The section apparently is intended merely to give legal sanction to the fundamental law of morals "that no man can serve two masters." We have no quarrel with this general proposition—in fact, as investment managers, we were to a very real extent pioneers in the application of this principle to the investment field. Therefore, we are and always have been strongly in favor of it.

In our own case, our trust indentures have always provided—now I am going to quote:

> The trustees and the managers covenant that they will not deal with themselves as principals in making purchases or sales of securities for the account of the management fund.

They contain the further provision that no trustee or manager may accept any commission in the purchase or sale of securities for the fund, or—and here I quote again—

> make any profit on any transaction for the management fund either directly or indirectly whether as a member of any partnership, association, or corporation or otherwise.

Yet, this legislation, designed to prevent dumping of securities by insiders, improper and fictitious transactions between investment companies of the same system, and other similar abuses, would require drastic changes even in a set-up such as ours, where any form of self-dealing by the affiliated parties has always been prohibited.

This section 10 says that we cannot sell the shares of the trusts we manage. I have already dealt with the reasons why I consider this unsound. It further says that a majority of the trustees cannot be connected with the management company. But why? I have already explained why we picked the officers of Eaton & Joward, Inc., to be the trustees; and why are they not qualified to serve as trustees? They receive no compensation. They cannot profit from transactions for the trust. They devote full time to the job of serving the investor; but we are told we must have outside trustees—presumably to protect the investors.

One of the witnesses here spoke just this afternoon in favor of outside directors, as a cure for self-dealing. I do not entirely agree with what was said. In certain situations an independent board may be desirable. I am not sure that I know just what the terms "outside directors" or "independent directors" imply; but I do say that if self-dealing is already prevented or if the only interest of the directors is to serve the shareholder in the trust, then in these instances I personally think that the witness went too far in his remarks about outside directors. However, from my remarks I think you will see what I mean.

In any case, I think the witness referred to this suggestion as a cure for a nonexisting disease; and this is certainly so in our case.

Senator HUGHES. But is it so with respect to other companies?

Mr. EATON. What is that, Senator?

Senator HUGHES. You say it is so in your case?

Mr. EATON. Well, I have taken our case; and I know that, in general and in great part, I am speaking—not formally, but informally—as a representative of a good many small trusts.

Senator HUGHES. But you know the business generally, I presume?

Mr. EATON. I have been in it quite a while, sir, primarily as an investment counselor and manager; and we have been managing our funds for a good many years.

However, the case for outside directors does not appear to be strengthened by the testimony of some of the Commission's witnesses in this hearing. Judge Healy on the first day referred to Mr. Charles A. Kettering as one of our finest and most useful citizens, who was a director of an investment company. Mr. Kettering testified before the Commission that he had been unable to attend meetings, he did not understand investments, and that he "saw life through the laboratory window."

Again, Mr. Stern, in describing the American Founders fiasco, referred to the fine research and investment department and testified before this committee:

> Then there were other things that were for the protection of investors. There were some fairly big names as on the directorate. The directors on the whole—a great many of them—just did not know what was going on. * * *

That, I can assure you, is not true of our trustees. They are there every day.

I am not suggesting that anyone who wants outside directors should not have them; but if the purpose is to prevent self-dealing and to insure the management of the trusts in the interests of the shareholders, then to require outside trustees in a case such as ours, where self-dealing is already prohibited, is certainly not necessary.

I would not object to having in the bill a prohibition of self-dealing. In fact, I do not object to most of the professed purposes of this bill. What I object to is its marksmanship in hitting so many innocent bystanders in the battle between the Securities and Exchange Commission and certain crooks who crept into a division of the investment company industry, which is no closer to us than a second cousin.

Another matter in which this bill would affect us and, we believe, would injure our clients is in the prevention of any investment manager from managing more than one trust. We can see no reason whatsoever why either we or any other investment management organization should be restrained in regard to the number of funds managed. Over a period of years we have had experience in managing funds; and in no instance have we been conscious of the slightest conflict between them. Also, Senator, one has not been handling bonds and the other one handling stocks, either.

In no instance to our knowledge has there been any occasion where one has suffered because of the existence of the other. On the contrary, there is in our opinion excellent reason why we should be free to manage funds which have different purposes and policies; and the occasion may very well arise when it would be advisable to manage more than one fund with the same purpose and policy. If, for instance, the tax laws were changed in certain directions—as might at any time be the case—then we can visualize a situation where it would be to the advantage of the small investor to have his money managed with others in units which were not too large.

Today, there are sufficient reasons why an investment manager should be allowed to manage more than one fund; and it is possible that the future may further justify, or even make necessary, the management of more than one fund.

To restrain the investment manager in this respect would, to our way of thinking, be no different from forcing a trust company to divest itself from the management of all trusts except one.

It may be of interest to mention the fact that several of the more fully established investment counsel or management firms are numbered among those organizations which have established more than one fund. Such a development has been a natural one, consistent with the policy of managing money for clients in accordance with a purpose and investment policy designed to meet the needs of that particular person.

Is it not the case that such a development as managing funds with different investment objectives by investment counsel organizations is backed by the logic of the situation, as well as by those organizations that, by the very nature of their professional approach to the subject of investing, are well suited to take the investor's point of view?

We believe this to be the case, and we also believe that such organizations are making every attempt to look after the best interests of such investors. Moreover, we know that funds managed by organizations where more than one fund has been under their care, have to date shown a satisfactory investment performance. I do not have any figures to support that statement; but if such figures would be of any value to you, I can submit them for the record.

Therefore, unless the Commission can see good reason why a firm of investment managers should not manage more than one fund or trust, we urge that there be no recommendation to Congress which might, in any way, restrain the development of a method of aiding the investor of moderate means. We feel that it would be counter to the public interest to interfere with the development of management funds managed in an effort to accomplish different investment objectives just at a time when, fortunately, an increasing number of investors of moderate means are becoming educated to the wisdom of such procedure.

During the half century just passed, the investor of moderate means has been handicapped by the service he has or has not received. Nobody doubts that. This certainly has not been entirely the fault of many of the people in the security business. It has been largely due to the system itself, combined with the weaknesses of human nature; and these are matters which in my opinion must be taken into consideration by this committee.

The last decade has witnessed the constructive development of an industry which has made real progress in coping with this serious problem. That development has taken the form of investment trusts—some of which, as I have indicated, are being sponsored and managed by investment management or investment counsel organizations.

This is, indeed, no time to handicap a movement which is so essentially constructive. To segregate control, management, and selling, and to restrain the number of trusts to be managed by any one organization, would strike a blow at us and others like us, and at our respective clients. The extent of the consequences of such a blow is not possible to foresee.

I believe sincerely that if such a blow were struck, it would be entirely unjustified and would strike at the heart of a wholesome development in the investment field at a time when its value is only beginning to be recognized.

I further believe that this bill would be a blow to the very investor it is designed to serve, because the enactment into law of this bill would result in putting out of business and out of the industry some

of those elements which constitute the investors' greatest protection.

In closing, may I quote two sentences from an article which a lawyer friend of mine showed me, written by Mr. William O. Douglas, former chairman of the Securities and Exchange Commission. The article was dealing with the subject of correcting, through legislation, certain abuses in the business system. In discussing such possible regulatory legislation, this is what the now Mr. Justice Douglas said:

> Our remedies should not be as hysterical as the practices which made the demand and need for regulation insistent. * * * It is a rebuke to our skill and judgment if we cannot effect competent police measures without driving from the field of enterprise the men of greatest competence and substance.

Thank you, sir.

Senator HUGHES. It seems to me that the Justice's judgment was very sound.

Mr. EATON. Yes, sir.

Senator HUGHES. And it usually is.

I wondered if I might say that I am sure the committee—although I am speaking personally—would invite from any of the persons who appear here to testify a draft of a bill which you think would cover all the needs of the occasion. Most of you recognize that there are some features of this legislation that are necessary, and that we do need something.

Mr. EATON. Yes, sir. We also recognize that drafting such a bill is most difficult.

Senator HUGHES. Yes; I judge that is so. I have tried my hand at it for forty-odd years, and I did not make any great success.

However, I say the invitation is out for any of you who see the situation in that way to approach the matter. It would help us.

Mr. EATON. We shall try to help. Many of us would like to help.

Senator HUGHES. Thank you. Does that conclude your remarks, Mr. Eaton?

Mr. EATON. Yes, Senator.

Senator HUGHES (presiding). We shall not hear any more witnesses today, as I understand.

Tomorrow we shall start at 10 o'clock, and we shall continue until 12 o'clock or perhaps a little longer; but you must remember that our colleagues have adjourned until Monday and that they will be going ahead to catch up with the work in their offices; and Senator Herring and I need an opportunity to do our office work, too, you understand. So I think we shall stop tomorrow at noontime.

(Thereupon, at 5:10 p. m., a recess was taken until tomorrow Friday, April 19, 1940, at 10 a. m.)

# INVESTMENT TRUSTS AND INVESTMENT COMPANIES

**FRIDAY, APRIL 19, 1940**

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

The subcommittee met, pursuant to adjournment on yesterday, at 10 a. m., in room 301, Senate Office Building, Senator James H. Hughes presiding.

Present: Senators Hughes (presiding), Herring, and Downey.

Senator HUGHES. The subcommittee will come to order. Mr. Myers, I alone will hear you until some other members of the subcommittee come in.

Mr. MYERS. I thank you.

## STATEMENT OF JOHN SHERMAN MYERS, NEW YORK CITY; VICE PRESIDENT OF LORD, ABBETT & CO., INC., PRESIDENT OF AMERICAN BUSINESS SHARES, INC., AND VICE PRESIDENT OF AFFILIATED FUND, INC.

Mr. MYERS. Mr. Chairman, my name is John Sherman Myers. I have been closely identified with the investment trust business for more than 12 years. At the present time I am vice president of Lord, Abbett & Co., Inc., the sponsors of two open-end investment companies; Affiliated Fund, Inc., with assets of approximately $25,000,000, and American Business Shares, Inc., with assets of about $7,000,000. I am president of the latter corporation and a vice president of Affiliated Fund, Inc. I am also president of North American Depositor Corporation, which is the depositor company for a number of fixed or unit-type investment trusts, with assets totaling some $20,000,000. You will thus see that the assets under our control, shall I say, approximate some $50,000,000.

I am appearing in opposition to S. 3580, the investment-trust bill.

I am not here to oppose constructive, realistic, and uniform regulation—if that should be the will of the Congress. But I am opposed to this or any other bill that fails to consider the practical side of this business and puts it, in all of its phases from formation to liquidation, under the domination of the S. E. C.

Mr. Chairman, I would like, with your permission, to insert in the record my complete statement. I will have the time to discuss only a few points that are contained in this statement, but if I may have your permission to have the statement in its entirety made a part of the record, I will appreciate it.

Senator HUGHES (presiding). Have you furnished a copy of your statement to the committee reporter?

Mr. MYERS. Yes, Mr. Chairman, a copy of my statement has been furnished to your committee reporter.

Senator HUGHES. Your request is granted.

Mr. MYERS. I would like, at this point, to interpolate one observation: A number of people have talked about the highly discretionary powers the Securities and Exchange Commission are given under this bill. No one, however, has attempted to bring them all in at one place. I am not going to repeat any more than I can help; and I do want the S. E. C. to appreciate that I am talking, not with a finger pointing at the present Commission or at any representative of that Commission; I am speaking purely objectively, and when I criticize the S. E. C. it does not mean I am pointing my finger at any of my friends, if I may use that word, that I have in that body.

I do not believe that it is contended that the bad practices described to you are by any means typical. Generally they have not existed in open-end companies. We constantly strive for improvement and are eager for suggestions from any source that will have that effect. Dishonesty and malpractice, however, are inherent in human nature and cannot be eliminated by the simple expedient of an act of Congress. If the existence of fraud, dishonesty, and chicanery are to be the base for Government regulation of investment companies, then all business needs Government regulation. Some instances of dishonesty and abuse will be found in every activity of mankind, including politics and the law.

If too much emphasis is placed upon abuses, upon lootings, and upon plunderers, the result may well be that the ordinary people in the investment-trust business—and the testimony so far presented to this committee admits that there are some honest ones left—will be unduly hampered in the administration and management of their companies. There would be no reckless driving if automobiles were abolished. There will be no lootings of investment companies if it is made impractical or unprofitable to operate them.

You have been told that in our earlier conferences with the S. E. C. we were able to discuss only general principles; no representative of any investment company saw this bill until, with the rest of the public, we were able to read the printed copy after it was introduced.

I must add that some of the proposals outlined to us are not in the bill, and I like to believe that our discussions influenced these omissions.

I must emphasize, however, that there have been inserted in the bill a number of important provisions not among the proposal discussed and which were never mentioned by the S. E. C. Needless to say, these new provisions include some that would have been vigorously discussed had we known that they were contemplated.

Judge Healey has said that the S. E. C. made known its willingness to discuss the details of the bill with representatives of the industry after it was introduced, and regretted that the industry did not see fit, with a few special exceptions, to accept that invitation. I was one of the few special exceptions. Time did not permit anything like an adequate discussion. Furthermore, the magnitude of the regulation of our business, which the bill contemplates, going far beyond anything that I could endorse as the basis for a realistic, practical, and constructive regulation of investing companies, made me believe that it would not be possible to modify the bill prior to these hearings to the degree necessary to merit endorsement by the business. After

these hearings are over I hope to take advantage of the Commission's willingness to discuss the bill and to go into it with them in complete details.

One of the most important objections to this bill, as a whole is the extraordinary power over nearly all phases of the formation, capitalization, operation, and even liquidation of investing companies, as well as the distribution of their securities, that it gives to the S. E. C. We must not forget that the S. E. C.—which will administer this bill—is its author. As an administrative or law-enforcing body the S. E. C. may be expected to be concerned with irregularities, violations of the law, and easier ways to enforce its penalties.

Of course, the easiest way for the administrative body to accomplish this is to obtain discretionary power in every possible connection. "Let us," says the S. E. C., "decide ourselves what is best to do in any set of circumstances. Give us the authority to fill holes in the bill by making rules; by making regulations; by issuing orders; by acting on application of an interested party; by acting on our own motion. Give us power to add here and take away there."

The administrative body naturally must be given a certain amount of discretion in the administration of a bill of this nature. A certain amount of flexibility—Judge Healy called it "rubber"—is essential. But there is a difference between discretion of that nature and the kind of discretion that appears throughout the bill.

I will be able to discuss only a few of the substantive discretionary powers that the S. E. C.'s own bill gives to the S. E. C. Not all of them, because, by actual count, there are some 80 or more clauses in the bill that gives the S. E. C. the power to do something or other. About 50 of these are of a substantive nature and only 30 are administrative.

The bill classifies investment companies, and subclassifies the management companies. Then the Commission, section 5 (d), asks for authority to make further classifications or subclassifications according to (1) organization, (2) capital structure, (3) nature of assets, (4) amount of assets, (5) investment policy, and (6) character of business done. These are perhaps not unreasonable guides, although they would permit a wide discretion in subsequent classification. But then come the following words:

or any one or more other characteristics which the Commission deems significant.

The practical effect of this catch-all clause removes whatever limitation may have been imposed by the earlier guides or standards. The power "further to classify" has no limit other than that of the S. E. C.'s own judgment.

Taking into consideration this section with the other provisions of the bill, the Commission, as a result of its power further to classify, obtains the right to prescribe a different form for each classification, as well as the scope and content of the reports filed by trusts in each classification. Numerous other powers could be so exercised by the Commission as to stifle the operations of any particular company, the character of whose business the Commission for any reason did not like. This goes far beyond mere regulation necessary for the protection of investors.

When I had an opportunity to examine S. 3580 carefully, I was surprised to learn that in section 6, subdivision (c), the Commission,

on its own motion or on application, may conditionally or unconditionally exempt any person, any security, or any transaction from any provision or provisions of the bill, or from any rule or regulation.

I cannot conceive of the law which will contain a provision giving to the bureau entrusted with its administration the power to pick and choose those who will come under its provisions—or even the right to select those who will be exempted from certain of those provisions. Here the "rubber" can be used completely to erase the effect of the bill on certain companies.

Please note that section 3, paragraph (b) and (c), expressly exclude certain companies from the definition of an investment company. An interesting question arises as to whether the power of the S. E. C. to exempt companies from the provisions of the bill includes the power to exempt them from the operation of these exempting clauses. Perhaps this was not intended, but I believe the bill may well be subject to that interpretation, particularly if it ever seemed desirable to reach that result in any given instance.

This is not as improbable as it seems, since the power to bring a specifically exempted company back under the provisions of the bill is expressly requested by the S. E. C. in section 6. This section says that a foreign investment company is exempt, that a company organized in the territories of the United States not offering securities is exempt, that a company in bankruptcy is exempt, that an employees' securities company may be exempt if the S. E. C. so orders. But in subsection (d) it is expressly provided that the S. E. C., if it wishes, may make each of those exempted companies subject to the provisions of the bill "as though such company were a registered investment company."

Putting these sections together we find the S. E. C. in its own bill to regulate investment companies, asking for the discretionary authority nevertheless to excuse certain people and companies and transactions from the provisions of the bill on the one hand, and, on the other hand, discretionary power to recapture the authority over such companies as may have come under the exempting clauses.

I submit that this bill means (1) that an investment company is what the S. E. C., in its discretion, says it is; (2) that this bill shall apply to such investment company or companies as the S. E. C. in its discretion may determine; (3) that this bill shall not apply to such investment companies as the S. E. C., in its discretion may decide to exempt.

Under section 8, the Commission, with apparent reasonableness, asks authority to prescribe the form in which certain material must be filed in connection with the registration of investment companies. However, the section also would give the Commission the right to require, in addition to certain specified information, any additional pertinent information (the S. E. C. to decide what is "pertinent") regarding the investment company, all persons connected with it, and the underwriters of its securities. One of the great objections to the administration of the Securities Act of 1933 is the voluminous, burdensome and costly requirements applicable to the registration of securities. All of the Commission's authority under the 1933 act is incorporated by reference in the new bill, and, in addition, we find the clause regarding "all pertinent information," which I have just described. The requirements for registration of an investment company could be made terrifically burdensome.

In section 11 the bill deals with the recurrent promotion of investment companies, i. e., no promotion of more than one new trust in any 5-year period, etc., a subject covered very well by Mr. Adler. Subdivision (d), however, would permit the S. E. C. in its own discretion to nullify this section as to given persons by exempting them from its operation.

This, of course, is more of the same latitude I have just described—the bill containing certain prohibitions and the S. E. C. asking power to deal out exemptions. But here the significance is even greater, since the prohibitions apply only to persons identified with investment companies who start new companies. Of course, I feel that this prohibition is completely wrong in substance. Under it, those who are inexperienced and who have had no important connection with investment trusts, may go right ahead and ask the public to participate in a new venture. The experienced trust people are barred—unless the S. E. C. sees fit to drop the bars. The prohibition, plus the power to exempt, results in complete S. E. C. authority to decide what, if any, new trusts will be formed if experienced trustmen participate in the formation.

The practical result is this: If the men in the investment company business have conducted their affairs according to the S. E. C.'s idea of what was sound and right, and if the S. E. C. finds no ulterior purpose in the promotion of a new company, and if the new company meets the S. E. C.'s then conception of what is desirable in investment company set-up and theory, then the S. E. C. can let them go ahead. The lack of restriction on the new promoters may be likened to the old common law adage that every dog is entitled to one bite. Until a given individual gets into the business, no one knows whether he will bite or not.

My difficulty with this sort of power is that the S. E. C. itself asks to be the final judge on this question. There is, I think, no appeal from a refusal of the S. E. C. to act under the exempting clause, and if there were, the Court might well hold that the judgment of the Commission on such a matter as this, under the bill, is final.

In section 13 (b) the bill presents what appears to be a reasonable requirement—that no investment company "shall change any fundamental investment or management policy" except by vote of its shareholders. But the reasonableness of this provision is nullified by the very next sentence in the paragraph—where the S. E. C. asks for the right to "designate those investment and management policies which are fundamental."

The possibility of arbitrary rulings or of erroneous conception of the S. E. C. of what is fundamental, the unchangeable fact that the company itself, through its management, is the only one who should decide such matters, and that it must be in a position to act quickly, all make this power highly undesirable.

I am not in favor of an investment company suddenly selling its listed securities and beginning the operation of a South American subway. But I am violently opposed to being compelled to accept whatever the S. E. C. may label "fundamental" in the operation and management of an investment company. Frankly, I do not believe the Commission or anyone else can adequately define these fundamental policies. Some of them, like the subway, are clear. But hundreds of others will fall within the twilight zone, and even after the S. E. C. defines them we will still be going to the S. E. C., saying