

wants that diversity as a backing for bonds and preferred stocks for the sake of income security, will you say to him, as this act does, "No; you cannot have the diversity without taking a risk of fluctuations in your capital and the income therefrom?" As fiduciary trustee, or agent for such an individual, would you assume the risk for the sake of diversity? I am sure I would not; and, accordingly, in my opinion, this proposed act removes from the economic and financial systems an investment medium, which is well suited to the needs of the very class of people the act is designed to protect.

As an example of what I mean, 75 percent of our bondholders are women and fiduciaries; approximately two-thirds of our preferred-stock holders fall in this same classification. The act does not alone dictate the type of security which shall be available for this very conservative investor, but it also dictates the behavior of the individual who wants to strive for a rapid increase in his capital to the point of wanting leverage. This individual is to be forced to create his own leverage by buying on margin with a broker or through a collateral bank loan the stock of an investment company having only one class of securities outstanding. Certainly, in the ordinary case, the speculative characteristics of this operation are much greater and so is the hazard to the individual. Yet the Federal Reserve Board in establishing limits on borrowings against securities has not prohibited borrowings on investment company securities, but merely classified them with other types of borrowings, some of which are on securities even more speculative.

There has been inquiry made of witnesses earlier in your hearings as to the extent to which investment companies should be permitted to issue senior securities. In the case of Railway & Light Securities Co. our certificate of incorporation contains a provision that the company shall not issue additional debt and/or preferred stock, if thereby these senior securities will aggregate more than three times the amount of the value of the common stock. This permits debt and preferred substantially in excess of the coverage limits contained in the dividend section 19 of the proposed act; notwithstanding this, we have maintained a high investment rating for both the bonds and the preferred stock and I fail to see how the issuance and service of these securities has been against the public interest or the interest of investors.

In 1935, the investing public paid par for our bonds currently outstanding with a required asset coverage written into the bonds of only 120 percent. At no time since their issue have the bonds to my knowledge sold below 97 and yet at no time has the asset coverage been as high as the dictated 300 percent. Interestingly enough the ratio of our company's senior securities to the common stock equity is practically identical with that required by the Federal Reserve Board for collateral loans, as covered in regulations T and U issued by the Board of Governors of the Federal Reserve System pursuant to the Securities Exchange Act of 1934. It would be my recommendation that the limits on the issue of additional debt be set at approximately the requirements established in the ruling of the Federal Reserve Board previously referred to, but that additional leeway be permitted for preferred stock. The experience of my own company would indicate that an overall restriction of debt and preferred stock of three to one is not disadvantageous to investors.

But irrespective of the limits so placed, broad exceptions should be made in the case of reorganizations and/or consolidations.

With regard to increased expenses resulting from operations under the act, any list or discussion of increased expense items will of necessity be incomplete in the absence of actual working experience under the numerous rules, regulations and/or orders contemplated by the broad delegations of authority to the Securities and Exchange Commission. I can point out the major ones traceable to specific requirements of the proposed act.

1. There is required a notification of registration, followed by a registration statement in such form and containing all the information and documents required of an issuer of securities under the Securities Act of 1933; notwithstanding that a particular investment company may not be an issuer, all of this information must be filed. But it does not stop there, we must also file such additional pertinent information and documents regarding the company or its affiliates as the Securities and Exchange Commission may wish, including periodical and special reports in unknown form and at unknown times, minutes of directors, stockholders, and other meetings and the answer to such specific questions as may be required. Any financial statements so required must be audited. Detailed information as required must also be obtained from investment advisers and underwriters. Under the proposed act, the filing of further material to keep this information reasonably current can and doubtless will be made a recurring obligation and therefore a recurring expense. In addition, there will be the burden of constant checking with portfolio companies to avoid possible cross-ownership.

2. Directors compensation will have to be materially increased because (a) they must in turn register (b) they may have to be bonded, (c) they must be paid a flat fee and not a fee for attendance at each meeting, (d) they must be prepared to analyze their own individual security transactions for the purpose of reporting transactions in securities bought or sold by the investment company, (e) they must be induced to resign from the directorate of any company whose stock is held by the investment company (except in those rare cases where the trust holds over 5 percent of the stock of the portfolio company, (f) if the director can be classified as an investment banker or an affiliate of an investment banker, he will lose an opportunity to do business with the investment company on an equal footing with other investment banking houses, (g) there is an additional risk due to the outlawing of exculpatory clauses.

3. Management fees may have to be increased because a substantial number of the points above under directors apply also to managers or investment advisers.

4. Under section 17 (f), the charter, bylaws, trust indenture, manager underwriting or brokerage contracts and/or any other instrument must be amended from time to time to eliminate any provisions in conflict with the act or future rules and regulations of the Securities and Exchange Commission, when, as and if the latter may be issued. In our case, we would have to propose promptly to our stockholders that they authorize material changes in our charter because in various places it "purports to authorize the violation of any provision of this title."

5. In addition, the title of the company or of any security must be changed when the Securities and Exchange Commission determines that it is not accurately descriptive of the company's business. Many of these changes will require calling a special stockholders' meeting and incurring all of the expenditure of money and time incident to corporate changes. I have grave misgivings about this section 35 (d). Under this section, the Commission can force companies to change their corporate title, or the title of any security, in accordance with the definitions under section 5 and may be even otherwise than contemplated in its definitions. In many cases of companies of long standing, there is a definite goodwill value attached to the name, but this good will can be dissipated merely because the Commission finds that any word or words are misleading. Railway & Light Securities Co. formerly was limited to the purchase of railroad and utility securities, but this is no longer true. Will we be required to change the name of the company and all of our outstanding securities, incurring the expense incident to amending the certificate of incorporation and reengraving all of our bond and stock certificates?

6. The Securities and Exchange Commission can require any corporate changes necessary to effect an equitable redistribution of voting rights and privileges. Entirely aside from what this requirement does to contractual rights existing under the law of the State of incorporation, what procedure must a company go through if the stockholders will not vote the necessary consent to the charter amendment? Legal studies and actions to accomplish changes of this type can be extremely expensive. In this connection, who is guilty of a breach of the law if the stockholders refuse to ratify these dictated corporate changes? Perhaps the penalty is revocation of registration which practically means cessation of business. In other words, the proposed act says to the stockholder or bondholder for that matter, never mind the Delaware law or your contractual rights under it, you vote to change these things or your company stops doing business.

7. Prevents the possibility of lowering fixed charges through refinancing existing debt or preferred with senior securities bearing lower coupons or charges.

Most of these requirements will fall with equal severity on the small company and the large company, that is equal severity in terms of dollars. As a percentage increase, however, in operating expenses the small and moderate size investment company and their stockholders will be severely hit. One of the purposes of the bill is to mitigate and, so far as is feasible, to eliminate the undue concentration of control or management of investment companies or the attainment of too great a size; yet by its very provisions, the act penalizes the small company. Between sections 10, 11, 12, and 15, the method of group operation of investment companies employed successfully by the British companies over a long period of years cannot be followed. This method is well adapted to small companies, from an economy standpoint. For example, there are a total of 14 companies in the so-called Robert Fleming & Co. group in England. The average size of these companies is £13,000,000. If a substantial portion of these numerous and expensive requirements stay in the bill, the provisions

of sections 10, 11, 12, and 15 should be modified to permit group management.

I mentioned above the necessity for making certain amendments to charter and contract provisions. Our collateral trust bonds are convertible into common stock at the election of the bondholder. As a matter of fact, our common-stock holders waived their preemptive rights to such common stock to make the conversion contract with the bondholders. Naturally, the bondholder is not going to be interested in converting to the common stock unless the asset value at the time is greater than the conversion price. But section 23 (a) of the act says that we can never issue common stock for less than asset value at the time of the issue. In the absence of retirement of our bonds by call at the redemption price of 105, we would certainly have a contract outstanding calling for the violation of section 23 (a) of the act, but here again section 23 (b) applies governing the call of securities and, furthermore, there is the question of whether it is in the interests of our common stockholders to be forced to retire $4\frac{1}{4}$ percent debt at 105.

But the conversion rights of our bonds are further affected by section 18 (a) (4), which requires all nonredeemable stock hereafter issued to carry broad preemptive rights. The preemptive rights of our present common stock, into which our bonds are convertible, are carefully limited so as not to interfere with the conversion rights of our bonds or with issues of stock for property. Does section 18 (a) (4) mean that we have to give to the common stock into which our bonds are convertible broader preemptive rights than our present common stock has? This would vary their contract, whether to the benefit or detriment of any class of securities one cannot say. Assume we do give such preemptive rights to that stock, and a part but not all of our bonds are converted, which is the way such conversions take place. Would this mean that further conversions could not be made unless those who have already converted waive the preemptive rights given them by the act? Could those who first convert block all other conversions?

I pointed out to you earlier that ever since its inception, Railway & Light Securities Co. has included among its directors men identified with the investment banking or brokerage business. Accordingly, the provisions of the proposed act which will eliminate these men from the board are contrary to a policy approved by the stockholders over a long period of years. I have checked the boards of directors of the 15 largest savings banks in the United States. Eleven out of the fifteen have on their board one or more men identified with the investment banking business or the brokerage business. The assets of these banks aggregate over \$3,766,000,000. A casual check of many educational and charitable funds devoted to the public welfare reveals that they likewise have turned to this financial profession for investment advice and assistance. It indeed seems strange that men capable of assisting in the management of funds of this type and size, should be outlawed from investment companies under any theory.

The main contentions against using these gentlemen as directors have been summarized as conflicts of interest. Conflicts of interest have, of course, long been regulated by common-law principles and rules. These enable transactions affected by such conflicts to be upset if unfair. The banking and brokerage profession or industry itself

suggested some time ago further workable restrictions in adopting their 1934 "Code of Fair Competition for Investment Bankers" approved on March 23, 1934, by President Roosevelt. Article VIII of this code expressly dealt with investment company situations. A copy of this article VIII is submitted with a request that you permit its inclusion in the records of this hearing.

Senator HUGHES (presiding). That will be included.

(The Code of Fair Competition for Investment Bankers referred to and submitted by the witness, is as follows:)

CODE OF FAIR COMPETITION FOR INVESTMENT BANKERS BY INVESTMENT BANKERS
CODE COMMITTEE

ARTICLE VIII. RULES PERTAINING PRIMARILY TO INVESTMENT COMPANIES

SECTION 1. If any investment banker has agreed to manage, or give investment advice to the management of an investment company (sometimes known as an "investment trust") all or part of the securities of which are held by the public, or if any partner or officer or employee of any investment banker is an officer or director of any investment company all or part of the securities of which are held by the public.

(a) Such investment banker shall not for his own account sell to or purchase from such investment company any securities unless a majority of the members of the board of directors of such investment company are not such partners, officers or employees, and unless the transaction is previously approved after full disclosure by a majority of such members of the board of directors of the investment company.

(b) Such investment banker shall use his best efforts to cause the investment company to prepare and distribute to its stockholders quarterly statements and annual financial statements, such annual statements to conform to the standards for such annual statements required by section 1 of article IV hereof.

(c) If such investment banker has received any compensation or commission for acting as agent for the investment company, or if such investment company has purchased from or sold to such investment banker any securities, or if the investment company has engaged in any other transaction in which the investment banker has a financial interest, the investment banker shall use his best efforts to see that full disclosure of such transactions is made by the company to the stockholders at an annual or special meeting. Where the investment banker has acted simply as broker for the execution of orders on a securities exchange it shall be sufficient disclosure if the total amount of securities dealt in and the total amount of commissions received shall be stated.

(d) Such investment banker shall not enter into any management or advisory service contract with such investment company providing for the payment to the investment banker of any fee or for any other compensation for managing or advising the management of the investment company unless the contract therefor has been submitted to and approved by the stockholders of the investment company.

(e) Such investment banker shall use his best efforts to cause the investment company not to use the term "trust" as part of the title of such investment company unless the use of the term "trust" is justified as a matter of law.

Mr. ORR. I have suggested the inclusion of the entire article because in addition to the restrictions on so-called self-dealing, they contemplate regulations which would go far toward correcting malpractices of the past in investment companies. You will observe that an independent majority of the directors must approve any transaction with the firm of an investment banker who is on the board. This and the other provisions of article VIII represent simple and workable rules which, I think, could properly be included in the legislation which you are considering.

Summarizing, in regard to the bill as a whole, I agree, in general, with the views which have been expressed here by other representatives of the industry. There is no emergency situation here that

requires hasty action to impose a strait jacket upon this industry. I urge that further careful and detached consideration be given to every proposed provision, if the committee concludes that some legislation is necessary. And I urge particularly that the provisions rigidly restricting dividend payments, regardless of contractual rights, those wholly forbidding senior security issues, and those virtually banning bankers and brokers from directorships, be carefully re-examined in the light of actual needs and results so that, if some restrictions on these matters are decided upon, the restrictions shall be limited to what is necessary, simple, sensible, and workable.

Senator HUGHES. Are there any questions?

Senator HERRING. No; I have none.

Senator HUGHES (presiding). We will next hear from Mr. O. Kelley Anderson, president of Consolidated Investment Trust, Boston.

STATEMENT OF O. KELLEY ANDERSON, PRESIDENT, CONSOLIDATED INVESTMENT TRUST, BOSTON, MASS.

Mr. ANDERSON. My name is O. Kelley Anderson. I am President of Consolidated Investment Trust. Our address is 111 Devonshire Street, Boston, Mass.

Let me tell you a little of what Consolidated Investment Trust is and what the trustees are seeking to do for the shareholders. It is a voluntary association organized under an indenture of trust in 1933 under the laws of Massachusetts. It has its place of business in Boston and its affairs are managed by a board of nine trustees. It is a closed-end investment company and has one class of shares of beneficial interest which are owned by approximately 4,500 shareholders. The average holding at December 31, 1939, was approximately \$3,200 and at that time the assets of the trust were valued at approximately \$14,000,000. The trust was formed by the consolidation of four Massachusetts corporations organized from 1921 to 1928.

The trustees have broad powers of investment. At the present time the trust has approximately 70 percent of its assets in securities dealt in on national exchanges. The balance is invested in real estate (approximately 5 percent) and in what may be called "special situations" (approximately 25 percent). This last group consists, for the most part, of investments of considerable size in industrial enterprises of relatively recent organization, many of which our trust or its predecessors assisted in financing.

Since the organization of our trust these investments in special situations have, for the most part, proved quite advantageous. It is the belief of the trustees that it will be in the interest of the shareholders of the trust, as opportunities are available, to make new investments in similar enterprises. We believe that there is a profitable field of investment in small or medium sized enterprises which need funds either as new money or to replace old money in connection with the refinancing of such companies.

A way in which this financing can be done, and if one may judge from the press, a way believed by the Commission to be desirable, is to have some kinds of investment companies which can furnish the money needed to such enterprises. Financing by investment companies is particularly desirable for enterprises which need permanent capital in sums more than \$100,000 but less than \$1,000,000 because

of the great expense of raising such sums by public offerings registered under the Securities Act of 1933. Consolidated Investment Trust believes this type of financing is desirable and has recently made a further investment in two of the special situations in which it had an interest.

Investments in special situations of the variety which I have described above are obviously different in kind from investments in large and well-established companies such as American Telephone or General Motors or Sears, Roebuck. We would expect to and do follow these special situation companies much more closely than could be possible in the case of most of those large companies. We feel that if we are going to invest a substantial amount of money of the Trust in these smaller companies we should take an active supervisory interest in their management and generally we should have one of the trustees on the boards of directors of these companies.

I would like to discuss with you the effect of the proposed law upon our shareholders. As Consolidated Investment Trust has the simplest form of capital structure, does not sell its shares and does not now have any "manager" or "investment adviser," many of the provisions which might affect other companies do not concern it except as an investor. It seems well to limit this discussion to those provisions which more directly have an adverse effect upon our shareholders. I have divided this subject into four headings, which are quite closely related one to another.

1. The provisions as to the choice and election of directors and trustees.
2. The limitations upon investment policy.
3. The increased expense to our shareholders.
4. The effect of the bill upon financing of small companies and underwriting of other securities by investment companies.

With reference to the provisions as to the choice and election of directors and trustees, it is essential that a management investment company have good management. This bill does nothing to improve the quality of management and actually excludes individuals no matter how desirable from acting as directors or trustees.

Besides myself, there are on our board of trustees two lawyers, an engineer, a manufacturer, an investment banker, two professional trustees, and the financial vice president of Harvard College. All of us are directors of other business organizations of various sorts, including banks, railroads and industrial concerns. This board meets every month. In addition, there is a flexible executive committee of three trustees which meets more frequently and has proved to be an extremely useful instrument in the management of the Trust. We conceive that it is the duty of the directors or trustees of an investment company to use their free and unbiased judgment to act as wisely as they can in the management of the funds in their hands for the benefit of their shareholders.

[Section 10] has a number of extremely complicated provisions as to who may be a director or member of an executive committee of an investment company. These provisions form a crazy quilt of rules, prohibitions, and exceptions which we believe to be very badly conceived and which, if enacted, will operate to the detriment of our shareholders and of shareholders in investment companies generally. The

alleged purpose of this section is to prevent certain conflicts of interest which the draftsman deemed iniquitous. The result, however, of these rules will be that either the shareholders will not be able to have their directors free to make what they judge to be the most desirable investments or that the shareholders will be deprived of the benefit of the judgment of men fitted by training, experience, and connections to act as directors.

Perhaps it would be helpful to the committee to discuss some of these rules in detail from our standpoint.

Subsection (a) provides that a majority of the board or executive committee cannot be affiliated with any one company other than such registered investment company. This does not present serious difficulties for the board of trustees of our trust so long as the number is nine; but if because of the increased expense due to the effect of other provisions of the bill it were necessary to reduce the board to three it could be very harmful. This provision means that there cannot serve at any one time on our executive committee of three, two trustees who are directors of the same bank or railroad or manufacturing company or hospital or wardens of the same church.

It is true that subsection (b) gives a limited exception to this rule for existing members of the board of an investment company who are affiliated with a bank. But this is a most illogical exception to an illogical rule.

Senator HUGHES. Don't you think you are going pretty far when you refer to wardens of the same church being prohibited from serving on the executive committee?

Mr. ANDERSON. Perhaps I am going a little too far there. If persons who are affiliated with one bank are unfit to become a majority of the board of directors or executive committee after the effective date of the act, it is hard to see why persons in the same category are not equally unfit, although they hold office on the effective date. It seems clear that the draftsman did not care to be consistent but rather sought to sacrifice the interests of investors for the benefit of persons now falling into such a category.

Subsection (c) says that no investment banker or broker and no affiliated person of such banker or broker may be a director of an investment company if he is a director, officer, or manager of another investment company not in the same system. The purpose of this is most obscure. There seems to me to be no reason for saying the broker or banker is a less suitable person because he or one of his affiliates is connected with another investment company. In our experience it has been very helpful to have the viewpoint and experience of an investment banker at our trustees' meetings. We have an investment banker on our board and although he is not a director of any other investment company, one of his partners is a director of another investment company in another city, so that one of them would be disqualified.

Subsection (d) relates to persons who may not be the "investment officer" or "manager" of an investment company. Under the definition of "investment officer" as it stands in section 45 (a) (15), when the board of directors votes to buy 100 shares of Telephone at a stated price and instructs one of its members or another officer of the company to attend to having the vote carried out, that member or officer is an "investment officer." I am barred from performing this purely ad-

ministrative function because I am an officer of another investment company.

Subsection (e) is extremely objectionable and most injurious to the interests of the investors.

If you were to choose an individual to be in charge of your property after your death, you would want to select a man with broad business experience and you would consider it extremely desirable to select a man who was a director of companies in which you owned securities. The fact that he was such a director would be an added recommendation because it indicated that he was considered by others to be an experienced and able person.

So it is with investment companies. They believe that it is highly desirable for their shareholders to have among their directors men who are on the boards of large companies. If subsection (e) is enacted, Consolidated Investment Trust (a) will have to ask each of its trustees to give up his connections with the companies of which the trust owns less than 5 percent of the voting securities, which these individuals will, naturally, not wish to do, at least without greatly increased compensation from the trust, and this would apply to seven of our nine trustees; or (b) it will have to dispose of its holdings in all of those companies and be precluded thereafter from owning securities in any of those companies, thus limiting the power of the trustees to act as wisely as possible for the best interests of the shareholders of the trust, otherwise these trustees must resign. This is so obviously ridiculous that further elaboration seems unnecessary.

In addition to the foregoing general objection, Consolidated Investment Trust has a further objection to this provision as it relates to the special situations which I mentioned before. In general, we would not want to invest the money of our shareholders in a relatively small company unless we could have one of our trustees to serve on the board of directors of that company. Our investment might be in the form of voting common stock, in which case we would not be apt to come within the prohibition of subsection (c) (1). That is, if it exceeded the 5 percent.

Our largest single investment happens to be in nonvoting common stock in a company of which I am a director and a member of the executive committee, and under this provision I could not continue in that capacity. Our investment might, however, take the form of preferred stock or bonds or an extension of credit in the form of an endorsement. In all of these cases our interest would be as great as if we bought voting stock and yet under the bill as it now stands we would be prohibited from having one of our trustees on the board of the portfolio company.

We do not intend to exercise control over the special situations in which we make investments. We do believe that we ought to supervise them. It is obvious that the prohibition of subsection (c) (1) is not related to any concept of control of the portfolio company, for ownership of 5 percent of the voting securities in a small portfolio company might well not amount to anything from the point of view of control of the company. If this provision is allowed to remain, the availability of Consolidated Investment Trust as an instrument in the national economy for the financing of small companies will be greatly limited.