signed in section 5—which now is confusing to stockholders—be for that sole purpose, and that the class of companies to be afforded this preferred tax treatment be made as broad as possible. This is a question of substance and not merely a question of draftsmanship.

A word of explanation with respect to why this is so is in order. As you have heard again and again, investment companies are particularly adapted to the needs of an investor of small means; but the fact of the matter is that unless the closed-end investment company receives some equitable tax treatment, the man of small means who solves his investment problem by purchasing shares of a closed-end investment company finds himself subjected directly and indirectly to a tax burden far greater than would concern him if he had invested directly for his own account, with all the expense and difficulties such direct investment involves.

Senator Hughes asked a question this morning about the tax burden on a small investor. I think this will answer your question, Senator.

Let us assume that a man of small means pays taxes on his own direct investments in the 4 percent or 5 percent bracket: If he places all his funds in a closed-end investment company it is perfectly obvious that he is subjected, in addition to his individual taxes, to the 18 percent corporation tax, with respect to the interest and capital gains which that company receives in the first instance, plus State franchise taxes, et cetera, and thereafter to further taxation—at whatever tax rate his income requires—as he receives profits or dividends from his investment company. If, for example, this happened to be about 5 percent, it is obvious that he would be paying directly or indirectly 400 to 500 percent of those taxes which would ordinarily be due if he were investing directly for his own account.

Senator HUGHES. Is that 400 or 500 percent?

Mr. MCGRATH. It is 18 percent plus 5 percent equals 23 percent, which is somewhere between 400 and 500 percent of 5 percent.

Indeed, this principle was recognized in the 1936 Revenue Act; and relief was accorded to the open-end section of the industry, through section 48 (e) of the revenue act. This same provision was again extended in the 1938 Revenue Act and is applicable to the open-end companies at the present time.

Senator TOWNSEND. When does this second extension expire?

Mr. MCGRATH. It is still in effect.

Senator TOWNSEND. Is there any date fixed for that extension?

Mr. MCGRATH. The new tax bill.

Senator TOWNSEND. All right.

Mr. MCGRATH. However, a very large section of the industry, namely the closed-end type of company, does not enjoy the benefits of any exemption.

Senator WAGNER. I must leave now, to take part in a vote. Senator Hughes and Senator Townsend have paired their votes, and I shall ask Senator Hughes to preside.

(Senator Wagner thereupon left the committee table.)

Senator HUGHES (presiding). Very well, Mr. McGrath, will you please proceed?

Mr. MCGRATH. Yes, Senator.

May I say, moreover, that profits arising from realized capital appreciation are defined as "income" in the Revenue Act of 1938 and are taxable. Section 102 of the Revenue Act of 1938 imposes a penalty tax on unreasonable accumulations of surplus. As interpreted by the Treasury Department, this may require a closed-end investment company to pay out in the form of dividends, to its stockholders all the profits, including capital gains, which it realizes in any year, except such portion as it can prove it requires to carry on its business. Consider the dilemma of the closed-end investment company, compelled to comply with the provisions of the Revenue Act of 1938 and with section 19 (a) of this bill; for, although realized capital appreciation constitutes income, under the revenue act, and taxes must be paid thereon and are distributable as dividends to the extent stated, under section 19 (a) a registered investment company may pay dividends only from "undistributed net income from interest and dividends" received, unless expressly authorized to the contrary by its charter or its stockholders.

I am not a tax expert and I do not wish to bore you, but the following must be answered in reconciling section 19 (a) with the revenue act:

What is undistributed net income from interest and dividends? Is it the intent of section 19 (a) that undistributed net income should be computed from the date of inception of a corporation or from the date of the enactment of the bill?

If it is intended that undistributed net income should be computed from the date of the organization of a corporation, the following questions will have to be considered and answered in regard to the method of computation:

First, if during the period since the organization of the corporation, it has incurred security losses in excess of security profits, will it be permissible to charge these losses against undistributed net income from interest and dividends, or will they have to be charged to capital surplus or carried forward as a deficit?

Second, if an investment company is permitted to engage in underwriting, as it is under the proposed bill, it would appear that it should be permitted to take into its undistributed net income, commissions from underwriting, syndicate profits, et cetera, and other miscellaneous income.

If the undistributed net income from interest and dividends has to be determined from the date of organization of a corporation, some apportionment of taxes and expenses will have to be made between such net income and profits and losses on the sale of securities. In some years this would result in practically the entire liability for Federal income taxes being charged against profits on sales of securities, and there would be a relatively small amount of taxes chargeable against undistributed net income from interest and dividends. A considerable portion of the expenses of any investment company consists of research and statistical services which are directed toward obtaining investments which have some possibility of capital appreciation. Consequently, it should be permissible to apportion these expenses to the profits realized on sales of securities.

Incidentally, the bill seems to be drafted on the theory that, henceforth, investment companies should be operated, not with the object of making profits on sales of securities, but with the object of obtaining the best yield on the capital invested. Investing for high yields is a speculative business.

Third, if it is the intention that the undistributed net income from interest and dividends should be computed from the date of organization of the corporation, and there is a deficit therein at the date of enactment of the bill, a company will apparently be bound henceforth by the restrictions imposed under this section, as far as payment of dividends is concerned, until the deficit is eliminated. This would result in penalizing a company for payment of dividends in the past in accordance with the law of the State in which it was incorporated. It is difficult to see how this provision could be of any benefit to security holders.

The bill appears to have been drafted without any particular consideration of the Federal income tax questions involved. These are so involved and intricate that I assume a committee of accountants will explain the conflicts between the law, the Revenue Act of 1938, State franchise tax laws, the excess profits tax, and so forth.

Furthermore, section 19 (b), despite the provisions of section 102 of the revenue act, prohibits an investment company with senior securities outstanding from paying dividends, unless such senior securities have an asset coverage as the Commission may, within the limits in section 19 (b), set forth, prescribe by general rules and regulations, or prescribe by an order applicable to a specific company.

Apart from the actual conflicts between this bill and the tax law, which must be resolved, you must realize that some kind of tax treatment must be anticipated if the closed-end companies are to survive. The basis for this anticipated tax treatment must be outlined in any classification of companies in this bill. Unfortunately, we are not now in a position to discuss this anticipated treatment, because we do not know what tax treatment the S. E. C. will recommend. I do not say this critically, because it is a difficult problem.

If by any chance the S. E. C. had in mind, by the proposed classification, not only laying the groundwork for tax preference but also using tax preference as a weapon to outlaw such other things as capital structure, trust systems, and so forth, we regard this attempted indirect method in this connection as totally inappropriate.

It seems to me that a more accurate classification under section 5 would be to provide for two classes of investment companies—one qualifying for special tax treatment, and the other not—and, as previously suggested, leaving under sections 8 and 13 of the bill the classifications having to do with investment policy.

Now let me turn to another point. It does not seem to me that it is wise to require that stockholders shall select auditors of a company. It has been said at these hearings that the proposal is largely for psychological reasons. I can understand this argument; but I do not think it has sufficient validity to justify the change which, as I understand it, constitutes a direct interference with the fundamental principle of corporate law of most States. As I understand it, this fundamental principle is that the management of the corporation shall be in the hands of its directors and that the directors are to be held responsible for such management. The State laws of incorporation provide for the election of directors by stockholders, and they then provide for the election of officers by the directors. With a very few exceptions, the matter of the selection of auditors is in the hands of the directors. There is no provision in the laws of most States for election of auditors by stockholders.

I realize that this is not a matter of overwhelming importance, because in most instances stockholders will elect the auditors proposed by the directors; and I realize that if the directors who are made responsible for the financial statements do not have confidence in the stockholders' choice, they must resign; but I do not see any reason for distinguishing in this respect between investment companies and any other type of companies, and I do not think that this provision will really accomplish anything. A certified public accountant is a professional man. It is difficult in a proxy statement to compare professional attainments. Whether the auditor is designated by stockholders or by directors, he has a public responsibility in respect of any account which he certifies; and nobody knows that better than a certified public accountant. To my mind, it does not add one bit to his responsibility to have him selected by stockholders, nor would it add one bit to the measure of care which he would employ in performing his duties. I shall not urge the point, but I do want to give you the benefit of my views.

Senator HUGHES. Mr. McGrath, is that based on your thought that whether he is selected by the directors or the stockholders or the officers, he would do his duty anyway along the lines of an accountant; or that if he is instructed by one to do it in a certain way, the others would do it the same?

Mr. McGRATH. Well, Senator, he is never instructed to do it a certain way; that is, any certified public accountant who will take instructions is no good.

Senator HUGHES. I have heard that before; yes.

Mr. McGRATH. But, of course, like all professional people, they have made some mistakes—and bad mistakes, too.

Senator HUGHES. Yes.

Mr. McGRATH. But I do not think the nature of his work would be affected by whether he is elected by an officer or by a stockholder.

Senator HUGHES. And it would contain just as important information for the stockholder, if selected in one way or the other?

Mr. McGRATH. I think so. As I have said, Senator, I do not think the point is an important one.

Sneator HUGHES. Yes.

Mr. McGRATH. But what I am afraid of is that some day the stockholders might elect for our company auditors whom I would not like—in whom I have no confidence. Then what would I do?

In conclusion, let me say that our economy badly needs reservoirs of capital with which to purchase equity securities. Thus, the investment trust business plays a most important part in our economy. It is a young and, we hope, a growing industry, born just prior to the panic of 1929. It has suffered acute growing pains and numerous children's diseases. It has not yet reached maturity, and has made numerous mistakes. We plead with you not to kill it off while it is still growing. All economists are agreed that the country needs venture capital and purchasers of equities. Undue restrictions on investment companies may not harm them individually as much as such restrictions may harm the country at large.

In our own company, we know we have done a good job for our investors; and we know that there are many other companies, as mentioned by Mr. Bunker and as represented here, with excellent records. The horrible specimens which have been exhibited to you are not representative of our industry. No industry, however, can continue to thrive and flourish if public opinion is hostile. If you and the country believe we should be surrounded with all the restrictive provisions of this bill, then we had better go out of business and put our capital to work in other fields, rather than to try to operate under the bill which has been proposed; because we know we cannot operate under it and do a good job for our stockholders.

Senators, do not cram this bill down our throats before we have had ample time to read it, to study it, and to digest it and see its ramifications; and I assure you that these are tasks which I, for one, have not yet been able to perform.

Great strides have been made in investor protection, such as the Securities Act of 1933, the Securities Exchange Act of 1934, the amendments to that act requiring that registration statements under the Securities Act be kept up to date, the amendments to that act giving the S. E. C. power over the over-the-counter market, and the supervision of the National Association of Security Dealers, the Public Utilities Act of 1935, the amendments to the Bankruptcy Act affecting corporation reorganizations in 1938, and the Trust Indenture Act of 1939. All of these acts are new, and they still present great problems.

Do not misunderstand me. We think there should be regulation of the investment-trust industry, along the lines indicated by Mr. Bunker and Mr. Quinn, not only for the protection of the investors but for the protection of the industry itself against unscrupulous elements that might wish to enter it. We hope you will not push us too fast; because under this bill we do not quite know where we are going, and we certainly do not know where we will be if this bill is passed.

Let me recapitulate. I have taken a great deal of your time to say in essence, among other things, the following:

The problem of future tax treatment for closed-end investment trusts is most important.

We urge that the basis for this taxation be laid in this bill.

We urge that you give serious consideration to your treatment of companies with senior capitalization, which we think are most unfairly treated.

We urge that turn-over is a matter of business judgment, and not a matter for this type of legislation. Consider the injury it may do to stockholders.

We urge reconsideration of the restrictions on dividends, in section 19 (a).

We urge that you give careful consideration to the principles involved in limiting size and its correlative features in this bill.

It seems to us that the bill shows evidence of hasty preparation and of failure to give adequate consideration to important and injurious collateral effects which it may have. The bill is too complicated and involved. The powers which it vests in the S. E. C. are far-reaching and, I must say, astonishing.

It has not seemed to me advisable, Mr. Chairman, to repeat what Mr. Bunker and Mr. Quinn have said about its unduly restrictive provisions—provisions which, in our judgment, unduly hamper management without adding to investor protection.

Thank you, gentlemen.

Senator HUGHES (presiding). I understood Mr. Bunker to say this morning that you had not had an opportunity, and the S. E. C. had not given you adequate opportunity to confer with them as to the wording of the bill?

Mr. McGRATH. Mr. Bunker covered that pretty well this morning. I concur in what Mr. Bunker said on that subject.

Mr. BUNKER. I might add, Senator, that we are all parties in the same group. The memorandum not only covers myself but the other members of my group.

(Senator Wagner resumed the chair.)

Senator WAGNER (chairman of the subcommittee). I think Mr. Quinn is to go on next.

STATEMENT OF CYRIL J. C. QUINN, VICE PRESIDENT, TRI-CONTINENTAL CORPORATION AND PARTNER OF J. & W. SELIGMAN & CO., NEW YORK CITY—Resumed

Mr. QUINN. Mr. Chairman, in my statement on Friday I said that the proposed bill contained a provision so novel, radical and important that, with your permission, we wished to discuss it at greater length.

I refer to section 18 which provides that, in the future, an investment company can have one and only one type of security, a common stock. Bonds and preferred stocks are to be legislated out of future existence, as far as investment companies are concerned.

What reason is there for throwing overboard the precedent of the British and Scottish companies, which have a long and creditable record and experience?

What argument is there for thus limiting any possible future individual choice on the part of investors?

What is the justification for asking Congress to legislate far beyond truth in securities but, in effect, to dictate future style in securities?

One must go for the answer to the declaration of policy in this bill, and to the testimony presented at these hearings. One would expect to find in the declaration of policy some statement of the reason for this radical provision, some explanation of the necessity for thus restricting the personal choice of individual investors.

The references in the declaration of policy bearing on this point are the following:

(1) Paragraph 3 says that when an investment company issues securities containing inequitable, discriminatory, or anomalous provisions or fails to protect the privileges of their outstanding securities the national public interest and the interest of investors are adversely affected.

(2) Paragraph 4 says that when the control or management of an investment company is unduly concentrated, inequitably distributed, or irresponsibly held it adversely affects the public interest.

(3) Paragraph 7 of the statement of policy says that when a company by the borrowing or issuance of senior securities increases the speculative character of their junior securities, the public interest is adversely affected.

Where in any of these sections is there any characterization of investment company senior securities which can be differentiated in the slightest from the senior securities of any other form of American business? If inequitable provisions of securities are bad, they are bad wherever they occur, and not only in investment companies. If control or management is irresponsibly held it can be just as bad for an industrial company as for an investment company. No one disputes the fact that borrowing and issuance of senior securities may tend to increase the speculative character of junior securities, but how in the world can this be said to apply to investment companies any more than to any business?

Isn't this just parrotting the obvious? Isn't it just saying that if, in the capital set-up of any business, there is present a class of security having priority in earnings and dividends over another, the junior stock is junior to the senior security? But is this more true in an investment company than in any other form of American business?

The existence of senior securities has nothing to do with whether or not the funds you have to invest will profit or lose. The existence of senior securities only means that losses and gains will be shared in different, but well understood and agreed proportions. The existence of senior securities may not even increase the speculative character of junior securities. If I borrow money or sell preferred stock and keep the proceeds in cash or government securities or securities which do not go down, I certainly have not increased the speculative character of junior securities.

I can however follow the future provisions of this bill and set up a common-stock company but I can go out and invest the funds I have raised in highly speculative securities and arrive at as speculative an investment company security as you wish. In other words, the way a portfolio of funds is handled can do as much if not more to make a security speculative than the existence of any reasonable amount of senior securities.

In the declaration of policy and in the discussion of section 18 here there has been no single important reason adduced regarding senior securities in an investment company which cannot with equal force and equal validity be applied to all companies in all businesses.

The important question is thus squarely posed. Is Congress prepared to say that there is something so intrinsically wrong with senior securities generally that their future issuance should be prohibited? Is Congress prepared to say that speculation should be legislated out of existence? Is Congress prepared to say that regardless of the fact that the investor is fully informed of what he is buying, Congress is going to tell him what is best for him?

I doubt if this is wise governmental policy, because, once you embark on this road, where is the logical stopping place? There isn't any. Why start on this dangerous course by making the investment company the guinea pig for a new and novel theory regarding the investment of capital?

I would now like to turn to the testimony presented in these hearings on the subject of senior securities of investment companies. Let me analyze and comment on what has been said. They started out by saying that the senior securities of an investment company are in many ways comparable to a fourth or fifth mortgage. Such a statement applied to the senior securities of investment companies generally is misleading. I don't know exactly what they mean. The example they gave of a senior security several times removed from underlying assets may have something to do with the argument over pyramiding but has nothing to do with a discussion of senior securities as such.

The next argument that they advance in favor of abolishing senior securities in the future is that there are arrearages in senior securities outstanding in investment companies, and some of them are under water. That is, the assets of the company are not equal to the par amount of senior obligations outstanding.

I haven't seen their detailed figures and I therefore can't comment on them. I could go into a long discussion of the performance of investment company senior securities. I could relate this as it should be related, for proper perspective, to the performance of other senior securities in the same period. But this doesn't seem to me to have much to do with the question under discussion.

What is the relevance of the argument? Are railroad bonds to be legislated out of future existence because a substantial portion of the outstanding bonds of railroads are in default? Are preferred stocks of industrial companies to be washed out in the future because during the depression a great many of them passed their dividends and have since failed to make them up?

I am not disputing the fact that the senior securities of some investment companies got into trouble. This was a fate shared by many other senior securities of many other American enterprises since 1929. But to use this as the basis for deciding that in the future there shall be no more senior securities in American investment companies seems to me both illogical and unsound.

One extraordinary statement was made in this same connection which I would like to take up at this point.

They said that the whole proposal of senior securities in investment securities is rather academic because no company could sell preferred stock now, and you can buy—I quote the testimony:

the preferred stocks of some of the most reputable companies at 50 cents on the dollar.

I rather resent that description, because that rules some of my friends out of reputable companies, because if you want to buy Tri-Continental preferred you have to pay 81. If you want to buy United States and Foreign preferred you would have to pay 93. If you want to buy Capital Administration preferred, you would have to pay 95, and, as Mr. McGrath pointed out, if you want to buy General American preferred you would have to pay 103½.

There was another statement which was made at that time, and that was that the senior securities of investment companies have never been able to earn their keep. Mr. Smith in this connection quoted from their voluminous report saying "that since 1871 they figured out that the greatest amount common stocks could pay would be 4 percent, assuming a 2-percent capital gain."

I think the stenographer must have gotten Mr. Smith wrong, because I have read that report, and it states that in that period the average yield was 4½ percent, not including an average annual capital gain of 2 percent.

I don't want to bother you gentlemen with an analysis of that section of the report. It may be theoretically right, although I doubt it. Practically it is full of holes.

They don't say that a common stock can only earn 4½ percent. That isn't what the report says. It says that dividends have averaged 4½ percent on the average value of common stocks. Let us see what this means. I buy a share of Du Pont at $100 and it pays $4.50 in dividends. That is a 4½ percent return on that price. But suppose I hold on to the stock and the earnings increase, so that I get $7 a share in dividends. To my mind, untutored though it may be, the money I have invested is then yielding me 7 percent; but in the S. E. C. study they say, No; that isn't true. The stock has advanced in price to 155, and therefore your yield is only 4½ percent on the then price of the stock.

Now, that may be academically interesting to the statistician, but from the point of view of the man handling funds he would say I am making 7 percent on the money which I invested, and no amount of statistical rigmarole will convince me to the contrary.

Gentlemen, I think that the suggestion that you should legislate senior securities out of existence on the basis of any statistical formula just does not make sense.

In the testimony it was also brought out that the existence of senior securities had permitted and facilitated the transfer of control and thus brought about abuses.

Here you have another example of the piling of one remedy on top of another. They put in the bill one provision which prevents the change of directors without stockholders' action. This is a sound provision and they admit that it would have stopped many of the abuses they cited.

Next, they put in a provision saying that management contracts cannot be assigned without consent of the stockholders. That is directed to the same point of changing management without the stockholders' knowledge or consent.

Next, they put in that no change of policy can be made without the consent of the shareholders. That is sound. But that isn't enough. Having set up three specific cures, they then go to the extreme of saying, although the existence of senior securities has contributed only incidentally to the abuses of the past, "Let's wipe them out in the future."

If anything further is needed to augment the remedies already in the act, surely it could be provided by some provision less drastic than the future abolition of senior securities.

They next say that senior securities make for complication and lack of clarity in reports. Personally, I don't see or believe that. The method of handling accounts which I suggested on Friday would, to my mind, make the position of every class of securities clear to the shareholders. And don't forget, gentlemen, that an investment company's statement is the clearest and most easily understood of statements. Few other forms of American business permit statements of such clarity and simplicity.

They next say that they want to eliminate senior securities in the future because there is an inherent conflict of interest between the junior security holders and the senior security holders. Of course the interests of the senior security holders are not identical with those of the junior security holders. That's why they spell out these respective rights and privileges in a contract. But in what respect, gentlemen, is this different from senior securities generally in any business?

Of course the senior securities want steadiness and continuity of income and all junior security holders want as big dividends as they can get. But these desires are not conflicting; both classes of security holders want their company to prosper.

There is no more reason on this score for legislating senior securities of investment companies out of future existence than there is in