out of its ultimate profits on its acquisition of the preferred stock of the investment company. The preferred stock of National Securities Investment Co. which had a par value of $100 a share had an asset value of about $72 a share and was selling in the open market in September of 1931 at about $50 a share—a substantial discount from its asset value. A. G. Becker & Co., Inc., was supporting the market in the preferred stock by buying and selling it in the market. These market-supporting activities were undertaken to provide the preferred-stock holders with a market for the shares which would not otherwise exist. However, as part of its agreement with Atlas Corporation, A. G. Becker & Co., Inc., agreed to cease supporting the market in the preferred stock of National Securities Investment Co. and to purchase such stock only for the account of Atlas Corporation and at prices dictated by Atlas Corporation.

With the aid of A. G. Becker & Co., Inc., Atlas Corporation succeeded in acquiring 95 percent of the preferred stock of National Securities Investment Co. at a price approximately $3,000,000 less than the liquidating value of such stock. Out of this gain in asset value at the expense of the preferred stock holders of National Securities Investment Co., Atlas Corporation paid A. G. Becker & Co., Inc., $1,900,000 for its worthless common stock. In addition, A. G. Becker & Co., Inc., received $50,000 for its services in inducing the preferred-stock holders of National Securities Investment Co. to accept Atlas Corporation's stock in exchange for their own stock even though the exchange meant a severe loss in asset values of the preferred-stock holders. The fact that Atlas Corporation was paying A. G. Becker & Co., Inc., commissions for its services was not disclosed to the preferred stock holders.

The net effect of the transaction was that the preferred-stock holders ultimately were compelled to bear the cost of the purchase of A. G. Becker & Co., Inc.'s, common stock by Atlas Corporation. The preferred-stock holders suffered large losses in asset value. A. G. Becker & Co., Inc., disposed of its entire investment in National Securities Investment Co. without any loss. Furthermore it obtained $3 a share for its common-stock holdings in National Securities Investment Co. whereas the public holders of the common stock obtained from Atlas Corporation sums ranging from 50 cents to $1.50 for their common stock.

Another example is the consolidation in 1937 of National Investors Corporation, Second National Investors Corporation, Third National Investors Corporation, and Fourth National Investors Corporation. National Investors Corporation had outstanding in 1937 (in addition to preferred stock) common stock and option warrants neither of which had any asset value. Large blocks of this common stock and warrants were held by interests affiliated with the common management of the four companies. The principal assets of National Investors Corporation consisted of common stocks and warrants of the other companies which had no asset value. The consolidation plan, however, in essence provided that over $2,000,000 of the asset values of the public stockholders of Second, Third, and Fourth National Investors Corporations were to be transferred to the common stock and warrants of the National Investors Corporation, large blocks of which as has been said, were held by interests affiliated with the management which was the proponent of the plan. This $2,000,000 loss in asset values suffered by the public-stock holders of the three other companies was not theoretical. The new company created by the plan was an open-end company so that the $2,000,000 in asset value created for the previously worthless common stock and warrants of National Investors Corporation out of the assets belonging to the public-stock holders of the other companies could be immediately realized by the common-stock holders and warrant holders of National Investors Corporation.

D. FULL DISCLOSURE IS INSUFFICIENT PROTECTION FOR INVESTORS AFFECTED BY VOLUNTARY REORGANIZATIONS

Section 20 of the proposed investment company bill empowers the Commission to require full disclosure with reference to plans of voluntary reorganization. Mr. Quinn of Tri-Continental Corporation in his testimony before this committee contended that this was a sufficient protection for the investor.

The Commission's experience, however, has been that investors are helpless to combat unfair plans of voluntary reorganizations even if the unfairness of the plan is fully disclosed to them. This is not because as Mr. Quinn charges that the Securities and Exchange Commission believes investors are incompetent or unable to decide for themselves that a plan is unfair. As will be described shortly, even if a plan is unfair to the knowledge of investors they are generally powerless to defeat it.

First, a large number of investors are not security analysts. Plans of reorganizations are complicated. The literature describing such plans uses many technical, legal, and financial terms. In many cases these plans even if fully disclosed will be confusing and incomprehensible to investors. Mr. Quinn admits this himself in his testimony. In discussing the proxy regulations under the Securities Exchange Act of 1934 which requires full disclosure of plans of voluntary reorganization affecting securities listed on National Securities Exchanges, Mr. Quinn stated:

"I would like, however, to say that the present proxy regulations to my mind work out to the utter confusion of a portion of the stockholders because it requires so much information that he really doesn't get a clear picture of it."

Of paramount importance in any determination of the effectiveness of stockholders action against fully disclosed plans of voluntary reorganizations which are unfair is the extent of the investment of the great majority of stockholders in investment companies. The widespread geographical distribution of the stockholders of investment companies must also be considered to obtain a realistic picture of the impotence of stockholders.

Figures for 18 investment companies show that approximately 65 percent of the common stockholders of these companies hold 50 shares or less; 95 percent of the stockholders hold 500 shares or less. Similarly, over 83 percent of the preferred stockholders of the investment companies hold 50 shares or less and over 93 percent hold 100 shares or less.

In terms of market values, over 60 percent of all common stockholders of these investment companies hold common shares with a market value of $500 or less and the holdings of over 75 percent of common stockholders of investment companies have a market value of $1,000 or less. Of the preferred stockholders 37 percent hold shares with a market value of $500 or less; about 54 percent hold shares with a market value of $1,000 or less and 93 percent hold shares worth a market value of $5,000 or less. (See part II, chap. V, of the Commission's report on investment companies, pp. 386 and 434.)

These stockholders are situated in every State and never attend corporate meetings. The Commission's record indicates that not more than one or two stockholders attend most meetings. Almost one-half of the incorporated investment companies are incorporated in Delaware and stockholders' meetings are almost invariably held in cities in that State. For stockholders residing in California, Ohio, New York, Illinois, or Massachusetts, States in which the bulk of stockholders of investment companies reside, the traveling expenses which would be incurred in attending meetings in Delaware prohibit their attendance at such meetings.

Now let us assume that the stockholders receive notice of a plan of voluntary reorganization which fully discloses its unfairness. What are the remedies of shareholders?

(1) *The effectiveness of voting rights.*—(*a*) The stockholder may vote against the plan. However, to do so he must appear at the meeting or retain someone to appear for him. Normally the management solicits and acts as proxy for the stockholders only to vote acceptance of the plan. The expense of attending the meeting to vote or to retain a proxy to vote for him may exceed the loss the stockholder will suffer under the plan.

(*b*) In a large number of cases the management holds a sufficient number of votes to enable it to consummate the plan by its own votes. (See pt. 3, ch. IV, of the Commission's Report on Investment Companies.)

(*c*) Preferred stockholders without voting power may have no vote with reference to plans of reorganization which adversely affect their interest. In at least five States the statutes provide for approval of a corporate merger or consolidation only by holders of voting stock. The only remedy of nonvoting stockholders is their right to obtain in cash the appraisal value of their shares, a remedy which, as will be described later, is in reality an ineffective one. For example, in Delaware, a State in which more than a majority of incorporated investment companies have been organized, the entire assets of an investment company can be sold for the securities of another investment or other company by the vote of a majority of the voting shares. Preferred stockholders without voting rights cannot vote on the sale. Furthermore, if the sale in their opinion affects them adversely, they do not have the right which exists in some cases as will be discussed later to demand in cash the appraisal value of their stock.

(*d*) Security holders in investment companies which in form of organization are business trusts have no voting power. At the end of 1936, out of 152 management investment companies with assets in excess of $500,000 each, 20 were business trusts owning assets valued at market at the end of 1936 at $218,000,000, the

equivalent of 12.2 percent of the total assets of all 152 companies. In only 2 cases out of the 20 cases were the security holders given any voice in a possible sale of the entire assets of the trust for the securities of other investment companies. In all of the other cases the trustees alone had the power without the approval of stockholders to transfer the entire trust assets to another trust or corporation for either cash or the securities of the purchasing trust or corporation. Nor do the security holders in these trusts have the right sometimes accorded to stockholders of corporations in the same situation, to secure the appraised value of their shares in cash if they are opposed to the sale.

(c) The stockholder can refrain from voting in the hope that his fellow stockholders will also refrain from voting in sufficient numbers to prevent the consummation of the plan. However, if the management already has sufficient votes to consummate the plan this will not help the stockholder. Moreover, if the management has not sufficient votes to effect the plan it will have available the funds of the corporation to conduct extensive campaigns of personal solicitation of stockholders by brokers, dealers, bankers and others who will be paid for their services. For example, the Atlas Corporation in June, July, and August of 1932 paid approximately $400,000 in commissions to virtually every known banker, broker, and security dealer in the country for their aid in inducing stockholders of its subsidiary investment companies to accept exchanges of Atlas Corporation's securities for the securities of such subsidiaries. Similar tactics were used by the Equity Corporation. See part 3, chapter IV of the Commission's report on investment companies. The Commission's record indicates that in their personal solicitation of stockholders, dealers spurred by the incentive of commissions, will use unfair tactics to induce acceptance of plans and exchange offers of securities. To indicate the type of pressure employed a letter written to the Commission by a stockholder on January 24, 1937, may be cited:

"In the fall of 1933 a representative of the Equity Corporation called at my home and tried to induce me to exchange my stock for Equity stock offering me 2 shares of Equity for 5 shares of American Founders pointing out at the time that American Founders was quoted at one-half and Equity at 1½ so the trade would be profitable to me. I realized that the portfolio of American Founders represented a greater value per share than the market showed so I argued against trading. The agent then stated that if I would not trade it would be just too bad for me as the Equity Corporation was planning on getting control of American Founders and then dissolving it so I would lose everything."

(2) *Effectiveness of appraisal rights.*—In some States stockholders dissenting from plans of merger, consolidations or sales of the assets of one company for the securities of another may be entitled to receive in cash an appraisal value of their shares. In some States the basis of valuation for this purpose is market value, a valuation which may be unfavorable to investment company stockholders, since, as has been stated, the securities of most closed-end management investment companies are selling in the market at prices between 30 and 40 percent less than their asset value. In most States, however, the stockholder is entitled to receive the "fair" value of the stock.

The appraisal right enables dissenting stockholders to escape from the operation of an unfair [or a fair] merger or recapitalization plan but does not enable them to prevent or undo its consummation. Minority stockholders who do not desire to cash in their shares at their appraisal value still have no other protection against an unfair plan than the doubtful expedient of legal action to enjoin or set aside such plan.

However, in 5 States authorizing mergers and consolidations of investment companies, no appraisal rights are granted dissenting stockholders. In 15 States which authorize corporations to sell their entire assets to other corporations, stockholders dissenting from such sales have no appraisal rights. In 8 States which authorize mergers, consolidations, and sales of entire corporate assets, appraisal rights are granted in the case of merger and consolidations but not in the case of sales of assets. Only 11 States permit stockholders to demand an appraised value of their shares if they are dissatisfied with recapitalization plans. These States, however, do not include Delaware, the leading State for incorporating investment companies, and Maryland, the second leading State for incorporation of investment companies.

As a result of this diversity of State laws stockholders of investment companies incorporated in particular States may have no appraisal rights. In practice sponsors of investment companies incorporate them in States which grant the least power to stockholders. Thus, over one-half of all incorporated investment companies are incorporated in Delaware. In this State stockholders dissatisfied with recapitalization plans have no appraisal rights. Appraisal rights are granted

in cases of mergers and consolidations but not in the case of the sale of the assets of one investment company to another such company either for cash or the purchasing company's securities—a procedure which accomplishes exactly the same purpose as a merger or consolidation. Moreover, in the case of a merger or consolidation in Delaware, the vote of the holders of two-thirds of the company's stock, including normally nonvoting stock is required. In the case of a sale of assets, however, only a vote of the majority of the shares endowed with voting power in the company's charter is required. In practice investment companies incorporated in Delaware which desire to combine will be likely to select the sale of assets method to achieve their purpose in order to avoid the possibility of the exercise of appraisal rights by stockholders. For example, the combination of the National Investors Corporation and its affiliated companies, which, as has been described, was detrimental to the interests of stockholders of the affiliated companies was accomplished by the sale of assets method in furtherance of a deliberate desire of the management to prevent stockholders of the affiliated companies from obtaining an appraisal value of their shares.

Realistically, therefore, stockholders of the investment companies incorporated in Delaware will have no appraisal rights if they are dissatisfied with a proposed combination of their companies with other companies by way of a sale of assets—the method almost invariably chosen by managements. Similarly, they will have no appraisal rights if they are opposed to plans to recapitalize their companies.

Even if the stockholder has an appraisal right the remedy is valueless to the small stockholder, and as has been pointed out, the number of shares and the financial stake of the great majority of investors in investment companies is comparatively small. For example, in Delaware in order to obtain an appraisal the stockholder must file a written dissent from the plan of reorganization and thereafter make a written demand upon the company for payment of what the stockholder considers the fair value of his shares. If the corporation refuses to pay the price demanded by the stockholders, he must apply to a Delaware court for the appointment of appraisers. This means, for example, that a stockholder who is a resident of Ohio must seek out a Delaware attorney and pay him a fee for instituting and maintaining the proceedings. It is readily apparent that the great majority of stockholders of investment companies who hold securities worth from $100 to $1,000 may not be able to afford the expense of these proceedings. Thus, if, as is true in the case of the great majority of stockholders in investment companies, the appraisal costs, court costs, and attorneys' fees bear a disproportionate ratio to the value of the shares held by the dissenting stockholders, the statutory remedy of appraisal is valueless, except, of course, where costs are assessed against the corporation. Except in such cases the dissatisfied minority stockholders will probably lose less by selling his shares in the market or by accepting the valuation placed thereon by the corporation than by litigating the valuation issue involved. Only a dissenting stockholder owning a comparatively large number of shares can afford to insist upon his strict appraisal rights.

(3) *Legal proceedings.*—In his testimony with reference to section 25 of the bill Mr. Quinn of Tri-Continental Corporation stated:

"Mr. Schenker in his comment made the further illuminating statement. He said: 'Sometimes the majority wish to do something which might be bad for the minority.' At least, so I understood his statement.

"What kind of a new doctrine is this, that a governmental agency is going to decide all questions for shareholders? Is the democratic rule of the majority no longer to hold, but must we all come down to find out what we can do and what cannot be done, regardless of existing laws, regardless of existing rights, and regardless of the wishes of those people who are concerned."

Mr. Quinn has overlooked the fact that the courts which certainly are governmental agencies have frequently interfered with the "democratic rule of the majority" where the rule of the majority is oppressive upon the minority or is an attempt to defraud or unfairly treat the minority. Minority stockholders may be granted injunctions or other equitable relief against unfair mergers, consolidations or sales of the corporate assets on the theory that the statutory power to merge or consolidate under existing laws, like other corporate powers, is subject to equitable limitations and cannot be exercised fraudulently or oppressively by the management or other controlling interest of a corporation.

Nor does Tri-Continental Corporation really believe that the democratic rule of the majority (free from any interference) should govern in all cases of merger and consolidation. In 1937 the common management of Alleghany Corporation and Chesapeake Corporation proposed a plan to consolidate the two corporations, Tri-Continental Corporation and Selected Industries, Inc., an affiliated investment company together held 36,500 shares of the common stock of Chesapeake

Corporation. However, Alleghany Corporation held 71 percent of the common stock of Chesapeake Corporation. In several aspects the plan proposed by the common management of Alleghany Corporation and Chesapeake Corporation was detrimental to the common stock of Chesapeake Corporation. As has been stated the plan was satisfactory to the holder of 71 percent of the common stock of Chesapeake Corporation. Tri-Continental Corporation was unwilling to let the democratic rule of the majority govern. It did not ask for the cash appraisal value of its Chesapeake Corporation stock. Instead it sought with others an injunction to restrain the consummation of the plan by the majority stockholders and an injunction was granted by the courts because of the unfairness of the plan to a certain class of Alleghany Corporation stock. Clearly the officers and directors of Tri-Continental Corporation were of the opinion that the majority should not rule where their acts are unfairly and inequitably oppressive of the minority. This doctrine is the guiding principle of section 25 of the investment-company bill.

Minority stockholders thus may have the remedy of judicial relief against unfair plans of voluntary reorganization. This however, is not true in two States, Michigan and California, which by statute expressly restrict the remedies of minority stockholders to their appraisal rights.

Nor is the remedy of judicial relief an effective weapon for minority stockholders. Tri-Continental Corporation, with $33,000,000 of assets, can afford to and does retain the most capable firms of corporation attorneys in the country. It can afford to institute litigation to restrain unfair plans of voluntary reorganizations. But, as has been described, the investment of the great majority of stockholders in investment companies does not exceed $500. It would cost much more than the total investment of the average stockholder to retain an attorney to protect him by litigation from unfair plans of voluntary reorganization. The average investor in investment companies simply cannot afford to retain counsel of the experience and caliber available to the management or the majority stockholders proposing the plan. In addition to the expense of hiring an attorney the stockholder would have to bear the expenses of investigations, court costs, appeal costs, etc. Since the management is normally the proponent of a merger or consolidation plan, stockholders who are attacking such plan may find it difficult to obtain access to the books and records of the corporation. Without such access, it may be impossible either to furnish affirmative evidence of unfairness or to refute ingenious arguments advanced by the management in justification of the plan.

Thus the remedy of judicial relief is largely theoretical as far as the average stockholder in investment companies is concerned. And the ascertainment of the names of other stockholders who might share the expense of a suit or the formation of a protective committee is extremely difficult. The stockholder will be unable to contact other stockholders unless they possess an accurate and complete list of their names and addresses. But the list of stockholders is invariably possessed only by the management and may be obtainable only after judicial proceedings which are themselves costly. If stockholders are compelled to institute suit in order to obtain the list of stockholders from the management, which usually will be the case, by the time that such proceedings are terminated the management may have obtained the consent of a sufficient number of stockholders to its plan.

CONCLUSION

The purpose of section 25, in essence, is to place the protection to be given stockholders of investment companies faced with voluntary reorganizations on the same plane as that afforded them in judicial reorganizations. Section 25 gives the stockholder, in addition to the safeguard of full disclosure, the protection of independent scrutiny of the fairness of voluntary plans by an unbiased body. This protection is deemed necessary by the Commission not because of any underlying philosophy that investors are incompetent to handle their own affairs. The simple fact is that because of the smallness of the financial stake in investment companies owned by the great majority of stockholders in such companies and their widespread geographical distribution it is impossible for such stockholder to take advantage of existing remedies which they have even if they know they have them.

Mr. SCHENKER. There was a great deal of discussion by the open-end companies, to the effect, "Well, if the shareholders do not like our management, they can get out."

Superficially, that sounds like an effective argument. Of course, that is not my concept of an investment company.

It seems to me that if I pay you a 10-percent load for the privilege of having my money managed, the fact that I can get out at any time should not be authority for the managers to mismanage my money. Furthermore, my concept is that I am investing in a going concern and that my status as a stockholder should not depend on the good behavior or misbehavior of the people running the company.

It does not help me any to say, "If you don't like my bad management or mismanagement, you can take your money out," because the difficulty is that by the time the mismanagement has taken place, my interest may not be worth much.

Furthermore, as in the case of the Maryland Fund and others, we can show you letters by the score where investors wrote to us about this situation and we had to reply:

> We are sorry, but the company can do that because the trust indenture says so.

A security dealer writes us:

> Don't tell me the trust indenture says that; because the salesman said I can get my money back any time I want it, and I can't.

That is the situation.

We should like to introduce a memorandum, an analysis of the trust indentures of the open-end companies which shows the extent to which they can suspend the right of redemption. Also you have the problem of corporate law about repurchases only out of surplus, some of the complications created by these corporate laws, and what effect that would have on the right of redemption.

Senator HUGHES. Very well; it will be included.

(Memorandum entitled "Redemption provision of open-end companies" is as follows:)

MEMORANDUM RE REDEMPTION PROVISION OF OPEN-END COMPANIES

The public has invested more than one-half billion dollars in the securities of open-end management companies, and is investing large additional sums at the present time.[1] Undoubtedly, the most important single attribute which induces purchases of the securities of open-end companies by the public is the so-called "redemption feature" of such securities—that is, the assurance that the shareholder may tender his shares to the company and receive at once, or in a very short time, the approximate cash asset value of such shares as of the time of tender. Not only does this "redemption feature" form the principal selling argument of the open-end companies but it constitutes the chief basis of the preferential tax treatment first accorded the so-called "mutual" companies under the Revenue Act of 1936 and continued under the Revenue Act of 1938.[2]

The importance of the "redemption feature" of open-end management companies was repeatedly stressed before this subcommittee by representatives of that branch of the industry during the past week. It was several times contended, among other things, that the shareholders of open-end companies ought not to be accorded voting rights, as is proposed in various sections of Section 3580, because their ability to exercise the "redemption privilege" is in effect tantamount to a voting right.

Although not concurring in the least degree with this latter contention, the importance of the redemption feature of open-end securities appears to the Commission beyond question. Accordingly, it has seemed pertinent to us to inquire precisely how certain and dependable for the investor is the "redemption feature" of the various open-end securities.

[1] See, for example, statement of Ferdinand Eberstadt of Chemical Fund before this subcommittee to the effect that Chemical Fund was started 2 years ago by himself and associates with an investment of $100,000, and now has assets exceeding $8,000,000.

[2] See Securities and Exchange Commission Report on Investment Trusts and Investment Companies, part II, p. 212, note 47, and part III, ch. III, pp. 3–5.

This inquiry was in fact forcibly suggested to us by receipt of a batch of letters last June and July from shareholders of The Maryland Fund, Inc., so-called open-end company, in which the public had invested more than $11,000,000 by the end of 1936, complaining that the company had wholly or partially suspended the redemption privilege for its shares. The study communicated with the company and received a reply from Ross Beason, its president, which read in part as follows: [3]

"Under the charter and under the prospectuses under which the stock of The Maryland Fund, Inc., was sold, the board of directors had the right, after the stock was listed as outlined in the prospectus, to withdraw the provision whereunder a shareholder might demand repurchase of his shares by the fund. Stock of The Maryland Fund, Inc., was listed on the Chicago Board of Trade on June 24, 1938. On June 7, 1939, the directors withdrew the right of resale to the fund, but instituted a regulation whereunder stockholders might deposit their shares with the fund, the liquidating value or repurchase price to be determined on the forty-eighth calendar day after deposit, and payment for the shares, less a discount of 3 percent, to be made within 3 full business days thereafter.

"On February 15, 1940, the board of directors rescinded the regulationa dopted on June 7, 1939, so that there is now no right of resale to the fund by shareholders."

The investment company's charter did in fact contain the clause adverted to by Mr. Beason. Unfortunately, it would seem that many investors do not study the complex provisions of investment-company charters before purchasing their stock. From the letters received by the Commission [4] it is clear that some, at least, of the shareholders had no idea that the charter of the company contained a provision permitting the company to nullify the redemption privilege merely by listing its securities on any stock exchange in a city with a population of 2,000,000. The effect of the withdrawal of the redemption privilege is indicated by the fact that the shares of the company are now selling at a discount of 25 percent from asset value,[5] which means that a stockholder desiring to sell his shares must suffer a loss of at least 25 percent because of the suspension of the redemption privilege, in addition to whatever loss he may suffer for other reasons. On the basis of total of assets, the aggregate loss in market value for all shareholders of this company has been over a million and a half dollars.[6]

Maryland Sponsors, the distributors of the shares of Maryland Fund, Inc., also sponsored another open-end company called Quarterly Income Shares, Inc., which at the end of 1936 had assets of $46,000,000. The charter of this company contained a clause respecting suspension of the redemption privilege identical with that of the Maryland Fund. This stock was also subsequently listed on the Chicago Board of Trade, and redemption of shares was then made subject to a waiting period of 48 days. The study has just learned that on February 15, 1940, the directors of Quarterly Income Shares further altered the redemption privilege to provide for redemption as of the 364 days after tender. This means a shareholder seeking to redeem from the company must wait an entire year before even learning how much he will receive for his share, and longer than that before he receives his money. Immediately before this change, the shares were selling at approximately asset value.[7] Immediately thereafter the price of the shares has dropped approximately 13 percent, in the face of an increase in the market average.[8]

A. TRUSTS

Of the 38 open-end companies studied, at the end of 1935 only 8 were in trust form, the remainder being corporations. Of the 8 trusts, 3 were organized in New York and 5 in Massachusetts. For the most part, the redemption provisions of the trusts are relatively dependable, although in several cases provision is made for suspending the redemption feature for any length of time that the New York Stock Exchange may be closed. The longest redemption period for the trusts as at December 31, 1935, were the 30-day provisions of Eaton & Howard Management Fund A, B, and F. Several indentures give the trusts the right to

[3] The full letter of Mr. Beason is appended at the conclusion of this memorandum. Without expressing any view as to its validity, attention is directed to Mr. Beason's opinion of the basic unsoundness of the open-end principle and his conclusion that "* * * we maintain that investment in a group of common stocks, coupled with a repurchase or deposit liability, is contradictory, and over a period of time will not prove workable in the best interests of stockholders."

[4] A copy of a letter received from a purchaser of the stock of the Maryland Fund, Inc., is appended at the conclusion of the memorandum. This letter is representative of others in the Commission file.

[5] Net asset value, February 29, 1940, $5.17; bid price, $3.90.

[6] Total net assets, February 1940, $5,899,745.

[7] Asset value, January 15, 1940, $8.15; bid price, $7.90.

[8] Bid price, February 29, 1940, 6⅞. Standard statistics 90-stock iudex on was 95.8 on January 15 and 96.3 on February 29.

determine liquidating values as of any day within a period of from 5 to 10 days, thus giving the managements the right to pick the lowest market within the allowed period.

Most important of the considerations affect the reliability of the redemption feature of certificates issued by business trusts is the possibility of abrogating such features through amendment of the declaration of trust or indenture. In the case of the three New York trusts, stockholders who dissent from any amendment to the trust indenture are entitled to have their stock redeemed. No such provision is found in the case of the five Massachusetts trusts. Instead, it is specifically provided that the indenture or declaration of trust may be amended if all (or merely a majority) of the directors so decide, provided a majority of the certificate holders assent (in only one case, the assent of two-thirds of the certificate holders is required). Although abrogation of the redemption feature would seriously impair the rights of the minority which did not assent thereto, these certificate holders would nevertheless presumably be without remedy, since they are expressly bound by all the provisions of the trust indenture, including the amendment provisions.[9] Relevant provisions as at December 31, 1935, of the eight trusts are summarized herewith. In some cases changes have been subsequently made in the provisions.

1. *Massachusetts Investors Trust* (Massachusetts trust, 1934).—Will repurchase at net asset value as of any date within 7 days after deposit, less 1 percent, but if New York Stock Exchange is closed, redemption right is suspended for the same period. Declaration of trust may be altered or amended at any time by written instrument signed by all the trustees and a majority of the outstanding shares.

2. *Century Shares Trust* (Massachusetts trust, 1928).—Trustees required to buy shares tendered to it for purchase, subject to following conditions: (1) That trust has available, or can secure, the funds necessary for the purchase, (2) that trustees may determine value as of any date within 10 days following tender, if New York Stock Exchange is open. Declaration of trust may be amended by unanimous action of trustees plus agreement of two-thirds of the certificate holders.

3. *Investment Trust Fund A* (New York trust, 1925).—Redeemable in cash or kind, at option of company, in 2 days. In case of amendments, dissenting certificate holders may redeem.

4. *Investment Trust Fund B* (New York trust, 1927).—Redeemable in cash or kind, at option of company, in 2 days. In case of amendments, dissenting certificate holders may redeem.

5. *Mutual Investment Fund* (New York trust, 1926).—Will redeem on the first business day of any month upon 10 days' previous notice. In case of amendment, dissenting certificate holders may redeem.

6. *Eaton & Howard Management Fund A1* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

7. *Eaton & Howard Management Fund B* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

8. *Eaton & Howard Management Fund F* (Massachusetts trust, 1932).—Must redeem in cash or kind within 30 days after notice of intention to redeem; valuation within 5 days of notice. Indenture may be amended if adopted by a majority of the trustees plus a majority in interest of the certificate holders.

B. CORPORATIONS

Of the 30 corporations studied, 7 were incorporated under the laws of Massachusetts, 7 under the laws of Maryland, 14 under the laws of Delaware, and 2 under the laws of the Dominion of Canada. Almost all the corporate charters which contain redemption provisions limit redemptions to surplus legally available therefor, or to assets or funds legally available therefor. Likewise, almost all the charters expressly or by implication provide for suspension of the redemption privilege for such period as the New York Stock Exchange may be closed, and in 1 case,[10] for such period as the Standard Stock and Mining Exchange of Canada

[9] Although an attempt to amend the redemption provisions of an indenture would doubtless cause a spurt in demands for liquidation, the extent of such increase would depend upon the speed with which the amendment was effected. In the case of trusts which impose a waiting period (e. g., 30 days for Eaton & Howard) the question would arise whether the shareholders' rights become vested as of the time of giving notice to redeem, or as of the end of the waiting period—at which time amendment may already be in effect.

[10] United Gold Equities of Canada, Ltd.

is closed. Four corporations reserved the right to withhold payments for a period of 60 days,[11] and others for a somewhat lesser period.

The charter of State Street Investment Corporation (the third largest open-end company in the country) is silent as to any redemption rights on the part of stockholders. The privilege rests on a resolution adopted by stockholders in 1933 authorizing the directors to redeem. It seems likely that this provision can be suspended at any time by a majority vote of stockholders, if not by action of the board of directors alone. The charter of Wellington Fund, Inc., is likewise silent as to redemption rights, the provision being merely incorporated in the corporation's by-laws, which may be amended at will by the board of directors. Spencer Trask Fund, Inc., and Premier Shares, Inc., have no redemption provisions in their certificate of incorporation, the former setting forth the redemption privilege in a contract between itself and the fund manager, the latter in an indenture pursuant to which the shares have been issued. Quarterly Income Shares, Inc., and Maryland Fund, Inc., provide in their certificates of incorporation that they will redeem their shares only until they are listed on a stock exchange (in any city of 2,000,000 or more population) and thereafter if the board of directors permits. It is our understanding that both companies have wholly or partially suspended redemption, after having listed their shares on the Chicago Board of Trade.

Supplementing the restrictions placed on redemption privileges by the provisions of charters, and the discretion to affect such privileges adversely by the failure to safeguard them through appropriate provisions in charters, are the further restrictions arising from the statutes of the States under which the various corporations have been, or may be, organized. At common law a corporation could ordinarily not purchase its own stock if its capital was impaired or if such purchase would result in an impairment of capital. In many States this is still the rule; New York, for example, has made it a penal offense for directors to permit the repurchase of their corporation's shares "out of any of its funds except surplus." [12] Open-end corporate investment companies subject to such State laws obviously must cease to redeem their shares whenever surplus is exhausted.

In order to circumvent this restriction, many corporations employ the expedient of allocating a large part of the consideration received from the sale of their stock to paid-in surplus account. This expedient is not, however, always available; and even where available is apparently not always taken advantage of. In several States paid-in surplus cannot be created;[13] in others, it is limited to a fixed percentage of the consideration received or otherwise;[14] and such restrictions seem to be the trend of modern corporation law.[15] In still other cases the use of paid-in surplus for repurchase of shares is restricted or prohibited.[16]

That the possibility of restrictions on redemption of stock is not ephemeral is evidenced by the fact that State Street Investment Corporation had a capital impairment at the end of 1930 of $2,700,000, and at the end of 1931 of more than $6,000,000.[17]

State Street Investment Corporation was not forced to suspend its stock repurchases when its capital was impaired, because under decisions of Massachusetts' courts a corporation may repurchase its own shares even though capital is impaired, so long as it is able to meet its debts and obligations as they mature.[18] However, had this company been subject to the laws of Delaware, as 14 of the present open-end investment corporations are, it would seem that the redemption

[11] State Street Investment Corporation; Spencer Trask Fund, Inc.; Fidelity Fund, Inc.; Premier Shares, Inc. It has been frankly admitted by at least 1 open-end company (Maryland Fund—see letter of June 19, 1939) restrictions are limited to 60 days only in order not to lose the tax preference granted to mutual investment companies by the Revenue Act of 1938 (secs. 361, 362). The regulations of the Commissioner of Internal Revenue define a mutual company as a company whose shareholders are entitled to redemption within 60 days, even though such privilege may be further suspended on account of emergencies, etc. (sec. 19-361-2, regulations 103, par. D).

[12] Penal Law of New York, sec. 664. Restrictions on purchases out of capital are also found in Delaware, Michigan, Nevada, Arkansas, Florida, Indiana, Pennsylvania, Rhode Island, Tennessee, West Virginia. Under Kentucky law (sec. 544), shares may be repurchased only to prevent loss on a debt previously contracted and may not be held longer than one year. Connecticut (sec. 3423) requires a three-quarter vote of stockholders "unless to prevent loss on a debt previously contracted."

[13] Florida (sec. 6547) and Indiana (sec. 1 h). Cf. Virginia (sec. 3840).

[14] Michigan (sec. 20) requires the capitalization of at least 50 percent of the consideration received for shares without par value. Canada (sec. 12 (7)) limits paid-in surplus to 25 percent of the consideration received. California, Colorado, Minnesota, Pennsylvania, and others provide that the consideration received for preferred stocks must be credited to capital.

[15] See Hills, Model Corporation Act (1938), 48 Harv. Law Rev. 1334.

[16] Illinois (sec. 6) prohibits purchase of shares from paid-in surplus. California (sec. 342) and Minnesota (sec. 21) limit purchases to earned surplus except in special cases.

[17] Reply to Commission's Questionnaire for State Street Investment Corporation, Pt. II, Ex. A, Schedule 20.

[18] See *Crimmins & Pierce Co.* v. *Kidder Peabody Acceptance Corporation*, 185 N. E. 383, 83 A. L. R. 1122.