10,000 shares bought at 10 cents less than their indicated worth. Obviously there appears to be some dilution here. Ten thousand shares times 10 cents a share makes $1,000. This $1,000 is my tentative dilution figure in this illustration.

This requires a little patience—but now let us assume (and this is often the case in a rising market) that in the last hour or half hour of trading before 3 o'clock the market stages another advance, so that at the close the shares are worth $20.30.

Here is the nub of the thing. The S. E. C. contends that the company should receive on that day $20.30 for all shares sold during that day, despite the fact that this would prevent investors from buying during market hours, and in 9 times out of 10 on any substantial advance, the closing price, that is, what the investors would have to pay, would represent virtually the highest price of the day.

Then the S. E. C. arrives at its dilution figure by taking the difference between the last determined price ($20 a share) and the price at the close of the market ($20.30 a share), multiplies it by the number of shares sold (10,000 in this example) and arrives at a dilution figure of $3,000, as compared to my $1,000 figure. I claim that the figure of $3,000 is purely hypothetical, because, among other things which I will discuss later, it rests on the assumption that the company should and would receive $20.30 a share for the sale of 10,000 shares, when, as a matter of fact, it should not and would not.

In the first place, it should not because at best (or worst) the company should not be entitled to receive any more than the value of the shares at the time that an investor wants to buy them. Thus, as in my illustration above, if a man wants to buy some shares at 11 o'clock in the morning, when they are theoretically worth $20.10, the company should not be entitled to charge him any more than that. Yet the S. E. C. says (and its so-called dilution figures are based on the following assumption) that the company should not allow him to buy until after the close of the market and then at the price of $20.30. As explained previously, the S. E. C. then says that by selling shares at $20 instead of at the day's high price of $20.30, the interests of existing shareholders are diluted to this full extent of price difference.

In the second place, the company would not receive $20.30 (the high price based on closing market prices) for the simple reason that investors would not buy shares on that basis.

If that doesn't sound reasonable, I believe Senator Glass could explain why this is true by reason of his experience in the Treasury Department. You might ask him how many Government bonds he thinks the public would purchase if the Treasury Department were to tell prospective buyers that it would sell bonds only on the basis of a price to be determined in accordance with the exact level of interest rates prevailing at the close of trading in Government bonds for that day.

This is a practical consideration of great importance and I will discuss it more fully later. Suffice it to say at this point that a prospective investor, no less than a prospective buyer of any product, does not want to buy "a pig in a poke."

You might also ask Senator Herring how many automobiles he thinks he could sell if he told prospective buyers that he couldn't tell them what the price would be until after the close of business that day—when everyone had gone home, even including his salesmen.

Just to finish this illustration, let me say that I hold no brief for my theoretical dilution figure of $1,000 as compared to the S. E. C.'s $3,000 figure—it might be more or it might be less. Salesmen usually work from 9 in the morning to 5 at night and orders are taken all during that time on the basis of a known price at the time of sale.

My point is, that while that known price may be less than the value of the shares at the exact moment of sale, thereby causing some possible amount of the theoretical dilution, the amount of dilution is not even remotely related to the amount of dilution that the S. E. C. has had written into the record of the testimony before this hearing. Let us generously assume, however, for the sake of this discussion, that instead of $1,000 the dilution might $1,500—that's a half rather than a third of the S. E. C.'s $3,000 figure.

Now let us take a look at some so-called dilution figures, with a view to reducing the S. E. C.'s implications to their proper proportions. We have the S. E. C.'s example, which, incidentally, is based on the extraordinary occasion of September 5, 1939, following the outbreak of the war. On that day there occurred one of the sharpest market advances in history and the volume of sales of open-end company shares was unprecedentedly large. You may recall that much stress was given to the S. E. C.'s statement in testimony that the dilution of the interests of shareholders of open-end companies on September 5 amounted to $1,585,484. This, we all might agree, would on the surface appear to be a rather severe indictment of the method of pricing and selling shares. There is little doubt that the public too would so view the matter if all the facts were not made clear. Certainly $1,585,484 sounds like a lot of money to anyone.

But to have any real significance, that figure must be related to something. What should it be related to? The S. E. C. said this figure represented dilution of existing shareholders' interests as a result of selling additional shares for less than their value. This dollar amount of so-called dilution should, therefore, be related to the dollar value of existing shareholders' interests. This total dollar value—that is, of shareholders' interests—was approximately $500,000,000. Thus $500,000,000 of assets was, we will say, diluted by some one million, five hundred and eighty-five thousand. Expressed in percentage figures, this amounts to some three-tenths of 1 percent. In other words, taking the industry as a whole, the S. E. C. has really said that existing shareholders' interests were diluted to the extent of three-tenths of 1 percent on this abnormal, unprecedented occasion.

Of course, this $1,585,000 figure, or three-tenths of 1 percent, reflects solely the S. E. C.'s basis of figuring. On the compromise basis, as established in my illustration a while back, the corresponding figure would be only 15 one-hundredths of 1 percent.

Let me cite a specific instance, which, incidentally, I believe to be less a specimen and much more a sample than the S. E. C.'s examples. In the case of Massachusetts Investors Trust on that same abnormal occasion, and on the largest single day's volume of sales in its history, the S. E. C.'s dilution figures come to only 142 one-thousandths of 1 percent, and the compromise figure would be only 71 one-thousandths of 1 percent.

Leaving the war market situation and going back to the last bull market, for the full year 1936, on the largest volume of sales—over

$36,000,000—for any 1 year in the history of the business, so-called dilution in Massachusetts Investors Trust on the S. E. C. basis was only about one-fifth of 1 percent, and on the compromise basis only one-tenth of 1 percent.

I might also cite the experience of 1937, but that would show that a fairly substantial proportion of the funds received from the sale of new shares during that year was held in cash. Thus, whatever the infinitesimal dilution figure was, it was many, many times offset by the advantage to existing shareholders which resulted from the cash holdings of the trust being increased by the sale of new shares during a year in which the securities markets registered a rather sharp decline.

So far I have confined my remarks largely to the abnormal and unprecedented occasion of the war market of September 5, 1939. The S. E. C. testimony states, "Now, granted, which we do, that September 5 was an unusual day, no one can contend that the market fluctuations on September 11 and September 19 were in any way abnormal." Then, the testimony states that the dilution on these 2 days was $72,000 and $104,000, respectively, making a total of $176,000.

Now, by the S. E. C.'s own testimony, this so-called dilution figure comes closer to representing the problem such as it is under normal circumstances. I say "comes closer," but I might add that it is still far from representing the true situation. As proof, let me point out that during the entire year 1939 and so far in 1940 there was only 1 day (excluding September 5) when the market advanced as much as it did on either September 11 or 19, the 2 days which the S. E. C. has chosen to represent as being in no way abnormal. Be that as it may, if the S. E. C. says this is the normal situation, then let us see what their dilution figures look like under the so-called "normal" conditions. According to the S. E. C. testimony, total dilution on these 2 days was $176,000 for the industry.

Now this is most illuminating: In relation to the value of shareholders' interests—some $500,000,000—the so-called dilution figure of $176,000 for the 2 days picked by the S. E. C. amounts to 00.035 percent, or about 35 one-thousandths of 1 percent. On an annual basis, this would come to about 5 one-hundredths of 1 percent; and if we double it to take care of a few semiabnormal days, it is only one-tenth of 1 percent; and if we triple it to take care of a few more, it is still only 15 one-hundredths of 1 percent.

That, gentlemen, by the direct process of employing the S. E. C.'s language and figures on a basis which has a significant meaning, is the so-called dilution problem in a nutshell.

In this connection, I would like to call attention to an editorial comment which appeared in the April 8, 1940, edition of the Christian Science Monitor, a paper which I think we may all agree has a well-deserved reputation for its impartial and intelligent reporting of the news. I quote in part:

> Nor is the Commission seen likely to get far with such testimony as that about the microscopic watering of the shares of open-end trusts by the sale of shares somewhat below closing prices during rising markets. * * * you can't help that very much. That's what the Treasury generally does when it sells a new bond issue and it promptly goes to a premium. It's an odd charge and seems to mean the open-end people are wrong anyway, for if they sold at the day's price and then it went down, that wouldn't be so good either.

I have explained the mechanics of the pricing system and have shown that the so-called dilution, even on the S. E. C.'s basis of figuring, is negligible when, as is fitting and proper, it is related to the dollar amount of shareholders' interests involved. But there are other and equally important considerations which require explanation in connection with this matter.

At the hearings the other day, one of the Senators asked Mr. Bane, the S. E. C. witness, What happened to all that one and a half million dollars or so of so-called dilution in September 1939? Was it lost? Mr. Bane replied that it was lost to the trusts. On further questioning, however, he stated that he did not mean that any particular individual got away with all that money, but he failed to point out that it was the incoming shareholder who got whatever advantage there was to be had. It was not, however, a loss to the companies as the S. E. C. theoretically contends, for the following practical and concrete reasons:

Reason No. 1: The value of the shares as established at the close of the market is at best something of a theoretical value in that it merely represents what the shares were worth as closely as could be figured at the precise moment at which trading on the exchange ceased for that day. Now, as we know, the market fluctuates from one day to the next and many days it opens lower than it closed the previous day. Is it not rather theoretical and inaccurate, then, to figure dilution as the difference between the closing price one day and the closing price of the next, when the opening price of the following day may be less than the previous closing price, as it often is? In other words, how can a definite fixed amount of dilution be established merely by figuring the difference between two prices, neither of which represents definite fixed values?

Reason No. 2: The money received from the sale of new shares is not necessarily invested at the exact level of security prices on which the S. E. C. has figured its so-called dilution. For example, the stock market as measured by the Dow-Jones industrial average stood at around 150 on September 5, 1939, when a lot of money was paid into open-end companies. And a lot more money was paid in later on in that month at higher stock-price levels—about half our sales volume for the month came in after September 5.

Now, since that time the stock market as measured by this index has fluctuated between a high of 155 and a low of 143. In fact, during most of the time in the last several months it has been in the 140's and managements have had ample opportunity advantageously to invest cash which was taken in at higher levels.

I have already touched upon the situation in 1937, and any study of the pattern of stock-price movements will reveal the fact that these opportunities to invest new money at favorable levels do not represent isolated examples. This, of course, is a matter for management judgment, but when a management is satisfied that the accumulation of some cash is advisable, then the proceeds from the sale of shares is a source which may provide such cash without incurring the expense of selling portfolio holdings. On other occasions the management may want immediately to invest new money, and I will describe how that works in relation to so-called dilution in my next point. But the essence of the situation I have just described is that the S. E. C.'s theoretical conclusions with respect to dilution are further invalidated by these concrete practical facts.

Reason No. 3: As a practical matter of operating policy, most investment trusts, open-end and otherwise, usually keep from 3 to

10 percent of assets in the form of cash. The average is perhaps 5 to 6 percent. Under what I might call the normal conditions which exist most of the time, this cash constitutes a sort of a liquid reservoir to facilitate operations, to meet expenses, and to serve in the occasional emergencies. I might interpose here to state that cash received from the sale of new shares on any one day very rarely ever exceeds 5 percent of a company's assets. Now, let us assume that a company having total assets of $10,000,000 has 5 percent or $500,000 in cash. The news of the particular day in this illustration is rather favorable and the management rather expects that a rising market might develop. With this thought in mind, and knowing from past experience that such a development would stimulate investor interest and that the company would doubtless sell some additional shares, the management naturally makes its plans accordingly.

What does it do? When the market opens in the morning, it begins buying some stocks at prices which reflect fairly closely the price level at which its own shares may be bought by the public. In other words, the management draws down from its reservoir of cash to buy securities, knowing that the reservoir will be refilled with cash from the sale of new shares.

Assume that the company described above anticipates, from past experience, sales of around two or three hundred thousand dollars. That is an extreme example, but let us leave it extreme to remove any question about my point. This company would thus invest, say, $250,000 of its cash during the day at the same time that investors would be paying new cash into the company for the purchase of new shares. I might explain that while actual cash might not be coming in, execution of orders amounts to the same thing from a bookkeeping standpoint, because they carry it the same way. What happens then is simply that new cash from investors is substituted for old cash on hand. The result is that by simple common-sense management policy designed to meet the practical business problem which arises from the receipt of new cash, the theoretical dilution factor which the S. E. C. has called a loss may be reduced to such negligible proportions that it cannot be measured. And this is no isolated example but a matter of everyday routine in the management of open-end companies.

This leads into another point. The S. E. C. witness discussed at length what he considered to be the evils of the so-called two-price system—that is, the old pricing system by which two prices were known to investment dealers at the same time. The two prices were (1) the price at which investors could buy, and (2) the price which would next become effective.

First, I want to say that in past years, the existence of two known prices was only an unimportant incidental in the actual selling of shares of open-end companies. Secondly, consistent with the past record of the industry with respect to improving its practices in the light of experience, steps were promptly taken to further refine the pricing system when the unprecedented experience of September 5, 1939, indicated the desirability of such action. The result is that at the present time there are relatively few companies having two established prices at the same time.

Despite these facts, the S. E. C. witness stated that the two-price system "enables it to be used as, and it is used as, one of the principal selling arguments by many of the open-end investment trusts." Now, I don't know how much "many" is, but the implication which I read in this statement, and the several other references to the same point in the testimony, is that it is a principal selling argument, employed pretty generally throughout the industry. I must take exception to any such implication, because the facts of the case as I know them from wide experience do not support it. If all we had to do to sell our shares was to impress on people that they could buy at a price based on an asset value which was a few cents under the theoretical value at the time, I assure you, gentlemen, that our job would be an easy one.

But what are some of our principal selling arguments? I would say that the backbone of all our selling arguments is the basic theory of operation of some 90 percent or more of the open-end companies. This theory is that when many individuals combine their capital in one fund under capable and experienced management, each one obtains the following important benefits: (1) Broad diversification of investment risk; (2) careful selection and continuous supervision of investments by individuals qualified to do this work; (3) greater assurance of continuous income; (4) low cost of administration, made possible because many investors share expenses. And, as an important safeguard, there is the fact that the investor can withdraw his proportionate interest if he becomes dissatisfied, or for any other reason.

That is the fundamental basis of our selling arguments—and it is a sound basis—and in its operation it produces worthwhile results. But I will tell you right now that it is more difficult to sell the average investor, and particularly one of moderate means, on a sound idea than it is to sell him on an unsound one. And I assure you that the process of selling him a sound idea cannot be undertaken successfully with no more logic and reason than is embodied in a few cents price advantage.

Incidentally, and I do not think the S. E. C. made this point clear enough in its testimony, the fact that an investor has to pay an underwriting commission or so-called loading charge virtually eliminates even the opportunity in our type of company to buy at one known price and immediately resell at the next higher known price. That is, in buying, the investor pays the asked price, which includes the loading charge of around 7½ percent on the average, and in selling he receives the bid price, which is the asset value of the shares. For example, even on the abnormal and unprecedented occasion of September 5, 1939, the price at which investors could buy shares of Massachusetts Investors Trust was above what they could sell them for the next day. Moreover, and this refutes the implications of the S. E. C. testimony with respect to many important companies, the incoming shareholder did not even know what the new bid price would be until after he had placed his order, because these companies stopped selling shares before the new bid became available.

My next topic has to do with what I consider to be the essential need for a firm price at which shares can be offered to the public. This matter ties in very closely with the foregoing discussion of the pricing system, as it will show what part the selling price actually does play in the distribution of shares to the public by investment dealers throughout the country.

I might mention at the outset that certain individuals in the industry do not fully concur with my views on this subject. I believe, however, that my views, which are based on a great many years of practical experience in the securities business, are fairly representative of a large majority of opinion. And if opinion were weighted according to the volume of business done, I think that any dissenting opinion would be of small relative importance.

As I mentioned earlier in this statement, the S. E. C. testimony convinces many of us that they have already decided upon a theory of pricing and selling shares which, we are convinced, would seriously cripple the whole industry. This theory contemplates that shares be sold only on the basis of a price to be determined as at the close of the stock exchange on the day on which purchase orders are executed. Adoption of this theory of selling shares would, in my opinion, be unsound, impractical, and unfair.

I referred a short time ago to the automobile business and how impractical it would be to do business if you had to tell a customer that you would be glad to sell him a car, but you couldn't tell him the price until the close of business that day, after everyone had gone home. Now, let me explain in a little more detail how this principle operates in the securities business. I have said that the S. E. C.'s theory of selling shares is unsound, impractical, and unfair. It is unsound because it would unduly penalize the incoming shareholder by making it impossible for him to buy shares during market hours. In many instances it would force the incoming shareholder to pay a higher price than their value at the time he wished to place his order, and in most of such instances that price would be virtually the highest of the day.

It would be impractical and unfair because it would not permit of a firm price at which shares may be offered by investment dealers during the business day. Such a firm price is essential to the successful distribution of securities on an investment basis. The need for a firm price is not peculiar to the open-end trust business. Virtually all new syndicate issues are sold at a stated price which is maintained until the syndicate is closed, regardless of general market conditions. A firm price is maintained in the case of bond offerings, even when similar bonds of the same issuer are already outstanding and are being traded actively at varying prices.

The United States Government has long recognized the practical necessity for a firm price in offering securities. The Treasury regularly sells United States Treasury bonds and notes on a firm basis, and it is long-established and accepted practice for the Treasury to price a new issue in relation to its outstanding obligations so that the new issue will immediately sell at a premium. So-called baby bonds are offered year in and year out at one fixed price so as to simplify distribution of a sound investment security to thousands of small investors. We maintain that it is as impractical to assume that the Treasury should sell bonds only at a price to be determined on the basis of interest rates prevailing precisely at the exact moment when trading in Government securities stops at the end of the day, as it is to assume that open-end investment companies should sell shares only at a price to be determined at the precise moment at which trading ceases for the day on the New York Stock Exchange.

In the case of open-end funds, there is no conscious effort to "price the shares favorably in relation to the general market." In fact, the only thing that is desired in connection with the pricing of shares of open-end companies is to establish a firm price as closely in line with the actual value as is practically possible.

We do not contend that open-end companies should have any advantage over any other type of issuer by distributing shares on a basis contrary to that generally followed in distributing other types of conservative investment securities. We maintain merely that we should not be, and that there is no necessity for our being forced to operate on a basis so different from that followed in other lines of the investment business and so impractical that we would be unable to place shares in the hands of individual investors who, we are convinced, would benefit from the service which open-end investment companies render.

The S. E. C. testimony reflects a highly critical attitude toward this entire matter of the pricing of shares of open-end companies. I wonder, however, if in considering this matter in broad perspective they have ever stopped to think just how the open-end pricing system has worked out over a period of time as compared to any other practical pricing system that might be devised.

The redeemable share feature of the open-end industry—and it is around this feature the pricing system has developed—has the great advantage that a shareholder can have his shares redeemed by the company at a price reflecting the full value of his proportionate interest at any time.

Now to preserve such a desirable feature on a practical basis may well involve some small expense, and as I believe I have shown you, it is an extremely small expense. If we assume, therefore, that the fractional percentage amounts of so-called "dilution" constitute the cost, in a practical sense, of preserving the desirable redemption feature of open-end companies, then perhaps the situation may reveal itself in a somewhat better light than I believe it has been presented to this committee by the S. E. C.

One further thought on this subject before leaving it. When I say a firm offering price is essential, I mean it with all emphasis. And if the industry were required to operate without a firm price, I doubt if it could live for long. But in endeavoring to live, one of the first things that would be necessary, in my judgment, would be to increase the selling commission. This is natural. Lack of a firm price would make the sale of these shares more difficult for reasons I have explained. And if selling them becomes more difficult, salesmen will have to be paid more for the effort.

As a result, I can envisage underwriting commissions being increased. Which is better—a healthy industry operating on a basis which insures preservation of the very desirable redemption feature at a cost of infinitesimal proportions, or a faltering industry that can only operate by increasing its charges for new business and possibly with increased costs of company operation in addition?

I now want to discuss very briefly the so-called abuses of the pricing system. I will not go into detail, because such abuses as have occurred are of little relative importance. This does not mean that the opportunity for the practice of any abuse should not be eliminated. This, however, could be done very simply and effectively. I must take emphatic exception to the implications of the S. E. C. testimony on the subject to abuses on much the same basis as I have taken exception to the testimony regarding so-called "dilution," although I shall not go into the details. Suffice it to say that in my judgment the implications of much of the S. E. C. testimony certainly tend to create an extravagant impression of the seriousness of the situation. This is not justified by the facts as I know them by wide experience.

I do, however, recognize that there have been opportunities for abuse and that abuses have been practiced. Isolated as the cases have been, however, and unimportant as they were in relative significance, I naturally deplore the possibility of their existence. In my own business, as opportunities for abuse came to light or were anticipated—and it was only by experience that sound progress could be made in this direction—we adopted various measures designed to prevent them. I can report that in so doing, we have encountered no serious difficulties and we believe that we have effectively accomplished our end.

To insure uniform observance of proper standards of practice for the entire industry, I believe it would be desirable to incorporate in specific law or in some code of fair practice—observance of which would be mandatory in the open-end industry under some such instrumentality as the National Association of Security Dealers formed under the Maloney Act—certain specific rules and regulations.

Steps have already been taken in recent months to formulate such a code. A committee has been formally appointed by the National Association of Securities Dealers to consider the matter and act upon it as soon as possible. In this connection I would like, if it is permissible, to place in the record an editorial on the subject of self-regulation under the Maloney Act which appeared in the April 8 issue of the Wall Street Journal.

Senator WAGNER (chairman of the subcommittee). That may be done.

Mr. TRAYLOR. The editorial is as follows [reading]:

[Wall Street Journal editorial, April 8, 1940, issue]

TRUST SHARES DISTRIBUTION

Because the distribution of the shares of open-end investment trusts is specialized and the problems often dissimilar to those in other investment fields, it is a logical step for the National Association of Securities Dealers to appoint a separate committee, as it has done, to study the underwriting and distributing of such shares in connection with rules for self-regulation of that business. As the association points out, the distribution of such shares is a dealer business and it is possible to formulate rules and regulations governing it and enforce them also through the National Association of Security Dealers.

Also quite in order is the indication that this new investment trust underwriters' committee will hold several open meetings at which all underwriters will be represented before the rules are drafted.

While a program worked out for such companies under National Association of Security Dealers supervision would not necessarily conflict with or overlap the new regulatory law proposed by the Security and Exchange Commission and now before Congress, it would seem that the National Association of Security Dealers program should get the right-of-way; that is, that Congress withhold any legislation of further investment company supervision until the National Association of Security Dealers gets a chance to develop its own plan for that business.

For the National Association of Security Dealers was organized for self-regulation and this would seem the logical time to give it a chance to function.

It seems to me that the problems which seem to exist in connection with the pricing and selling of shares may best be solved by people in the industry who have had practical experience in meeting them. A solution arrived at on this basis could be most helpful to the conduct