

So we are in process of discussing with the Federal Reserve Board the language or phraseology which we think would eliminate those bank holding companies which ought to be exempt from the purview of this legislation.

You have, then, a definition of the type of company which is encompassed by this bill, and you have the specific exemptions also. You have the provision which gives the Commission power, in certain instances, to make additional exemptions.

Our next problem was, after the area of investment companies had been circumscribed, to see if we could not set up a simple system of classification of investment companies. That is an important problem, because if you look at the sales literature or the circulars, or even the prospectuses, and particularly if you look at the articles of incorporation of these institutions, they have the broadest powers.

That is a strange thing, Senator. Here is a type of institution which is supposedly organized to invest or handle people's savings. In some respects it is not unlike an equity savings bank, rather than a legal savings bank. Yet, when you take a look at their articles of incorporation they have got the same ones that the United States Steel Corporation has. There is absolutely no limitation in the articles of incorporation as to the activities they can conduct or as to the business they can engage in.

I shall not take much time on that, but I would like to read the topic sentence of each paragraph of the articles of incorporation of a corporation which I have before me. [Reading:]

To manufacture, improve, and work upon minerals, metals, wood, oils, etc.
To manufacture, improve, repair, and work upon any and all kinds of machines, instruments, tools, implements, mechanical devices, etc.

To own, purchase, lease or otherwise acquire lands and/or coal, oil, gas, mineral, and timber rights, etc.

To plan, design, construct, alter, repair, remove or otherwise engage in any work upon bridges, railroads, dams, canals, piers, etc.

To buy, sell, exchange, trade, and otherwise deal in any and all kinds of manufactured articles, etc.

To carry on the business of trucking, warehousing, and storage, including the storage of all kinds of goods, wares, and merchandise, etc.

To acquire, buy, hold, own, lease, manage, and control lands, interests in lands, concessions, railroads, canals, etc.

To acquire, buy, hold, own, sell, lease, exchange, dispose of, finance, deal in, construct, build, equip, improve, use, operate, maintain, and work upon (a) any and all kinds of plants and systems for the manufacture, storage, utilization, supply or disposition of electricity, gas or water, etc.; (b) any and all kinds of interurban, city and street railways, railroads, and bus lines, etc.; (c) any and all kinds of works, power plants, substations, systems, tracks, machinery, etc.

To acquire, buy, hold, own, sell, lease, exchange, dispose of, distribute, deal in, use, produce, furnish, and supply electricity, gas, etc.

To undertake, manage, and control any and all kinds of scientific, historical, geographical, artistic or other enterprises and investigations, and to conduct, promote, and finance any and all kinds of experiments, investigations, expeditions, and explorations in aid thereof, etc.

This goes on——

Senator WAGNER. What is excluded?

Mr. SCHENKER. Nothing is excluded.

Senator WAGNER. Do you mind saying what company that is? That is, is it a substantial company?

Mr. SCHENKER: Well, Senator, I am not citing this as a horrible example——

Senator WAGNER (interposing). I am not talking about that; but is that charter the charter of a very substantial company?

Mr. SCHENKER. It is a substantial company, in existence at the present time. But, Senator, from the little you have heard, a great many of these investment trusts have gone into that. You have had the instance where a subway was bought in Buenos Aires; where they bought the Venezuela Oil Co., and where they bought other investment trusts.

I want to be clear on this, Senator. This bill does not say that they cannot go into that business. The fundamental approach of this bill is that if you are going to go into that business, you have got to tell your stockholders you are going into that business. If you find you cannot make money, and you want to go into the business of acquiring South American subways, all you have to do is to tell your stockholders, "We have not been able to make money speculating on the stock market; we would like to change the nature of our activities, and since you bought in reliance upon the fact that we were going to deal in listed securities, and we want to change the nature of the business, we are just getting your approval to change the nature of it."

What are the classifications that we have devised?

There is the certificate company which issues these unsecured promissory notes which it sells on the installment plan. That is one type; and we will discuss their problems when we come to that section.

Then there is the so-called fixed trust, which is a device whereby they sell an individual an interest in a package of securities, a list of which is made known. In essence, they cannot change the package except under certain circumstances. He gets a small cross-section of the securities listed on the New York Stock Exchange. Those are put into a package in a safety deposit box, and there is no management, and the value of his interest in that package gyrates with the fluctuations in the stock market. That is why we call it a fixed trust.

Senator HUGHES. Does that belong to him or to other stockholders too?

Mr. SCHENKER. He acquires by the purchase of the certificate an undivided interest in that package. The package consists of quite a few securities in pretty substantial blocks. There is a corporation which is known as the depositor corporation that makes up a package. Each package is identical because the trust indenture specifies the securities to go into the package. It is deposited with the bank, which is a trustee. In essence, it is merely a custodian, because it has no trustee functions. That is one of the difficulties with these installment plans and fixed trusts. They say the bank is a trustee, and you think you are getting a trustee service, that you are getting their investment judgment, their investment advice, when the fact of the matter is that the bank is only the custodian of the securities.

Senator WAGNER. Like a storage warehouse?

Mr. SCHENKER. Yes; like a storage warehouse. They deposit it with the trust company or bank, and certificates are issued representing a beneficial undivided interest in the package. The price of the certificate is computed this way. They take all the securities, find out what the market value is, the total market value, and divide it by the number of certificates outstanding. That gives you the present market value of the certificates; and then they sell new certificates to the public.

Senator HUGHES. There may be hundreds that are interested in that particular package?

Mr. SCHENKER. That is right, Senator. Legal title of course is in the trustee. The certificate holder, in legal contemplation, is the cestui que trust.

Senator WAGNER. You say they have a trust indenture?

Mr. SCHENKER. That is right.

Senator WAGNER. Which sets forth the securities held?

Mr. SCHENKER. Yes.

Senator WAGNER. Is there a provision that those securities cannot be substituted for other types of securities?

Mr. SCHENKER. I will take one second to explain that, Senator.

Senator HUGHES. They can be sold, can they not, and others substituted?

Mr. SCHENKER. That is the same question that Senator Wagner asked. I will take a minute to explain that.

The first type of investment company was the closed-end type. Let us say the company decided to raise \$100,000,000, and in one public offering they raised it, and that was the fund they managed for the public. Up to October 1929 almost all the investment companies ever formed in this country were of that type. They raised \$100,000,000 or \$60,000,000 or \$50,000,000 through one public offering; and the emphasis, of course, as you have heard from Mr. Stern in connection with the Founders group of investment companies was that this was a device to give you expert management and diversification. And I am not being critical, because hindsight is better than foresight. But the expert management did not materialize; and after the crash in 1929 the management companies sustained terrible losses. As we will show a little later on, Senator, some of those losses were not attributable merely to the decline in security prices. Some of them were attributable to transactions between the insiders and their investment trusts.

But in any event, these companies which were supposed to be managed by experts sustained bigger losses, or as big losses as anybody else, whereupon the confidence of the American public in the expertness of the people who were managing these companies faded a little bit. As a consequence, you found that investment-company securities were selling at what we call a discount; that is, that their market price was less than their asset value. If you liquidated the company and realized the market value of the securities that the company held, and distributed it to the stockholders, the stockholders would get \$50 per share. However, the securities were not selling at \$50. They were selling in the open market for \$25. In many instances there was a lack of confidence of the American public in the expertness of their management, because they were in effect saying that a dollar in the hands of these expert managers is worth only 50 cents.

So there was this reaction about these managements, and an individual who wanted to liquidate his interest in an investment company had to sell his securities at a discount ranging in some instances up to 50 percent.

Then they devised these fixed trusts. They said the difficulty with investment trusts in the past was that you had too much management. You did not know ultimately in what security your money was going to be invested, because these managers had the broadest

power. They could invest in anything. So they said, "We will eliminate the abuses of these closed-end management companies. First, we will tell you in what securities we are investing, and we will never shift. Secondly, we will make this arrangement, that if you want to tender your certificate you can get in cash or in your aliquot share of your securities, the asset value of your shares."

So in that respect they were open-end companies.

We will have somebody describe the terrific amount of securities of fixed trusts which were sold. My recollection is that in a short period of time they sold \$800,000,000 of fixed trusts.

What happened? They bound themselves in their trust indentures so rigidly that they could not eliminate or substitute the securities except upon the happening of a certain contingency; and one of the early contingencies was that if the company passed a dividend it had to be eliminated. But when a company passed a dividend, that was the worst time to sell its securities. So they had to eliminate out of the package those securities which passed a dividend, which was the worst time in which to eliminate them.

Through the years, through experience, they became less rigid, so that today, in essence, a great many of them are really management companies which disclose what they call the primary list of securities they can invest in, and a so-called secondary list from which they can substitute into the primary list.

Does that make it clear, Senator?

Senator WAGNER. Yes. That secondary list is set forth, is it?

Mr. SCHENKER. It is. But there are a great many aspects of that. In many instances the management has a right to change the secondary list without the consent of the stockholders, and so forth.

The third type of company is the so-called management company, where the management is given untrammelled discretion as to the investment that can be made. There are, therefore, three big categories of investment companies: Face amount certificate companies, fixed trusts, and the management investment type where the management has the right to make any investment it wants to, except in some instances, subject to certain limitations.

Here you have this big class of management investment companies, and it was incumbent upon us to try to get a subclassification of these management investment companies.

There is a broad classification based upon whether the stockholder has the right to tender his certificate and get his money, his asset value, or whether he does not have such a right. We say the management investment companies are divided into two broad classes: One, open-end which gives the stockholder the right to compel redemption of his share; and closed-end companies into which he does not have that right.

I would like to point out, Senator, that the open-end company is the one in which the stockholder can compel the company to redeem his share. It is not the situation where the company can call his stock, as in the case of callable preferred stock. The right to require the redemption must be in the stockholder.

Having subdivided these companies into those in which the stockholder has the right to tender his security and get his asset value, and those companies in which he does not have that right, we then tried to classify management investment companies on the basis of

their investment policies. The first classification is really one of structure; the second classification is based upon the answer to the question, "What is the nature of your activities? What are you going to do with the money that is turned over to you to invest?"

Senator WAGNER. I would like to ask a question here that I forgot to ask Mr. Bane when he spoke about open-end corporations. He recited instances of diluting the assets by fixing the basis of redemption, I suppose you might call it. Was that the general practice of open-end corporations, or was that just in specific instances? Was that a general practice, or not?

Mr. SCHENKER. Senator, the only way I can answer that question is that that dilution is possible in every open-end company.

Senator WAGNER. I understand that.

Mr. SCHENKER. As to the extent to which it was done actually, I think Mr. Bane is better qualified to pass upon than I am.

Senator WAGNER. I will ask him at another time.

Mr. SCHENKER. He made a specific study.

Mr. BANE. You can ask me now if you want to, Senator.

Senator WAGNER. Perhaps this is a good time to ask it. I forgot to ask you that question before.

Mr. BANE. I presume you are referring to instances where they could redeem the share at a greater price than the share was worth at the particular time of selling?

Senator WAGNER. Yes.

Mr. BANE. That was not the practice in all cases. There were generally three ways, with some minor exceptions, by which shares were redeemed. You sell today at a price based on yesterday's close. The market has risen. You present your share for redemption. You get his redemption price; you know the closing price of the market this afternoon. If that is higher, you get a higher price for the share, of course, than the price at which the share sold.

There are other cases where you get, on redemption, the asset value of the stock at the moment or hour you present it for redemption. If the price on a rising market is higher than the closing price the day before, you would, of course, get a larger price for your share than the price at which the share is selling.

There are other cases. Another one is that you present your share for redemption today. You are paid the price as of tomorrow's close. There, of course, you take the chance of whether tomorrow's close will be higher or lower than the price at which you buy.

I should say most of these cases, in my estimation, fall into the first two classes.

Senator WAGNER. Of course the industry may be able to explain that as a perfectly proper practice, but it seems to me that the investor was not being treated fairly there.

Mr. BANE. That was the point I tried to make, Senator.

Senator WAGNER. If you sell at a lower price than the actual redemption value, you are depriving the present shareholder of a part of that fund to which ordinarily he would be entitled. Is not that so?

Mr. BANE. As Judge Healy suggests to me, Senator, it is like watering good whisky.

That is quite general; and I tried to make it clear that during the periods when the market price rose, in a great many of these trusts it is possible to buy the securities right now and at the next moment

turn them back at a price that will give the purchaser a substantial profit.

Senator WAGNER. I suppose an insider knows he can make a very good profit there.

Had you finished, Mr. Schenker?

Mr. SCHENKER. I have not completed my statement, Senator.

In our analysis of the investment company industry, Senator, we virtually studied every one that has ever been in existence in this country. We find that you can make three broad categories of subclassification and still be able, if proper disclosure is made in the registration statement, to apprise the prospective purchaser of the investment company's security of the nature of its activities.

You have to read, Senator, section 5, which classifies and subclassifies these companies, in conjunction with section 8 (b) (1) on page 17, which contains the provisions with respect to what the registration statement should contain, and in connection with section 13 on page 30, which deals with changes in investment policy.

The whole three sections are integrally interrelated, because it is a problem of disclosure to stockholders.

The first class is in section 5 (b) (1), which is known as the diversified investment company. In essence that paragraph says this: That a diversified investment company is a company which will not invest more than 5 percent of its assets in the securities of a single corporation and will not own more than 5 percent of the outstanding securities of that corporation.

In other words, a diversified company must have at least several different securities in its portfolio, and cannot make investments which will put them in a controlling position in the company in which they made the investment.

There is one little adjustment that we made in that general definition. You have heard a great deal, Senator Wagner and Senator Hughes, about the necessity for new capital for industry, and here you have institutions which represent probably the biggest pool of liquid funds in this country. In order not to make it impossible for this type of company to make new funds available to industry, we have said, "You may still retain your status as a diversified investment company if you desire to use up to 15 percent of your total assets in underwritings or loans to certain companies."

So that section says that a diversified investment company is a company 85 percent of whose assets consist of cash or securities in each issue of which it does not have more than 5 percent of the investment company's assets and each issue of securities held does not represent more than 5 percent of the outstanding securities of the issuing corporation.

With respect to the reservoir of 15 percent, you are not limited by these restrictions.

There is one other little angle, and that is with respect to this 15 percent reservoir. We say you can own more than 5 percent of the outstanding securities of any one corporation, but you cannot invest more than 5 percent of your total assets in any one portfolio company. Why do we say that? Take a small company that needs some capital. This diversified investment company wants to make capital available to it. The investment company will want to take a ride on the prob-

able success of the small company in which it is making the investment; so the probabilities are it will not take the form of a loan; it will take the form of an investment in the stock of that small company.

You have a situation where the investment company may be making a substantial investment in a small company which does not have a market for its securities. It is an un-liquid stock. Therefore the investment company must be in a position where it can have some control or influence over the management. So, therefore, we say that in this situation where you want to make loans or you want to make capital available to industry, you can have a controlling position in that company; and therefore we do not limit you to 5 percent of the outstanding securities, although we do say you cannot put more than 5 percent of your total assets in that small company.

Is that clear, Senator?

Senator HUGHES. Yes.

Mr. SCHENKER. So, the first characteristics of the diversified investment company are those I have stated. You notice that its name signifies diversification of investment rather than controlling influence.

The first limitation is with respect to the amount of money they can put into one company and the amount of securities of any one company they can own.

Then we go on to say that the portfolio turnover of a diversified investment company during its last fiscal year must not exceed 150 percent.

What does that mean?

I see that some of the representatives of the industry are waiting for me to explain it. They evidently have had some difficulty with it; and it is not an easy problem, Senator. Let me tell you what the principle is, and then we will see if the language says what we intend it to say.

You can invest your money in an investment company in the belief, or in the representation, or in the hope that the company is going to make analyses of the various industries in this country and is going to pick those industries which, in its opinion, show the greatest prospect for development. They are going to buy stocks in those industries and stay with them for the long-term pull, and are not even remotely interested in the intermediate gyrations of the price of the stock on the stock exchange.

A lot of people have told us that they are not interested in short-term trading; they are interested in the long-term trading, say in the chemical industry. They are prepared to make their investment in the chemical industry, and what the immediate public appraisal of the chemical industry is that is reflected on the stock exchange is of no interest to them. That is one type of company. You turn your money over to expert investors who are going to analyze the industry and pick out an investment for the long-term pull.

On the other hand, a fellow says, "I am not interested in the long-term pull; I am interested in beating the stock ticker tape. I have got a scheme where I can give you quick profits. I will get in or out of certain stocks rapidly, I can guess when there is going to be a change in the trends in this country, when the utility industry is going to be good and when the steel industry is going to be good and when the automobile industry is going to be good. So that primarily my activities

are going to be different. I am going to trade fast, either in one security, or I am going to shift my position rapidly from one industry to another."

We say those two companies are two different animals. One is an investment company and the other essentially is a trading corporation. An individual who invests something in an investment company ought to be told whether it is the first type of company or whether it is the second type of company.

That problem was recognized by the Treasury as being a very essential problem, because in connection with section 48 (e) of the Revenue Act which gives the open-end companies a tax preference, it says that you cannot get this tax preference if more than 30 percent of your gross income comes from the sale of securities which you have held less than 6 months.

So that was their idea to protect against quick portfolio turn-over and shifts in portfolio.

The industry had some difficulty with that. Why? Well, in order to get within that provision they would deliberately sell stocks upon which they might take a loss so that would keep down the amount they made on securities they sold which they had held less than 6 months.

We said that the criterion or the test of whether you are an investment company or a trading corporation is, How fast do you turn over your portfolio? How fast do you get in and out of stocks? If you turn over your portfolio more than one and a half times you are a trading corporation.

Let me explain that just a little, Senator. We say that if your total purchases and total sales of portfolio securities are one and a half times your average total assets, then you are a trading corporation, and if it is below that you are not a trading corporation.

We have also taken into consideration that in computing the portfolio turn-over ratio they do not have to consider the securities they bought by virtue of the fact that they raised new capital. In that instance we recognize the new capital.

I am not unmindful, Senator, and it is not an easy problem, that there may be some difficulty with this portfolio turn-over. The thing we have no difficulty with—and I think the industry does not have any difficulty with—is that there ought to be a distinction between those two types of companies.

Recently an individual came to me who wanted to organize an investment trust. We have no jurisdiction. He brought in a chart about one-third the size of this table, with a lot of lines and blue circles and red squares on it. He said, "I want to organize a trading trust with particular emphasis on short selling."

This bill does not say he cannot do that, Senator. What this bill says is when you sell your securities you are going to tell the public the type of trust that you have. If you have a long term investment trust and overnight either you or somebody to whom you turned this trust over has got some ideas to play the stock market, the stockholders must be apprised and their approval obtained.

Our definition of portfolio turn-over is contained in section 45, subsection (30), page 93 of this bill.

We can conceive of a situation where an emergency is present and the best policy is to sell the stock and get into a cash position and,