Massachusetts Investors Trust took it under their wing. It has had, at relatively small cost, all the advantages of management that the larger company has had. Any attempt to place it under any existing competent management would be fraught with the same difficulties. It would either have to be taken over by an entirely new and untried management, merged with some other company, or liquidated.

In the foregoing discussion, I have ignored the advisory board, as I said I was going to in this discussion of the effect of section 10, although it is a very important element in this set-up. I have done so because I don't know, under this bill, whether the members of that board are to be deemed directors of either company or both, and if they are to be deemed directors, I don't know whether, for the purposes of computing majorities and minorities, the five trustees and the five members of the advisory board constitute one board or two boards. At any rate, practically all of them would be disqualified under section 10 (e) because of holding directorships in companies which either are or well might be issuers of securities held in the portfolio of one or the other of the two investment companies. There is also the possibility that the members of the advisory board might individually be held to be investment advisers, which would lead to a lot of other complications and subject them all to the requirements of title II.

I don't know how many other companies have advisory boards of this kind—some I think do but probably not many. But it seems to me a very sound arrangement, centralizing responsibility in a small working board of directors or trustees and yet giving them the benefit of independent advice and criticism. Moreover, there can be no possible incentive to place on such a board men who would not be wholly independent and helpful. If any bill is to be adopted which attempts to specify who can or cannot hold certain positions, recognition should be given to members of such a board, and their classification clarified. My own opinion is that they should be classified separately, that they might well be required to register, if directors are so required, but that they should not be subject to the other rules or requirements applicable to either directors, officers, or investment advisers, because their functions are very different from those of either directors, officers, or investment advisers.

Now, that concludes my exposition of this particular concrete example of the practical difficulties in an existing situation, which seems to be a wholesome one, which would occur if section 10 were enacted into law.

Now, very briefly I am going to make a little statement which constitutes an effort I have made to analyze the points of conflict, the different kinds of supposed conflicts, which give rise to this whole question of independent directors under section 10:

1. Conflict with management company: If you have a real management company, i. e., one which is empowered by contract to make decisions, which I think is a very rare situation, then the management company really constitutes the management of the investment company and I do not see what function independent directors could perform.

2. Conflict with investment adviser: The common type of so-called management contract is with a corporation or firm which acts in the capacity defined in the bill as "investment adviser," i. e., its recom-

mendations require action by the board of directors to become effective. That is the common type of the so-called management contract. In this situation, I don't question the fact that independent directors of character and sound judgment might be useful, but I fail to see any essential conflict of interest between the company and the investment adviser to justify the mandatory requirement that some of the directors shall be independent of the investment adviser.

3. Conflict with portfolio companies: This point has been so thoroughly discussed that if the members of this committee are not already convinced that any restriction in this case is unwise, I do not believe anything I can say will be of very much help. Mr. Adams spoke on that subject, and a number of other men have spoken on the same subject.

Senator WAGNER. Let us suppose that a director of an investment trust is also a director of a concern in which the investment trust, we will say, owns a 40 percent interest, or has in its portfolio 40 percent of the investment trust's entire portfolio, do you think nevertheless there would be no conflict of interest there at all?

Mr. MOTLEY. You are now assuming that 40 percent of the assets of the investment trust are in it?

Senator WAGNER. Exactly, are invested in a company which has on its board a director of both companies. Do I make myself clear?

Mr. MOTLEY. You do. But I think you could have there two very different situations. If a small investment company, for instance, had invested 40 percent of its assets in the stock of the General Electric Co. it would only be a drop in the bucket so far as control is concerned. On the other hand, if it invested 40 percent of its assets in a small industrial company so that it had perhaps control of the small company, in that latter case they would be permitted to have a director on the board as this bill is drawn, but in the former case they would not be permitted to have a director on the board, I mean in the case of the General Electric Co. I do not really see so far as any possible conflict is concerned that it makes very much difference what percentage of the assets of an investment trust is invested in the securities of the other company.

Senator WAGNER. I want you to understand that my mind is entirely open on this and that I am merely asking the question for information. Let us suppose it is a large investment trust, say an investment trust of $300,000,000, and 40 percent of its assets are in the stocks or securities of the General Electric Co., taking your example again. That would be a very substantial sum of money, but nevertheless you see no conflict there, where one of the directors is on the board of both corporations.

Mr. MOTLEY. I do not see any conflict there that is objectionable. If that investment were big enough to constitute more than 5 percent of the voting stock of the General Electric Co. this bill says they can have a director.

Senator WAGNER. Well, I was not thinking of the bill for the moment but was getting your view of that factual situation.

Mr. MOTLEY. I see. You are testing the matter without any reference to the bill?

Senator WAGNER. Yes.

Mr. MOTLEY. Why, I should think it would be quite proper and desirable if an investment trust had any such large proportion of its assets in one company for it to have a director on the board; I mean, to follow the affairs of the company in which it had invested such a large proportion of its assets. Looking at it the other way round, from the point of view of the industrial corporation, certainly it would seem that a particular stockholder, namely, an investment company which had such a large investment, ought to be represented and might properly be represented on its board of directors.

Senator WAGNER. Thank you. You may go ahead with your statement.

Senator MALONEY. What board do you mean?

Mr. MOTLEY. In that last reply I meant on the board of the industrial company.

Senator DOWNEY. There could not be any diverse relationship arise out of such a position, do you mean?

Mr. MOTLEY. I do not see how there could, Senator.

Senator WAGNER (chairman of the subcommittee). You may proceed with your statement.

Mr. MOTLEY. My next item is—

4. Conflict with other investment companies: This situation may well be subdivided into (a) conflicts with other companies in the same group; and (b) conflicts with other companies not in the same group. By the word "group" I mean two or more investment companies under the same general management. I am not speaking of systems. In both of these situations the alleged conflict is that directors having this common affiliation may tend to favor one company in which they are interested over another company in which they are interested. The only specific instance of favoritism as between these two companies having common directors that has been suggested, so far as I can recall, is that preference might be given to one company over another in the placing of orders for the purchase or sale of securities. In the case of group companies having the same executive management, this difficulty can easily be overcome by prorating each purchase or sale order among the companies. Where the executive management of the two companies is distinct, there can at least be no purposeful discrimination, and it would seem that any accidental advantage that one might obtain over the others at a particular time is hardly to be considered an abuse which merits legislative action. It might happen that the executive management of one was quicker than the executive management of the other, but that would be no purposeful favoritism on the part of the common directors.

5. Conflict with investment bankers: In considering this situation, I assume that purchase-and-sale transactions between an investment company and any of its directors, or any firm with which such director is affiliated, acting as principal, is prohibited, as is contemplated by section 17 of the bill. The general principle of such a prohibition seems to be pretty unanimously favored by everyone who has testified here. There may be some criticism of some of the details of section 17, but I do not think we have heard any criticism of the general principle that self-dealing should be prohibited. That in itself removes the primary conflict of interest. In addition, there are said to be possible conflicts in connection with underwritings, even in the absence of direct dealings between investment company and investment banker. Subsections (f) and (g) of section 10, on page 26 of the bill are intended to eliminate these conflicts. I do not want to go into

the details of these. There has been some criticism of these provisions, some of the witnesses indicating that they thought they went a little too far in the matter of restraining underwritings, but if the conflict in connection with underwriting is removed, in that or some similar way, then it would seem to me that the necessity for legislating against interlocking between the investment company and the investment banker does not exist. If, on the other hand, even though direct dealings are forbidden, it is desired to permit more freedom in the matter of participation in underwritings; then it may be wise to require that the investment company shall have some directors who are independent of the investment banker. The necessity of that, it seems to me, would depend very largely on the other provisions prohibiting certain types of dealings.

6. Conflicts with "underwriter": I use the word "underwriter" in the sense in which it is used in the bill, meaning what we generally term "the general distributor" in the case of an open-end trust. It has been clearly brought out in the testimony that in the case of a great many open-end companies the underwriter or general distributor is closely affiliated with the management, and several witnesses have testified as to the advantages of that arrangement.

I particularly recall the statement of Mr. Parker, of Incorporated Investors. He testified a few days ago as to the identity of distribution and management in his set-up, and of the advantages which he thought were absolutely obtained for the shareholders from that relationship.

If your committee is satisfied that there is no sound reason for requiring a separation of the functions of distribution and management, and if you agree with the opinion I have already expressed as to the absence of essential conflict between the investment company itself and its management company or investment adviser, then I think it follows that there is no sound reason for requiring that the investment company shall have a majority, or even a minority, of directors who are unaffiliated with the underwriter.

Here, again, I say that some completely independent directors, independent of the underwriter, may well be useful, if you get the right kind of men, but that I doubt very much if it is wise or necessary to require by law that there be independent directors, because I do not think there is a real conflict of interest.

Senator WAGNER. As you know, a great many of those who have testified here have expressed the idea that they think it desirable to have some independent directors.

Mr. MOTLEY. Independent of the distributor?

Senator WAGNER. Well, no. I guess I am mistaken about that. The testimony related to another matter.

Mr. MOTLEY. The whole purpose of my——

Senator WAGNER (interposing). Would that not be desirable?

Mr. MOTLEY. I think some independent men, of the right judgment and character, are always bound to be useful. But that is a very different thing from saying that there is an essential conflict which requires independent men. I think you will find in most cases that there are actually men on boards of directors who are wholly independent of the distributor. I am very sure that in Mr. Parker's case, for instance, where there is identity of management and distribution, nevertheless he has some wholly independent men on his board of directors.

Senator WAGNER. But you do not think in any case there should be a provision of law requiring independent directors in the operation of an investment trust.

Mr. MOTLEY. Senator Wagner, my purpose in making this analysis was really to bring out that you do not get anywhere when you merely talk about independent directors in general, that you have really got to analyze it to see just what particular conflicts you are dealing with. I think there is a lot of difference there.

Senator WAGNER. All right. You may proceed.

Mr. MOTLEY. I have only a couple of pages more.

7. Conflicts with brokers: The alleged abuse in connection with this situation is that a broker who dominates an investment company may encourage or create trading in-and-out of investment securities to make stock-exchange business for himself. Whether there are actually any cases of domination by brokers I do not know, but there has been a good deal said about that possibility. Probably the best real safeguard against this abuse would be to require periodic disclosure to stockholders, as well as disclosure in the prospectus, of the existence of the affiliation, the proportion of the stock-exchange business handled by the broker in question, and the amount of commissions paid to the broker by the company—a matter of publicity.

8. Conflict with banks: I do not recall that any evidence has been offered as to any abuse arising out of this situation. In the absence of such evidence it would seem as if a group of men, all directors of one bank, might very appropriately be the directors of an investment company. Apparently, the drafters of this bill were not much concerned about this possible conflict, because by section 10 (b) (2) existing situations of this sort are permitted to continue by specific exceptions.

9. Conflicts with companies or institutions which have no connection with the investment company picture: I think it has been sufficiently brought out that the mere fact that more than a minority of the directors of an investment company are affiliated with some one company or institution which has no points of contact with an investment company, cannot give rise to any conflict, and that there is no possible reason for legislating against such a situation. Our churchwarden case, and many other cases which are analogous to it, will prove that.

That concludes the analysis which I have tried to make, about section 10, and to separate the different types of conflicts which the bill apparently was seeking to control.

My own conclusion, from the foregoing analysis, is that all of the restrictions contained in subsections (a) to (e), inclusive, of section 10, may safely be eliminated and should be eliminated. I believe that the conflicts which they seek to prevent either do not exist or can much better be cured by prohibition of certain direct dealings plus certain requirements for publicity along the lines which I have indicated. I also believe that the restrictions imposed by these subsections would be extremely harmful, for reasons which have been abundantly brought out in the testimony of others. And, finally, I doubt if the type of restriction imposed by section 10 would actually be effective to cure the abuses which they are aiming to cure.

Senator WAGNER. Does your company issue redeemable certificates or stock or whatever they may be?

Mr. MOTLEY. Both companies which I am representing here today, Massacusetts Investors Trust and Supervised Shares, Inc., are open-end companies, issuing redeemable shares.

Senator WAGNER. I take it you heard some testimony here on the question of dilution?

Mr. MOTLEY. Yes, sir.

Senator WAGNER. Do you not think that there is a situation that might give rise to improper practices?

Mr. MOTLEY. Senator Wagner——

Senator WAGNER (interposing). Let me be a little more specific in my inquiry and then you can direct your answer to it: The testimony given here was that you fixed each day the value of the shares of a particular investment trust—and I suppose that practice is followed generally—and that that is the shareholder's proportionate share of the investment trust.

Mr. MOTLEY. That is right.

Senator WAGNER. And that that price remains fixed during the entire day, isn't that so?

Mr. MOTLEY. The price is normally fixed at the close of the stock exchange on each day. That is the price which under the practice has been in effect during the whole of the following day, although recently some companies have established a new practice, that of fixing the price again in the middle of the day, so as to do it twice a day.

Senator WAGNER. Let us take a company which fixes a price you say at the end of the day—after the close of the day, is it?

Mr. MOTLEY. It is taking the closing prices of the stock exchange.

Senator WAGNER. And that price remains fixed during the entire day following, although your assets may, because of increase in value of the stocks, go up considerably.

Mr. MOTLEY. That is right.

Senator WAGNER. So that actually if you buy stock in the middle of the day, assuming that increase to have taken place, you are buying stock which is cheaper than the interest represented.

Mr. MOTLEY. That is right, as of that particular moment.

Senator WAGNER. Yes; as of that particular moment. So that goes on toward the end of the day. It is alleged, and I am entirely dependent upon the testimony, that insiders know that that price tomorrow morning is going to be higher, because they have watched prices go up, I mean prices of different securities that are held. They have that information, and toward the end of the day they buy in a considerable number of shares and therefore have a sure thing proposition, and they make a so-called insider's profit. Now, if that is possible is there some way by which we can prevent that sort of thing by the inside trader? It does dilute the assets, and to that extent I think it is an injustice to the present shareholders.

Mr. MOTLEY. Senator Wagner, it has been brought out that the outsider, who has to pay a load or selling commission on top of liquidating value, has no incentive or possibility of doing that because the rise in the market in a day would never be nearly enough to let him out with his load.

Senator WAGNER. Well, right there—but never mind. You may state your view.

Mr. MOTLEY. Let me make that a little clearer if I can, and I would like to make it clear. If the price is fixed as of the close tonight on a basis of $20 liquidating value, and I, being an ordinary investor, want to buy some shares the next day, I have to pay $20 plus a load, which load averages perhaps 7 percent, which would be $21.40 if my arithmetic is right.

To do what you suggest, to buy at the price at the close and then turn it back at a higher price, would not be possible unless the market rose at least 7 percent.

Senator HERRING. Is not that load fixed from day to day? Is not that part of the fixing of the price each day? Therefore it does not change the margin as between one day and another. This 7 percent always follows, does it not?

Mr. MOTLEY. Yes, Senator Herring; but you pay the 7 percent load when you buy in. You do not get the 7 percent load back when you redeem.

Senator HERRING. Is not that reflected in the price of the shares from day to day, though?

Mr. MOTLEY. Not in the redemption price.

Senator HERRING. It is not in the redemption price?

Mr. MOTLEY. No, sir.

Senator WAGNER. There is testimony in the record to the contrary that has been presented here by experts, to the effect that vast profits were made because of inside information.

Mr. MOTLEY. I have not really answered your question yet. That was preliminary.

As far as insiders are concerned, the State regulation which has been spoken of as Q3 to which at least 80 percent of the open-end trusts are now subject, now forbids selling shares to anyone except the general distributors and dealers at a price less than the price to the general public. That is why I brought out this point, that the general public cannot take advantage of the situation which you have mentioned. Under that regulation, which I think is a good one, it is forbidden to give a lower price to anyone inside the company. The distributor of course, buys at the flat liquidating value, because he has got to put on the load to pay his expenses and make his profit. The dealer to whom the distributor sells in turn pays a price somewhere between the price which the distributor pays and the price which the public pays.

There is the theoretical, perhaps actual, possibility of the distributor or the dealer taking advantage of the situation which you point out. In well regulated trusts the distributor is forbidden by his contract to do that. He agrees to use his best efforts and does use his best efforts to prevent any dealer from doing it. That is a situation, however, which we all recognize and which, as Mr. Traylor suggested, we feel could best be regulated under the Maloney Act by reason of the fact it is a situation which can only be availed of by distributors and dealers, all of whom are necessarily members of the association created under the Maloney Act.

Senator WAGNER. Of course we are not legislating here for responsible, legitimate operators, because they do not need any regulatory legislation. All of this legislation—I need not argue that with you—is because of abuses that exist by reason of irresponsible operators, and it is those abuses that we want to prevent. The mere fact that you have adopted that regulation shows the possibility that abuse does exist, and you are trying to meet the situation.

Mr. MOTLEY. That is right, Senator. But our suggestion is that what we have done in policing ourselves can be done very well and logically under the Maloney Act, through the association.

Senator WAGNER. Somebody has referred to it as the Maloney association.

Mr. MOTLEY. Yes.

Senator DOWNEY. I would like to inquire what are the items making up that load that you speak of, of 7 percent. Did you call it load?

Mr. MOTLEY. Yes.

Senator DOWNEY. What are the items that make that up?

Mr. MOTLEY. The liquidating value of a share is fixed at the close of business every day. That is the price which the investment company itself gets. It gets cash based exactly, or as nearly as it is possible to base it, on liquidating values. The people that sell those shares have to make a profit and have to pay their expenses. So the load is a surcharge, you might say, added to the liquidating value. The investor pays liquidating value plus load, which averages about 7 percent, I think; and that load is divided between the general distributor and the dealer in such proportions as they may agree upon among themselves, and it goes to cover their selling costs and their profit.

Senator WAGNER. We have some testimony, too, as to abuses in regard to loads. They run as high as 18 to 20 percent in some of these very large trusts. You heard that testimony, I take it?

Mr. MOTLEY. I have heard the question asked of some witness, whether he thought 20 percent was too high, and he certainly admitted that he did. I do not know what the highest load in an open-end investment trust is. It is nothing like that, I think. I remember Mr. Traylor testifying that it averaged about 7. We also think that competition goes a long way to control that. We also think that that is a matter which concerns the dealers and the distributors and which could very well be handled under the Maloney Act.

Senator WAGNER. There is testimony, as I recall very distinctly, that they did, in some of the operations of some very large investment trusts, charge as high as 18 or 20 percent. It was in relation to testimony given that the investment had to earn 20 percent before the investor could even get his money back.

Mr. MOTLEY. I think that must have been in connection with some of these partial-payment plans, or something of that sort.

Senator WAGNER. Yes; I think it was a partial-payment plan.

Mr. MOTLEY. I think someone testified that actually it was not possible to make a living selling to these very small buyers and keep the load down to a bare minimum amount.

Senator WAGNER. I cannot view it with indifference. With all due respect, I think it was an outrageous practice to charge small investors 20 percent as a load for the purchase of their securities. The testimony was that one of them was a rather large concern; and it was factual testimony, not probabilities at all.

Mr. MOTLEY. Senator, I do not want you for a moment to think that I am attempting to justify anything like a 20-percent load. I am only saying that I do not recall that there was testimony as to anything like that except possibly in connection with a partial payment plan.

Senator WAGNER. Thank you. Are there any other questions?

Mr. MOTLEY. Senator, would you permit me to put one remark into the record?

Senator WAGNER. Certainly.

Mr. MOTLEY. Mr. Traylor has just sent me a little note which indicates that I made a slight misstatement which I did not mean to make. I said that the five directors of Supervised Shares were identical with the five trustees of Massachusetts Investors Trust. I had known that there used to be seven directors of Supervised Shares, but I had understood that the two outsiders had dropped off. Mr. Traylor now explains to me that there are still two directors on the board of Supervised Shares who are not trustees of Massachusetts Investors Trust.

Senator WAGNER. We know you intended to be accurate.

Mr. MOTLEY. It is not important, but I would like to put it in for purposes of accuracy.

Thank you, Senator.

(The following statements were submitted by members of open-end companies for inclusion in the record.)

STATEMENT BY S. L. SHOLLEY, PRESIDENT OF KEYSTONE CUSTODIAN FUNDS, INC., OF BOSTON, MASS., BEFORE SENATE BANKING AND CURRENCY COMMITTEE, ON THE WAGNER INVESTMENT COMPANY BILL

My name is Sidney L. Sholley. I am president of Keystone Custodian Funds, Inc., of Boston, Mass., which operates a group of mutual-type, open-end trust funds with a combined market value of over $23,000,000 under what is known as the Keystone plan, which I shall later briefly describe.

I am in favor of proper regulation. Proper regulation safeguards not only investors but the investment trust industry as well. An approach to the problem of regulation which would enact into law those principles widely accepted as being both sound and desirable would receive my wholehearted approval. The proposed bill, as drafted, not only covers these principles but goes much further. It seeks to mold investment companies of all types, true trusts as well as corporations, into predesigned patterns to an extent which, in my opinion, goes beyond what is necessary to attain the objectives desired. This will both needlessly complicate sound operation and materially increase expense to investors.

The Keystone plan, which I shall now briefly describe, came into being in 1932, near the low point of the long bear market, but has had its greatest growth during the past 3 years. It was the result of a careful study of the problems and requirements of the investing public and is a serious and, I believe, successful attempt to solve a number of these basic problems. For instance, it was recognized that the investment objectives of individual investors are different. One type of investor is primarily interested in safety of principal; another, maximum return on capital; still others in growth of capital. Different types of securities are needed to meet these different investment objectives. Accordingly, in the Keystone plan, the securities market, consisting of over 4,000 bonds, preferred and common stocks—listed on the New York Stock Exchange and the New York Curb Exchange, is divided horizontally into different groups or classes of securities. Good-quality bonds, medium-priced bonds, low-priced bonds, and speculative bonds; income preferred stocks and appreciation preferred stocks, quality common stocks, income common stocks, appreciation common stocks, and low-priced common stocks are all typed into their respective classes. There is a separate Keystone fund in each of 10 classes of listed securities, 4 funds in the different grades of bonds, 2 funds in preferred stocks, and 4 funds in common common stocks. Approximately $14,000,000 is invested in the bond funds, $4,000,000 in the preferred-stock funds, and $5,000,000 in the common-stock funds, a total combined market value of $23,000,000.