A year or so ago there was an amendment made to the Exchange Act of 1934 which made it unlawful to engage in fraudulent and deceitful methods in the distribution of securities; and the Investment Bankers Association—and I can again cite the record on this—appeared before committees of Congress and urged that the power of defining those things should be given to the S. E. C. Their reasoning was this: They said, "If we can get definitions from the S. E. C. and rulings in advance, we know 'where are are at;' otherwise we are going to be subjected to all kinds of suits and trouble."

I thought when I went along with this that I was doing something which would aid the industry and would prevent law suits. Now, let us strike out that second sentence of 13 (b), according to that recommendation, and see what we have got left. We have got a prohibition against fundamental investment and management policy changes. They do not want us to define those things. All right. That means that the courts will define them. It means that every time an investment trust turns around in a way that some bad-tempered security holder does not like, he is going to sue the investment trust.

I think it is far wiser, from their point of view, to give the Commission some power of definition, when you bear in mind that a later provision in this bill states that anybody who relies upon an order or rule of the Commission is protected against liability, even though it be found that the Commission acted erroneously.

If the idea or the purpose is not good and nobody likes it, throw it out. If the idea is a good one and the means of expressing it has been poor, then let us try to rewrite it and make the statement of it as good as the idea itself.

Senator HUGHES. The purpose is the protection of the companies, is it not?

Mr. HEALY. Yes; I suppose the real purpose of that first sentence is so that if the stockholder has gone into the corporation on the basis, say, that it is a conservative company which relies for its income on dividends and interest, but without his knowledge and consent he should find himself suddenly in a corporation that is doing a lot of underwriting and speculating wildly on the New York Stock Exchange, I think that kind of a prohibition is a very necessary thing. But you can, I believe, make the position of the industry easier in the face of that if you can get some kind of power of definition by getting an advance ruling from the Commission. I think the writing of a rule of universal application would be very difficult because so many of these companies will have said different things in selling their securities, and in their charters, and so on. I would not be surprised if every one was almost a law unto itself; but certainly there is some advantage through the administrative process in coming down and finding out, before you do a thing, whether you are going to get into trouble if you do it, and then if you get into trouble you have got protection against suits and injunctions.

I think those are good reasons. The provision is not for my benefit. As far as I am concerned, it can be thrown out if that is what the industry wants.

Now I would like to spend just a few minutes on the subject of the size provision in section 14. So far as I am aware I was not actuated, when I went along with this proposal, by any economic theory based

on the fear of bigness. I notice that Mr. Paul Cabot stopped his trusts when he got to $50,000,000, and I was sorry that there was no opportunity to ask him why he stopped at $50,000,000. The philosophy of it, in general, from my point of view, at least, is that when a man gets to the point where he is managing $150,000,000 worth of investments in volatile common stocks, he has got his hands full and that he cannot do a first-class job for the people for whom he is trustee when he gets above that.

The Commission will find no fault and has no right to find fault if the committee strikes it out. But the Commission wishes to maintain before the committee its position that this would be found to be a wise provision. If the committee thinks otherwise, all right. If you do think so, then perhaps you will substitute a provision for a special report on that subject at some future time. There is nobody in the industry that is within such a short distance of these figures that they are in any trouble from it.

Senator HUGHES. I think, Judge, after a large number of witnesses have testified it is pretty difficult to recall just how unanimous the opposition to that provision is among the witnesses who have testified here. Whether they were unanimously opposed to it or whether some were not opposed, we will not know until we have reviewed the testimony.

Mr. HEALY. I think that everybody who commented on it spoke against it. There were several who refrained from commenting on it.

Senator HUGHES. I thought there were some who did not comment, and I did not know whether they favored it or did not oppose it, or whether the industry as a whole had any unanimous voice on it.

Mr. HEALY. I do not know. I must confess that I got the distinct impression that they were against it, but for some reason some of the boys did not say anything about it. I do not know why. Maybe they were against it or maybe they do not care. But the statement has been made here that this is an innovation, that this is one of the most novel things that has ever been proposed in any legislative body, and this fear of size was frowned upon or ridiculed as a sort of senseless phobia.

Now, let us see about that. I would like to submit to this committee that taking off the limitation upon size of corporations is the novel thing. I would like to submit to this committee evidence to show that until comparatively recent times there was hardly a State in the United States that did not limit the size of corporations.

Let me spend just a minute on a little footnote taken from Justice Brandeis' dissenting opinion in *Liggett* v. *Lee* which I think was handed down about 1932. He says [reading]:

> Limitation upon the amount of authorized capital of business corporations was long universal in many States, including the leading ones.

I will skip a good deal of this. [Continuing reading:]

> In some industries the removal of the limitations upon size was more recent.

In the part I skipped he showed how limitations had been removed at earlier periods in some States. Then he goes on, and I will go on with the quotation [reading further]:

> Pennsylvania did not remove the limits until 1905.
>
> Vermont limited the maximum to $1,000,000 until 1911, when no amount over $10,000,000 was authorized if, in the opinion of a judge of the supreme court,

such a capitalization would tend to create a monopoly or result in restraining competition in trade.

New Hampshire did not remove the maximum limit until 1919. It had been $1,000,000 until 1907, when it was increased to $5,000,000.

Michigan did not remove the maximum limit until 1921. The maximum, at first $100,000, had been gradually increased until in 1903 it became $10,000,000 for some corporations, $25,000,000 for others, and in 1917 became $50,000,000.

Indiana did not remove until 1921 the maximum limit of $2,000,000 for petroleum and natural gas corporations.

Missouri did not remove its maximum limit until 1927.

Texas still has such a limit for certain corporations.

So we are not the purveyors of novelty; we are old-fashioned reactionaries. The truth of the matter is since the topic has come up and the ink is flowing in the pen, that about 85 percent of all the things that plague S. E. C. grew out of modern innovations, so-called liberalization of State corporation laws. Under the laws of some States you can pay dividends out of almost anything, including the ashes by the heater in the basement.

There is a phobia in connection with the American worship of size. You get to thinking sometimes that anything that is big must be wonderful. That is not so, in my opinion. Primo Carnera was big but he could not punch his way out of a paper bag. United Founders was big; it was $500,000,000 big, but it was far from wonderful. Even in manufacturing concerns any good economist will tell you that there is a point at which size does not increase efficiency. There is a point where you begin to go down the other side of the bill.

I am not arguing these points with the hope of convincing the committee to leave these limitations in; I am just arguing to show that we are not original in these provisions, that they are not innovations, that they are ideas that found favor with our fathers and grandfathers for a great many years in the United States.

Senator HUGHES. Judge, I have a more radical view than that. I think there ought to be a limit to the size of cities, especially when a city gets to a size where so many people have accumulated there that it makes it impossible to police them. I think, if it were possible, it would be a mighty good thing if we could limit the size of cities to, say, 500,000 people.

Mr. HEALY. Managing a big city is no more difficult than managing $150,000,000 of common stocks. I think in some of these situations, certainly in the business world, it is not a question how big you are; it is a question of how good you are. If you can keep on being good and doing a good job, then I for one would be willing to have you grow as big as you want to, as long as you keep on doing a good job. My doubt is whether anybody who is not a double or triple Napoleon can run $150,000,000 of common-stock investments and do a good job for the people who have entrusted $150,000,000 to him.

I have a few words that I would like to say, with the committee's approval, with reference to section 33 of this bill. That relates to the matter of the settlement of civil actions. It provides that when there is a representative action brought there shall not be a settlement without an advisory report from the S. E. C. I am stating it crudely, perhaps. I mean, there shall not be a settlement until an advisory report has been filed by the S. E. C. We do not have to approve it or disapprove it, but we do have to write an advisory report and hand it to the court.

That does not apply to the supposititious $50 lawsuit that some witness saw in a bad dream. It applies only to representative actions.

You have heard, and I think it is true, that investment trusts are especially susceptible to suits and strike suits. There is a lot of money there and it is all in a small space and easily handled, and the reputation of the companies is a pretty precious thing; but, after all, the susceptibility of many of these investment trusts to lawsuits is not due to any of those factors at all: it is due to the way some of them have misbehaved—and I want to be careful to exclude the good ones. Of course, these trusts did not send their poorest men down here to testify as witnesses. Mr. Kenyon, and Mr. Groves, and Mr. De Rondes, and Howard Hopson and the rest of those boys did not come down here; there are two or three others that could not come—the warden had the key—but one of the reasons that some of these companies are so susceptible to these actions is that the management has misbehaved. Now, when they get in trouble over it, instead of the fellows that were responsible for the misbehavior settling, the corporation which has already had a slap on one side has to get hit on the other side by defending the suit and buying them out of it.

But here is the peculiar thing about it, as it seems to me. I never heard much about representative actions up in the part of the world that I came from, but I understand the law is that when the defendant settles a representative action with the approval of the court, that settlement is binding on all of the other security holders of the class represented, whether they were parties to the suit, whether they ever heard of it or not, and that it bars an action under certain circumstances, at least, by the corporation.

Now, what happens? A lawyer gets seven or eight clients—they may be a very small fraction of the security holders of the corporation—and he finds that somebody has mistreated the funds of the corporation entrusted to him, and he brings a representative action, and presently there is a settlement. Perhaps there is nobody there except these few people, and very often one of the most interesting or potent elements in the proposed settlement is that the defendants pay the plaintiffs' lawyer's fee which may run from $200,000 to $400,000 or $500,000.

Of course the sight of all that money immediately spurs the plaintiffs' lawyer to reject the settlement. I say that in irony. I think it is only human nature that when a lawyer or anybody else, for that matter, sees $300,000 all in one spot, he gets very much interested in that amount of money. It is a very attractive sight. Whether any of them ever have gotten more interested in the $300,000 or $200,000 fee that their opponent was going to pay them, all of course in the open with the approval of the court, than in the merits of the litigation that they were supposed to be prosecuting, is something that I cannot speculate about.

Having had some slight experience with human nature, and having observed that a great many of those cases are settled when the plaintiff's lawyer's fee is paid by the defendant, it raises a slight presumption in my mind, at least.

The courts have actually had things "put over" on them in those cases. The court is busy. If there were nothing involved except

settling the suit with the plaintiffs actually before the court, we would not be here with this proposal; but when in a representative action the settlement of it binds the corporation so that nobody can sue those defendants again for the same wrongdoing, then I submit it is in the public interest that this Commission be allowed at least to write a report and put it on the desk of the court. That is all we want.

Senator HUGHES. I see no real objection to that, myself, without having considered it carefully. I can see that there may be some of my brothers at the bar who may have objections. I was in contact with one case where the settlement brought a firm of attorneys over $3,000,000; and I suppose they would not look kindly at interference with such a situation.

Mr. HEALY. I should think they would be completely hypnotized if they looked at the money long enough.

May I pass on to one or two other topics? I will not take very long with them. The first is the matter of statistics.

I have discovered that I do not know anything about statistics. I have made the discovery that a great many other people have made, people who thought they knew something about accounting or arithmetic, or even lower mathematics, that that does not necessarily mean that you know anything about statistics. We had a statistical job to do, and one of the things that we wanted to find out was whether the expert managers—these people who were asking other people to give them their money to manage because they were so good at it—really had performed very well. It was a difficult thing to do. I confess I did not know how it should be done. I felt that there ought to be some way of measuring it. It is difficult to appraise the performance. You had to establish a standard; you had to have something to compare it with, and it was difficult. The Commission turned it over to two men that we regarded as competent statisticians. I still think they are competent statisticians. One of them was Dr. Raymond Goldsmith. I would like just briefly to give you his background and training.

He is a graduate of the University of Berlin. He had a research fellowship at the Brookings Institute. He did graduate work at the London School of Economics, London, England. He taught Economics at Carlton College in Northfield, Minn. He has been with the Commission since September of 1934. He is the author of a book, "The Changing Structure of American Banking," and has written various studies that have been printed by the Government.

The other statistician whom I mentioned is Mr. Vass. He is a graduate of Rutgers, where he got his B. A. in 1931 and his M. A. in 1933. He completed his requirements for his Ph. D. at Columbia in 1935. He taught economics and statistics at Rutgers in 1932 to 1935, and he came with us in 1935.

I have no doubt that the industry has on its various staffs men just as competent as those two men. Who is right and who is wrong in this dispute about statistics that developed here before this committee I confess I do not know. I cannot follow them into some of these higher altitudes. I do think that whomever the statistician represented, he did what he believed to be an honest and sincere job. And this is not the first time that differences of opinion have developed pretty sharply between statisticians. In fact, I should be very much

interested if anybody could produce a case for me where two groups of well-trained statisticians had agreed.

When we were preparing report there were some differences inside the staff as to the correct approach. It was discussed and talked back and forth, and finally I said, "I would like to learn the name of the toughest and hardest critic of statistical method in the United States;" and I was given the name of Dr. Wilson of the Harvard Business School. I sent the whole thing to him, and he came back with some recommendations, and he seemed to think it was all right, so we went along with it. So much for that.

As a layman and inexpert in the matter of statistics, here is where I come out. I do not ask anybody to accept this conclusion, but after reading the statistical reports and the reports of the S. E. C. filed with Congress, the impression left on my mind, not scientifically expressed, is just this, that these men who traded in securities in and out of the stock exchange are just about as smart in handling those matters as most of the rest of us, and no more so; and I think that is about what the statistical study proves.

I would like to talk for a couple of minutes now about the matter of dilution. There, again, we get off into mathematics and disputes that I confess I have a great deal of difficulty in following. But there are certain things that do emerge from all that dispute pretty definitely, and I do not think the industry disagrees very much with this, that this problem of dilution, this problem of pricing these redeemable securities, is difficult. It is important to those who buy; it is important to the old security holders of the corporation who are left still remaining in the corporation, and it is very important to the future reputation of this industry. They all recognize it, it seems to me.

Mr. Traylor says there is disagreement in the industry as to how to handle it. I am not surprised at that. It is a very difficult matter. And Mr. Traylor said that he came down here with the idea in his mind that the subject of pricing ought to be left to the S. E. C. under this statute. Well, so did I. I had the same idea. But he says that he changed his mind because of some things that Mr. Schenker and Mr. Bane said in their testimony.

I may have missed something that Mr. Schenker and Mr. Bane said about dilution. I do not recall hearing them say very much about the correct method of pricing, although they did say a great deal about dilution. I can very solemnly say to this committee and to the industry that I don't know what the correct pricing method ought to be. I can say to them that if that matter is left to the Commission they will be given a fair hearing on it, and an effort will be made to find a correct pricing system. And that is precisely what the vice president of Massachusetts Distributors, which is Mr. Traylor's company, recommended to the Securities and Exchange Commission in the letter which Mr. Bane read to this committee yesterday morning.

Now, was there a sufficient basis for Mr. Traylor to change his first opinion because of some criticism that came from Schenker and Bane which he found it a little difficult to take? I submit there was not. I submit that the Commission, as distinguished from its employees, and even the employees themselves, has expressed no opinion on the proper pricing method. It is a difficult problem and a vital one, and nobody is in position right now to solve it by a rigid provision written into the statute.

I do not think it is appropriate to leave as important a matter as that to the Maloney Act association, much as I admire it. They do not cover the whole industry, and it is such an important matter and susceptible to such abuses that it should be a matter of law, and not a matter of mere code practice which people can voluntarily adopt or discard as they please.

There has been some controversy that developed here on the subject of what opportunities the industry had to discuss with or deal with the S. E. C. In my opening I did not think I was criticizing them when I said I regretted that they had not done it. They acted wholly within their rights. I do not care to pursue it any further than just to say this. I have had a typewritten compilation made showing about the following: First, approximately the number of pages of our record devoted to discussions by members of the industry as to what the legislation ought to be; second, a compilation of all memorandums filed with the Commission by various members of the industry on what our recommendations ought to be, and, third, a compilation of the time devoted to conferences with the industry by the Commission and the members of the staff. It is necessarily incomplete, because we did not keep books on it. There is a great deal more than appears in this statement. I will offer it for the record now.

Senator HUGHES (presiding). Let it go into the record.

(The document referred to and submitted by Mr. Healy is as follows:)

CONFERENCES WITH REPRESENTATIVES OF INDUSTRY

Throughout the period of the public examinations beginning July 1936 and later while the various drafts were in preparation, members of industry consulted with members of the staff of the Study in numerous conferences about the points to be considered in legislation. For example, the following letter from Mr. Earle Bailie, chairman of the board of directors of Tri-Continental Corporation dated January 21, 1937, shows the scope of such conferences and the detail in which the various problems of regulation were considered.

TRI-CONTINENTAL CORPORATION,
New York, January 21, 1937.

Dr. RAYMOND W. GOLDSCHMIDT,
Securities and Exchange Commission,
Washington, D. C.

DEAR DR. GOLDSCHMIDT: Following your suggestion the other day, I enclose herewith a list of the points that we have been thinking about in connection with investment company operation and practice. I understand that after you and your associates have had an opportunity to go over this list you will send me a note regarding any additional points that I may not have covered. As soon as we receive this additional list and have had an opportunity to find out how much additional work it involves, Paul Bartholet will telephone you and arrange with you for a convenient date when we can get together and discuss the subject.

Faithfully yours,

EARLE BAILIE.

POINTS TO BE CONSIDERED IN CONNECTION WITH INVESTMENT COMPANY OPERATION AND PRACTICE

I. MANAGEMENT

1. Management and investment service contracts: should they be prohibited; if not—

(*a*) What should be length of term.

(*b*) Should there be approval by stockholders in all instances.

(*c*) Should basis of compensation be market value of assets, income, realized profits, or a combination of these.

2. Directors:
(a) Should any restrictions be imposed on persons eligible to serve on investment company boards.
(b) Are directors independent of management desirable.
3. General:
(a) Should loans to officers, directors, or firms of which officers or directors are members, be prohibited.
(b) Should direct dealings between investment companies and their officers, directors, affiliated companies and 10 percent stockholders be prohibited, or is publicity with respect to such transactions adequate.
(c) Is substantial stock ownership by management desirable.

II. CAPITAL STRUCTURE

(a) Multiple security company versus common stock structure.
(b) What is "ideal" division between senior capital and junior capital.
(c) Should issuance of stock purchase warrants and options be restricted.
(d) Should any restrictions be imposed upon size of bank borrowings.
(e) Should restrictions be imposed upon repurchases of own securities.
(f) Open-end versus closed companies.

III. INDENTURE AND CAPITAL STOCK PROVISIONS

(a) Advantages and disadvantages of "touch-off" clauses in debentures.
(b) Pre-emptive rights; advantages and disadvantages.
(c) What is proper distribution of voting power?

IV. DIVIDEND POLICY

(a) Are restrictions desirable with respect to dividend payments (e. g., prohibition of dividend payments out of capital surplus, etc.), or is full publicity as to the source of dividends sufficient?

V. PORTFOLIO POLICY AND OTHER ACTIVITIES

(a) Should limitations be imposed upon the percentage of an investment company's assets which may be invested in the securities of any other company?
(b) Should restrictions be imposed regarding maximum percentage of voting securities of other companies which may be held by an investment company?
(c) Should any distinction be made between specialized companies and companies with a diversified portfolio (for instance, a company specializing in tobacco stocks versus a company with a portfolio such as General American's)?
(d) Should short term trading be restricted?
(e) Underwritings and syndicates; should restrictions be imposed?
(f) Trading accounts, puts and calls, commodities, "short" sales: Should such activities be restricted?
(g) Should any restrictions be imposed upon directors, officers, and employees with respect to purchasing, holding, and selling securities which are held, being purchased, or sold by their investment company?
(h) Problem of interchange of services and information between investment companies and sponsors, affiliated companies, brokers, and nonaffiliated persons.
(i) Advantages of broad versus narrow charter powers.
(j) Problem of notifying stockholders with respect to changes in investment policy.
(k) Portfolio turn-over: Is any restriction desirable?

VI. LISTING OF INVESTMENT COMPANY SECURITIES ON EXCHANGES AND/OR REGISTRATION THEREOF WITH SECURITIES AND EXCHANGE COMMISSION

(a) Should listing or registration be made compulsory?
(b) Problem of preventing "selling down the river."

VII. REPORTS TO STOCKHOLDERS

(a) Material to be covered.
(b) Frequency.

VIII. FINANCIAL STATEMENTS AND ACCOUNTING METHODS

(a) To what extent is standardization of basic accounting principles feasible or desirable (for instance: Method of determining security profits, valuation of portfolio, provisions for tax accruals, determination of true income, etc.)?

(*b*) To what extent is standardization of method of presentation of accounts feasible or desirable?

(*c*) Should regulations to be promulgated call for details in financial statements such as detailed analysis of expenses; amount, basis of determination, and recipient of management or service fee; special compensation to officers and others in the form of stock, options, etc.; supplementary statements such as a summary of a company's assets at market value, comparative asset values, classification of portfolios by groups, etc.?

(*d*) Should independent auditor's certificate be insisted upon for interim as well as annual reports?

(*e*) How should auditors be chosen?

IX. TAXATION

(*a*) Undistributed profits tax.

(*b*) Capital gains tax.

(*c*) Analysis of mutual investment company provisions in Revenue Act of 1936.

(*d*) Effect of present Federal and State taxes on investment policy and operating performance of investment companies.

PREPARED STATEMENTS FROM REPRESENTATIVES OF THE INDUSTRY

While the various public examinations of investment companies were being held, members of the industry also prepared and submitted their own recommendations for legislation. Mr. Floyd B. Odlum, president of Atlas Corporation, presented to the Securities and Exchange Commission on July 2, 1937, a "General Statement and Recommendations on Investment Trust Legislation" (15 printed pages). Mr. Earle Bailie, chairman of the board of directors of Tri-Continental Corporation, Selected Industries, Inc., the Broad Street Investing Co., Inc., and Capital Administration Co., Ltd., all investment companies, and a partner of J. & W. Seligman & Co., presented on July 16, 1937, a statement entitled "Investment Company Regulation" (21 printed pages). Lehman Bros. also issued a statement of recommendations on November 9, 1936, which it later sent to stockholders of Lehman Corporation as "Message to Stockholders of the Lehman Corporation, Recommendations for Regulation of Investment Trusts, filed with the Securities and Exchange Commission, November 9th and 10th, 1936."

All these statements were before the investment trust study of the Commission and were carefully considered before the first draft of October 1937.

On June 30, 1938, Dr. Leland Rex Robinson, connected with the Founders Group, submitted a statement entitled "Statement on Regulation of Investment Companies" (12 typewritten pages, legal size, and exhibits). This and other statements of representatives of the industry were considered by the investment trust study in the preparation of later drafts.

CONSULTATION WITH INDUSTRY ON TERMS OF THE BILL

Mr. Arthur H. Bunker, of Lehman Corporation, in his testimony on April 15, 1940 (p. 324) indicated that the industry did not have sufficient time to consider actual provisions of the bill after it was prepared and prior to its introduction in the Senate by Senator Wagner, and House of Representatives by Representative Lea, on March 14, 1940. Mr. Cyril J. C. Quinn, of Tri-Continental Corporation, in his testimony on April 16, 1940 (p. 374), indicated that the Securities and Exchange Commission had not considered the wording of the bill with the industry prior to its introduction in Congress. Mr. Paul Cabot of State Street Investment Corporation, in his testimony of April 15, 1940 (p. 374), made the same charge.

The fact of the matter is that after a more or less final draft of the bill had been completed, but before its introduction in the Senate and House of Representatives, approximately 21 conferences were held with representatives of investment counselors and of various types of companies. These conferences, the first of which was held on May 15, 1939, were actively held from January 23, 1940 until the end of February. A list of these conferences with the representatives of industry who attended is as follows:

LIST OF CONFERENCES HELD WITH MEMBERS OF THE INDUSTRY PRIOR TO THE HEARINGS

May 15, 1939:

J. L. Thomas of F. I. F. Plan Corporation.

A. J. Wilkins of Wellington Foundation.

H. J. Simonson, Jr., of Independence Fund of North America, Inc.