would prevent you from paying a preferred stockholder a dividend, even though it is a limited amount.

Section 20, "Proxies; voting trusts; circular ownership," is substantially the same as in the old bill.

Section 21, "Loans," is substantially the same as in the old bill.

With respect to dilution, we have this suggestion: That in the first instance the National Association of Security Dealers under the Maloney Act should deal with that problem to see if they can work it out within a year. After the year, the Commission can make rules and regulations with respect to that problem.

The approach is that if the dealers can work it out to the satisfaction of the Commission we shall be glad to see the industry police itself. If the Commission feels they have not dealt adequately with that problem in accordance with the standards set forth in the act, then the Commission can provide rules.

If the association adopts rules satisfactory to the Commission, then the Commission can make them its own, and everybody will be subject to them, whether a member of the association or not.

Senator WAGNER. That is interesting. Where is that?

Mr. SCHENKER. Page 65, section 22.

Senator WAGNER. All right.

Mr. SCHENKER. Page 70, section 23, "Distribution and repurchase of securities": In order to stop this practice in the old days of issuing stock of investment companies for personal services, this bill says that no company hereafter can issue any of its stock except for cash or securities. We have included provision that no company can sell its own stock below asset value, except in accordance with the limitations we have here prescribed.

In connection with the repurchases by closed-end companies of their own stock, we have made a provision that they can do it in the open market; they can do it by tenders, in accordance with such rules as the Commission may formulate. However, they must tell the stockholders, in advance, of their intention to repurchase their own stock, so that all their stockholders—and not only the officers and directors—know when the company is repurchasing its own stock.

That is a very salutary provision. The stockholder who is not an insider knows that the company is doing it, and he can make up his mind whether he wants to avail himself of the opportunity and sell his stock back to the company. He is approaching a parity of treatment with the insider.

Section 24, "Registration of securities under Securities Act of 1933," is the same as the previous draft.

Section 25, on page 73, "Plans of Reorganization"—you remember the old proposed bill provided that reorganizations should be subject to the approval by the S. E. C. That provision was opposed. The compromise we have worked out is that in connection with a reorganization which includes general offers of exchange.

Senator WAGNER. You are speaking of legal reorganizations?

Mr. SCHENKER. I am talking of voluntary reorganizations.

Senator WAGNER. Oh, yes.

Mr. SCHENKER. Reorganizations under 77 (b) we do not touch.

Senator WAGNER. Yes.

Mr. SCHENKER. There is a specific provision here stating that no provision here shall act in derogation of the power of the courts under the Bankruptcy Act.

But the voluntary reorganizations, mergers, and consolidations do not require the approval of the S. E. C. However, if any investment company that is involved in that type of transaction wants to get an advisory opinion from the Commission with respect to the fairness of the plan, the Commission is authorized to issue such an opinion on that plan; or if 25 percent of the security holders want the Commission's advisory opinion, they can get such an opinion.

Otherwise, the jurisdiction of the Commission is limited to the power to go to a court of equity and obtain an injunction against the plan, if the plan is grossly unfair. The term "grossly unfair" was selected in order not to include that type of situation where there may be a reasonable and honest difference of opinion as to the fairness of the plan. However, if it is obviously unfair, then the Commission is authorized to get an injunction and stop the consummation of the plan.

Senator WAGNER. Then of course there is the court review.

Mr. SCHENKER. Yes; then there is a court review; that is correct.

Senator WAGNER. I meant that the injunction, of course, in itself gives the court review.

Mr. SCHENKER. That is right; that gives the court the right to review the plan, to determine whether or not it is grossly unfair.

Senator WAGNER. Yes; or whether you are acting arbitrarily.

Mr. SCHENKER. Section 26, "Unit investment trusts," is the same.

Section 27, "Periodic payment plans," except for some changes in the language, in the technical aspects, is the same.

Section 28, "Face-amount certificate companies," Judge Healy has explained the situation on these companies. We hope to be able to agree with them by tomorrow; and then we shall submit to the committee a draft of the language.

Section 30, "Periodic and other reports," on page 89, is in some respects the same as the old draft, except there is a more detailed itemization of the items that have to go into the report to stockholders. Rather than having broad language, we attempted to set forth those things which the report should deal with.

Section 32, "Accountants and Auditors," is substantially the same as the old bill, except I should like to call the committee's attention to one factor that the next draft I should like to submit will include a provision that hereafter the accountant must be selected by the directors who are independent of the managers and the officers. Such selection has to be ratified at the next meeting of the stockholders; and the stockholders, by a majority vote, shall have the right to remove that accountant; and, fourth, any certificate or report of the accountant must be addressed to both the directors and the stockholders.

So that you have the element here of the accountant in the future having some responsibility to the stockholders. The initial selection will be made by the independents on the board of directors, and he will be in all respects the accountant for the stockholders as well as for the directors, Senator.

Senator WAGNER. Let me ask you this: How do you define an independent?

Mr. SCHENKER. Senator, an independent director is a director who is not an investment adviser to the company, he is not a partner of that investment adviser, and he is not an officer or employee of the company.

That is, the accountant has to be selected by those people on the board of directors who have no pecuniary affiliation with the manager and have no affiliation with the officers and directors.

Senator WAGNER. Yes.

Mr. SCHENKER. With respect to section 33, "Settlement of civil actions"—settlements of lawsuits—you remember that there was a provision in the old bill for the Commission's participating in that type of situation. What we have done with that is that we have made provision that in connection with certain types of lawsuits under certain conditions the information shall be filed with the Commission, so that the Commission can study that and see how to deal with that very important problem of representative actions against investment companies, so that we shall get the information with respect to that type of situation.

Section 34, "Destruction and falsification of reports and records," is virtually the same.

Section 35, "Unlawful representations and names"—so far as the future is concerned, we can stop any name that is misleading. So far as the present situation is concerned, it presents a somewhat more complicated problem. The Commission has the power, if the name is misleading in a material respect, to get an injunction restraining them from using that name.

We had to distinguish between new companies and old companies because certain goodwill has been built up with respect to existing names. You have the Tri-Continental Corporation. We do not want to stop that name, although a person might say, "I thought I was going to invest in a company which invested in securities of three continents." That name is not materially misleading and we do not want to disturb the goodwill that the company has built up.

However, in the future if a company wants a name of "Old Age Secured Investors," that type of representation and that type of name will be stopped.

We have incorporated a provision which gives the Commission the right to institute an action to get an injunction where the officers and directors and their affiliated persons are guilty of gross abuse of trust or gross misconduct—section 36, "Injunctions against gross abuse." In that case the Commission goes to court; and the person will have a right to have his case passed on by a court.

In connection with section 37, "Larceny and embezzlement," we have specifically incorporated that provision because of the difficulties that we see the Federal Government has encountered in connection with the enforcement of any of its acts. The Government is required to spell out a mail fraud case. This bill contains a provision that anybody guilty of embezzlement of investment company funds shall be guilty of a Federal crime and shall be prosecuted for that crime.

With respect to section 38, "Rules, regulations, and orders; general powers of the Commission," I think the only substantial change there

is that we have made provision that before the rules and regulations are formulated, the Commission, as a matter of policy, should confer with the representatives of the industry before it formulates its rules.

In order not to create other problems of jurisdictional defects, we have attempted to eliminate that aspect of the problem by saying that the Commission is not bound by the record and, therefore, can rely on its own knowledge and information and other sources of information. The record made does not constitute a basis for review.

The principle is that it is a statement of the declaration of the policy of the Congress. The S. E. C., before it formulates its rules and regulations, should continue the practice it has followed in the past, of conferring with the industry before it formulates the rules and regulations.

I think that is substantially right, is it not, Mr. Healy?

Mr. HEALY. Yes.

Mr. SCHENKER. The rest of the provisions are similar, except I should like to make this observation: that we have not given the definitions the same thorough going over that we have given the other sections; and we are still polishing those definitions. We hope to make them available in the future for the committee's consideration.

Senator WAGNER. Of course I have not read the bill; but in connection with the making of rules, you say that a policy should be expressed for consultation with the industry's representatives? I was not very clear about that.

Mr. SCHENKER. Yes; on page 101, Senator, section 39 (b).

Senator WAGNER. What are the mechanics of it?

Mr. SCHENKER (reading):

> It is hereby declared to be the policy of the Congress that, before issuing under this title any rule or regulation which affects the substantive rights, privileges, or obligations of any class or classes of persons, the Commission or appropriate officers of the Commission consult with representatives of the classes of persons thus affected, if and to the extent that such consultation is practicable and consistent with the public interest. It is likewise declared to be the policy of the Congress that whenever there is a substantial demand for a public hearing regarding the provisions of any such rule or regulation, and under the circumstances such a hearing appears practicable and in the public interest, such a hearing be held before the issuance of such rule or regulation. The effectuation of the policy of this subsection is committed exclusively to the Commission, which shall not be bound or confined to any record made in the course of any such consultation or public hearing, and the exercise of the Commission's discretion hereunder shall not be subject to judicial or other review; but it shall be the duty of the Commission, in each annual report submitted to the Congress pursuant to section 42, to describe the practices and experience of the Commission under this subsection during the preceding year.

Unless you have phraseology like that, Senator, you may get yourself into difficulties every time you formulate a rule or regulation. The question may be raised: "Did you conform with the precise method of giving notice?"

Or you may get yourself into a situation where nobody shows up for a hearing where, apparently, no one has any interest and no formal record is made.

Senator WAGNER. These rules and regulations are not subject to review at all, are they?

Mr. SCHENKER. Yes; they are.

Senator WAGNER. I thought you read that they are not.

Mr. SCHENKER. No; I said—

The effectuation of the policy of this subsection is committed exclusively to the Commission, which shall not be bound or confined to any record made in the course of any such consultation or public hearing, and the exercise of the Commission's discretion hereunder shall not be subject to judicial or other review.

Senator WAGNER. Oh, yes; I misunderstood.

Mr. SCHENKER. I thought the record should indicate unequivocally that to no small extent the industry itself is responsible for the inclusion of this provision, as well as the Commission. They feel that this is a way, so far as the industry is concerned, of dealing with the whole subject of rules and regulations.

Senator WAGNER. How do you determine whom in the industry you should notify? You do not have anything in the law about that.

Mr. SCHENKER. If they have an association, then it is a comparatively simple matter.

Senator WAGNER. Yes.

Mr. SCHENKER. The fact of the matter is that in the past, Senator, before any rule—so far as I know, and I was in the Trading Division and in the Investment Trust Division——

Senator WAGNER. Yes.

Mr. SCHENKER. Before any rule was formulated the Commission called in the people who were affected by it. If it affected exchanges, we consulted with the representatives of the exchanges; if it affected underwriters, we called in the underwriters.

Here we had no difficulty in getting the representatives of $2,500,000,000 to $3,000,000,000 of the industry to talk to us for a period of 11 weeks. The Commission has always followed, so far as I know, this procedure.

As I say, that has been the general policy, although I am not sufficiently familiar with every instance of the formulation of a rule or regulation by the Commission.

Senator WAGNER. Yes.

Mr. SCHENKER. But that is what the Commission has attempted to do. This bill contains a codification of this practice and an expression of intent of what the Commission expects to do in connection with rules and regulations in the future.

Mr. HEALY. If I may interpose for just a moment, please?

Senator WAGNER. Yes.

Mr. HEALY. I do not believe that, when you get to the point of trying to write a rule, you can get much benefit or put much dependence on the mere legal formalities; that is, if you can sit down around a table with a group of people who are interested in a particular subject and discuss what a rule ought to be, I think you accomplish a great deal more than when you make a formal record and have a lawyer make a speech.

Senator WAGNER. Yes.

Mr. HEALY. By this method that this statute envisages, you are also in a position where, if you have had some experience—as most of us have had down there—in the particular subject with which you are dealing, you are not expected to throw that experience out of the window, when you come to write the rule, and give your attention merely to formal testimony any more than a member of this com-

mittee, when he comes to deal with legislation, may not use his own common sense and knowledge as well as anything that is in the record.

Also you have to look out for the unpredictable emergency which comes up, as it frequently does, where you have to write a rule in a hurry or, again, to repeal a rule in a hurry.

For example, if the S. E. C. found itself in the position where it was very desirable to suspend trading on the stock exchange for any length of time or to suspend trading in particular securities—which we have authority to do to a limited extent and to a further extent with the approval of the President—if the situation were bad enough to warrant any such action, I do not think there would be very much time for court reviews, notices, and formal records.

Senator WAGNER. Yes.

Mr. HEALY. And a great many of the rules that we pass, especially in the nature of exemption rules, are rules that are proposed by the various industries; they are for their benefit.

Senator WAGNER. Then, it was the industry that suggested this particular provision? Is that so?

Mr. HEALY. My memory is that this suggestion originated with Mr. Jaretzki, during the hearing. Is that right?

Mr. JARETZKI. That is right.

Mr. SCHENKER. Senator, if I may be so bold as to express a personal word, I think I ought to express my personal appreciation of the most valuable help given us by the industry, particularly Mr. Alfred Jaretzki of Sullivan & Cromwell, Mr. Warren Motley of Gaston, Snow, Hunt, Rice, & Boyd, and Mr. Paul Bartholet of the Tri-Continental Corporation, and the assistance of Mr. Charles Jackson, Jr., of Gaston, Snow, Hunt, Rice, & Boyd, and Mr. John Sheffey, of the Tri-Continental Corporation, who have worked day and night with us to try to put this proposed bill in proper shape.

Senator WAGNER. You are all to be complimented. I think it has been a magnificent cooperative result.

Senator HUGHES. We appreciate the cooperation very much; because, of course, we do have doubts about a great many of the things; and we are glad that the industry itself has tried to cooperate in working out a real plan. It is very helpful to us.

Senator WAGNER. In talking it over with the Senators, I know that one of the things about which we were concerned was this: While we were very anxious to remove the abuses, we did not want to do anything that would injure legitimate industry; and that is a problem that you gentlemen, yourselves, have solved, I think.

Now, we shall have to hear from the representatives of the face-amount companies; and then what else is there to be done?

Mr. HEALY. The investment advisers—that is, we may not be able to agree; and if we cannot, then we shall report back to the committee as to the respects in which we can agree and the respects where we disagree.

Senator HUGHES. It ought to be done very soon.

Mr. HEALY. Yes; I think Monday morning ought to be the latest and should be the deadline. I think the committee could very properly fix it.

Senator HERRING. It looks as if you are going to get along with the face-amount companies.

Mr. SCHENKER. Senator, I have been meeting with them day and night. They have been very helpful, and I think we can get together.

In connection with the investment advisers, I think that Robert Page who represented Scudder, Stevens & Clark—you remember Mr. James White of that firm testified with respect to that bill—submitted a draft of the bill to us, which is the draft that is included in this new bill. I have not heard any opposition from any investment advisers. I cannot say and Judge Healy cannot say—as we are able to say with respect to the close-enders and the open-enders—that we have their affirmative approval. The only thing we know is that they have not disapproved the bill. We do not have the same affirmative approval with respect to that title of the bill as we have with respect to title 1.

That does not mean that anybody is opposed to it or that anybody besides Scudder, Stevens & Clark is for it. Do you see what I mean?

I know of no way of being able to say to the committee that this title 2 has the same sanction that title 1 has.

There are just one or two slight changes in title 2; and I personally feel that there will not be any vigorous objection to it. I think we have tried to meet all the objections that were asserted at the committee hearing.

Mr. HEALY. May I say one further word?

Senator WAGNER (chairman of the subcommittee). Certainly.

Mr. HEALY. That is this: If we do not come to an understanding with the face-amount people, I think it is quite possible that we shall recommend to the committee that the provisions relating to face-amount companies be dropped from the bill completely, and that they be made the subject of separate study and separate legislation.

In other words, if there is a chance of getting the rest of the bill through without that, then I think it is wise to take it.

Senator HERRING. I think that is wise.

Mr. SCHENKER. Yet, on the other hand, in fairness to them, I think the record should indicate that they want legislation and are trying to cooperate with us; and if they can work it out, I think it ought to be included. I think legislation will be helpful to them and will be helpful to the investors.

Senator HERRING. Is not one of the difficulties with them the matter of transfer of securities?

Mr. SCHENKER. On that aspect they do not really disagree with us.

Senator HERRING. No; but are there not difficulties?

Mr. SCHENKER. They say they have difficulties with five States which, by statute, require them to make a deposit with the State's securities commissioner. They would love to see a situation where they can deposit with a central depository.

Senator HERRING. Yes.

Mr. SCHENKER. The question in Judge Healy's mind and in my own mind is as to which is the most effective way of accomplishing that end. Shall we attempt at this time—which would be a great help to those companies—to include in this legislation such provision which would put everybody in the country who is a certificate holder in that type of company on a parity?

What is the best way to accomplish that purpose? Is it to let the status quo go on, so far as the future is concerned, to prevail upon the securities commissioners to conform to a new policy to be contained in this bill.

Senator HERRING. You see our position. We are protecting our face-amount policyholders and are taking care of them, and we are not going to give up that security, for some State that does not take care of them.

Mr. HEALY. We have the problem of future sales.

Senator HERRING. Yes; that is all right.

Mr. HEALY. They are in trouble with future sales; because they are not permitted to make sales in certain States without making certain deposits. It seemed to me that Congress should not consciously or expressly permit inequalities between its own citizens. in the administration of the law.

Senator HERRING. Not in the future.

Mr. HEALY. That is right. So our problem seems to be to try to work out some scheme with the face-amount people whereby they can satisfy State requirements and at the same time prevent any inequality and create the same kind of protection for all of their investors all over the country, that a few good State commissioners have succeeded in doing here and there.

Senator HERRING. Of course, that will require legislation in these States, before they can do that.

Mr. HEALY. I think it may possibly be done without that.

Senator HERRING. You will have to change our statute which compels them.

Mr. HEALY. No; under this suggestion, which I heard for the first time last night—and I am not committed to it—but under the suggestion I heard last night, they would continue to make deposits, just as the State law requires, and then they would make a deposit with the national agency, which would be maintained at such a rate that in case of the liquidation of the company, all the security holders would receive approximately the same rate of return.

Senator HERRING. Could we make a double deposit?

Mr. HEALY. It would not require a double deposit.

Senator HERRING. It would not?

Mr. HEALY. What would happen if the company went into bankruptcy would be this: The people in your State should use up the deposit; and then if it had not been paid for in full, when they came to take their share out of the national deposit, there would be an equalization process there, so that their share of the settlement recovered would be the same as everybody else's. But in the meantime they would have that deposit.

Senator HERRING. Yes; it might be done in that way. Then they would have all the security?

Mr. HEALY. Yes.

Senator HUGHES. Mr. Chairman, I move that we recess or adjourn, to meet on Tuesday morning.

Senator HERRING. Do you have a regular meeting Tuesday?

Senator WAGNER. I do not think we have a meeting of the full committee then.

Mr. SCHENKER. And by that time we hope that we shall be able, on Tuesday, to give you a final bill, down to the last comma and period.

Senator WAGNER (chairman of the subcommittee). Yes; and then the rest is up to the full committee; and I cannot predict what they will do. Thank you.

Mr. SCHENKER. Thank you, Senator.

Mr. HEALY. Thank you, sir.

(Thereupon, at 12 o'clock noon, a recess was taken until Tuesday, June 4, 1940, at 10:30 a. m.)