senator, I should rather confine myself now to an over-all review, and come back to that at some later time, if I may do so, with your permission.

Senator HUGHES. Very well.

Mr. QUINN. I now come to a section and a whole set of prohibitions which I think go way beyond the bounds of reasonable legislation. I refer to section 19½ which deals with dividends.

§ 19

After listening to the hearings, this subject is even more difficult to discuss than it was before. Mr. Smith, in discussing it the other day, said that one section means something that it does not say; and Judge Healy stated that he does not agree with it and is not yet ready to discuss it.

I recognize the limitations there have been on his time, but I just want to mention that point.

It does mystify us a little bit as to what is really intended; but I should like to cover some of the provisions of this section, as they have been written into the bill.

I shall not take up your time with a discussion of paragraph (a) of section 19, except to point out that it raises many important questions. When you are dealing with a definition of income of investment companies, do not think it is a simple matter. The income account of an investment company is affected seriously by the recurrent capital gains and losses which are inevitable. If you try to say that the only income you can qualify as income is net income from interest and dividends, you run smack against tax laws, you run right against and across State laws; and even then it is not attuned to the realities, since you can have income from other sources, under this bill, such as underwriting. This is a rather technical question, and I do not want to take up your time with it; but I should like to pass to another portion of that same section.

Section 19 (a) (1) provides that if a dividend is paid from other than what is called aggregate undistributed income from interest and dividends, the man who receives the dividend must be given a reasonable opportunity to invest such portion of that dividend as the Commission shall prescribe in the securities of the company without the payment of any sales load. This is intelligible, although highly controversial, if applied to the open-end companies; and Mr. Smith has said that that is what is intended. But that is not what the bill says.

Now let us look at the situation of the closed-end companies, as the bill is now written. It states that a closed-end investment company, when it pays a dividend of this sort, has to offer rights equivalent to a portion of that dividend to its stockholders. First, you have the not inconsiderable expense of registering that stock with the S. E. C. for such an offer; next you have the expense of communicating with the shareholders, in making this offer. What is the result? You offer shareholders the right to subscribe to stock, presumably at liquidating value, because that is what another section of the bill practically says; but these stockholders who are offered this right may be able to go out into the market and use that dividend to buy more stock of this investment company at a discount. Certainly, in many cases at the present time this offer provision and the offer would be silly and futile, and it would really be expensive.

Consider, however, the situation of closed-end companies with more than one class of securities. The dilemma is impossible. What is the justification for offering preferred shareholders such a right? They are entitled to an agreed amount of dividend, an agreed liquidation on dissolution; and the source of the income does not in any way affect their ultimate contract rights. If you give them anything extra, it is nothing but a pure gratuity at the expense of the common shareholder.

However, aside from this, under the bill the issuance of preferred stock is specifically prohibited. Therefore you cannot give them preferred stock; and if you offer them common stock, it runs directly counter to the idea of the bill that all common stock should have a preemptive feature.

As it is written—and I say this with due reservation, because Mr. Smith's discussion of that section indicated that it was not so intended, and I do not want to be unfair in that respect—the bill asks you to do something, in the case of the closed-end companies, which in one case is futile and in the other case is impossible.

I turn now, however, to the further portion of this bill which in my opinion is a completely indefensible confiscation of valuable rights. It is also in my opinion an unwarranted interference with management discretion.

Senator WAGNER. Before you go to that, may I ask you, Mr. Quinn, whether you have any doubts as to whether or not dividends should be limited by law to profits, and should not be permitted to be paid out of capital?

Mr. QUINN. Out of capital?

Senator WAGNER. Yes; dividends.

Mr. QUINN. Oh, out of capital surplus, do you mean?

Senator WAGNER. Yes.

Mr. QUINN. Well, Senator, I think that the question of governing dividends by Federal law is a very difficult one. In the first place,

you have State laws governing that. Most of these companies are incorporated under State laws. You have tax laws which define income in certain ways. If you now put in another provision regarding dividends, I think you get in a hopeless state of confusion.

Senator WAGNER. I do not know if that is so confusing. We had an instance here where—I have forgotten the amount—a rather large sum, $800,000, I think, was paid out of capital.

Mr. QUINN. Yes; but, Senator, if you recall that $800,000—and I think Judge Healey will agree with me—that was a misstatement of the income account, that permitted that. Because if you remember, Senator, he said that they manipulated things so that there was $800,000 more of income reported than actually should have been realized.

Senator WAGNER. Then you are not in favor of the payment of dividends out of the assets or out of capital or surplus or whatever you want to call it?

Mr. QUINN. Well, Senator, if you want me to go into a highly complicated discussion of the question of the payment of capital surplus and so forth, I should like to do it at a later time; because I think it is a complicated subject.

Senator WAGNER. It may be. I thought it was simple, but I do not know.

Mr. QUINN. It is not, sir.

Senator WAGNER. Well——

Mr. QUINN. I think, Senator, that really that question is so complicated that to attempt to legislate on it, you get really——

Senator WAGNER. How do you suppose the States have legislated on it?

Mr. QUINN. States have set down certain laws under which you are incorporated.

Senator WAGNER. Yes.

Mr. QUINN. You have been following those all the time; and your charter sets down certain requirements governing the declaration of dividends, and you follow those. The tax law sets down certain requirements on dividends.

Now, Senator, if following those you put in another, it seems to me a difficult proposition.

Senator WAGNER. Is it not a general proposition that dividends ought to be paid out of earnings?

Mr. QUINN. I do not think you can make that flat statement, sir.

Senator WAGNER. Well, I thought you could.

Senator HERRING. There is a distinction between dividends being paid out of capital, and being paid out of surplus, is there not?

Mr. QUINN. Yes, sir.

Senator WAGNER. I am talking about dividends being limited to earnings. That has a very definite meaning, it seems to me.

Senator HERRING. That is right.

Senator WAGNER. I thought that proposition was rather acceptable.

Senator HERRING. But might not surplus be earnings?

Senator WAGNER. That may be.

Mr. QUINN. Senator, under the tax law an investment company has to consider as earnings capital gains. That has nothing to do with interest and dividends. I mean that the tax law recognizes that there are other things than interest and dividends that have to be considered as income.

Senator WAGNER. Well, I am sorry to have interrupted you.

Mr. QUINN. That is all right. However, Senator, I should like to take up again that section of the bill which, as I said before, I think is a confiscation of valuable rights of shareholders, as well as an unwarranted interference with management discretion. I realize that that is a fairly strong statement, but I think I can prove that.

The proposed law provides that no dividend on junior securities may be paid by a management investment company having senior securities unless immediately after such payment any indebtedness of the company shall have an asset coverage of 300 percent, and any preferred stock shall have an asset coverage of 200 percent. That is bad enough, but that is not the worst part of it.

See what it does to existing contract rights: In all probability, outstanding bonds have indentures which provide the required coverage before dividends can be paid; and this might be 200 percent, 150 percent, or even a lesser percentage. You may have preferred-stock provisions in a charter which provide that junior dividends may be paid if the preferred stock has a coverage of less than 200 percent, which is the standard set down in this bill.

But all of these rights which have been agreed upon and accepted—and securities have been exchanged and securities have been purchased and bought—all are scrapped by this provision.

I think you will agree that, upon consideration, it is going pretty far thus to retroactively—and I want to stress that word—retroactively destroy existing contract rights, legally entered into and agreed upon by the people who were affected.

I should like to point out just how drastic and just how unworkable this provision is. I suppose it is designed to protect the senior security holder, by preventing the payment of dividends to junior security holders under circumstances that they do not think are proper. But let us take a possible case: Let's say that a company started out with $100,000,000 of assets. That $100,000,000 of assets is represented by $40,000,000 of bonds and $60,000,000 of common stock; that is the way they started, years ago. It would seem reasonable that if the charter provided that no dividends should be paid on the common stock unless this original ratio of contribution of capital was maintained, then that would be a reasonable provision.

This bill now comes along and says to the bondholders: "You made a very poor deal for yourselves, and we are going to come to your rescue. We are going to say that the common shareholders can no longer receive dividends, even though the company has kept all its funds, has not lost a penny, and has plenty of income not only to pay the bond interest but to pay a reasonable dividend on the common stock."

But this bill says:

> We shall not let you pay interest on the common stock until you have made at least $20,000,000.

That is what the law says; because it is only at that stage that the bonds will be covered 300 percent.

This sounds bad enough, but let me go on and point out how much farther this section goes. The coverage provided for debt is 300 percent. The coverage provided for preferred stock is 200 percent. If that were all, the stockholders could measure exactly just how badly their existing rights were being interfered with; they could measure

the exact amount which would be taken away from one class and given to another. But this section says that the Government agency can come along and change these percentages. It can make the coverage requirement on the debt as low as 200 percent or can raise it to 400 percent. It gives the Commission the power to say that the preferred stock need be covered only 150 percent or that it must be covered 300 percent. The law itself destroys rights; the S. E. C. is given the right to mitigate or increase that destruction. This is not merely by general rules and regulations, Senator; the Commission is given the authority to tell each individual company by specific order, addressed to that company alone, just when it can pay dividends.

What is the limitation on this authority? It is solely what, in their opinion, is desirable—and I quote—"for the protection of investors or to preserve the financial integrity of the company concerned."

Now, Senator, this bill contains one provision which I probably ought to leave to the lawyers to discuss; but I should like to say just one word. Section 17 (e) says:

> Any gross misconduct or gross abuse of trust in respect of a registered investment company * * * shall be unlawful.

Now, Senator, no one can quarrel with the general idea. Certainly, I have no word to say in favor of misconduct or abuse of trust, whether it is gross or petty; but I think you will sympathize with anyone's unwillingness to be subjected to a criminal penalty for violation of so indefinite and undefinable a prohibition.

I have only high-spotted certain portions of this bill which go too far afield from proper regulation. I do not want to take up your time with a number of other important portions which also need careful scrutiny.

I am coming to another section, Senator, and to a whole discussion of another group. So if you want to stop at this point for the recess, of course that is perfectly acceptable to me.

Senator WAGNER. Well, I want to confer with my colleagues here.

Mr. QUINN. I just mention that, Senator, to see if it is convenient for your to continue or to stop at this time.

Senator WAGNER. Would you gentlemen like to go on for half an hour longer or so?

Senator HERRING. It is all right with me.

Mr. QUINN. This is a rather long section, Senator, dealing with delegated powers.

Senator HUGHES. I should like to do it, but I really have made an engagement for 1 o'clock.

Senator WAGNER. Would you come back and be back at 2:30?

Senator HUGHES. I shall if I can.

Senator WAGNER. Can you come back at 2:30?

Senator HERRING. I think so.

Senator WAGNER. You will come back at 2:30?

Senator HUGHES. I will come back for a little while, but I may have to leave.

Senator WAGNER. All right. Then we shall recess at this time until 2:30.

(Thereupon, at 11:55 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.

STATEMENT OF CYRIL J. C. QUINN—Resumed

Senator WAGNER. Now, Mr. Quinn, will you continue, please?

Mr. QUINN. Yes, sir.

I took up this morning those portions of the bill which I thought could be properly included in any regulatory bill. I made the reservation that I thought they needed considerable reworking. I also went on to point out certain things which I thought should not go in a regulatory bill.

I would now like to take up a rather important subject and to turn to a discussion of the broad and vague delegations of authority to the Commission in the proposed bill.

Senator WAGNER. In other words, you are going now to the discretionary features of the bill?

Mr. QUINN. That is right.

I want to point out at the start that I am not now discussing procedural matters but matters vitally affecting every investment company, which intimately touch day by day operations and which directly concern the security holders. To my mind some of the most dangerous portions of this bill are contained in those sections which I will now discuss.

In this connection I recall a few of the comments of Judge Healy when he addressed you gentlemen in his opening remarks. He stated that to him the greatest virtue of administrative processes is flexibility. I do not dispute this. I agree that within limits flexibility is desirable, but I must remind you gentlemen that reasonable flexibility in the administrative processes is one thing and broad delegation of powers is quite another.

Judge Healy speaks of the false idea that the rule-making power is the power to make laws. He says that the Commission does not have this power; that no one has the power to make laws except Congress. I am not a lawyer and I accept this statement of Judge Healy. But, gentlemen, it makes no difference to me whether I am sent to jail for 2 years for violating a law enacted by Congress or whether I am sent to jail for the same period of 2 years for violating a rule or regulation promulgated by the S. E. C. Whether they are called rules and regulations or laws makes no difference to me. I feel that I have a right to demand as an American citizen that these mandates be the mandates of the duly elected representatives of the Congress. Flexibility, yes. I appreciate that that is necessary. But the fundamental dictates that are to govern me and my industry should come from the Congress and not from any governmental agency.

At this point I would like to say that I wonder if some of you gentlemen have ever looked carefully at a rule of the S. E. C. I would like to show you one, which is the present rule covering the solicitation of proxies, consents, and authorizations. That is the rule which I said, with regard to the companies I represent, is already