I can show you a number of similar provisions of that sort. The New York Stock Exchange, in the case of one big trust, had a similar provision of 200 percent for preferred stock. We have made the provision of 300 percent for debentures because they are further up the line.

Senator WAGNER. But, I take it, that problem does not arise if we provide only for common stock.

Senator HERRING. And that provides for existing common stock.

Mr. SMITH. That is to take care of companies that are now existing. I showed to you Senators yesterday, although I did not introduce it in evidence, company after company with control stock where 95 percent of the voting power is in stock that has no asset value at all and probably won't have any asset value for years to come. It is to prevent that control from being misused.

I do not say that it is adequate to meet the situation, but it is one protective provision. It may be we ought to have more on that.

Senator WAGNER. If there were an actual prohibition against paying dividends except out of profits this question would not arise, would it or would it not?

Mr. SMITH. This question would not arise then. That is right. But you might interfere with a fairly common practice.

Senator WAGNER. I understand that. There are two sides to the question.

Mr. SMITH. Yes, and it is a difficult question. I do not think we here have by any means met all the problems that can arise in paying dividends. I think Judge Healy may be prepared at some time to tell you why. I think he is interested in accounting methods which go back to what the original contributed capital was.

A difficulty with that situation is this: I know of a number of investment companies that have been organized with common stock, that started off with a deficit—had no asset coverage at all when formed. To base any historical value upon what the original contract was seems to me not to take into account the inherent difficulty, that the investor did not realize it was unfair to him. Also the stockholders have changed, in 10 years the original investors are out of the picture. It is not a realistic approach to the problem.

Mr. HEALY. Mr. Chairman, last night I hoped that this morning I could express myself on the subject of this section dealing with dividends. But I was pressed for time overnight, because I was needed to make a quorum at the Commission, and there were a number of opinions to be written, so that I do not find myself at this time in position to discuss it as I would like to. I think Mr. Smith and I do not understand each other on the subject of dividends, and I would like the subcommittee to postpone my discussion of dividends until a later time. My difficulties center around paying dividends out of capital. I am also not convinced that you can make one rule on the subject of dividends that would apply to all these different types of investment companies, regardless of whether open-end or closed-end, or regardless of whether they have senior securities or not.

May I leave it there for the present?

Senator WAGNER. Yes; is that all, Mr. Smith?

Mr. SMITH. Yes, sir.

Senator WAGNER. Thank you very much.

Now, Mr. SCHENKER.

Mr. SCHENKER. Mr. Chairman, Mr. John Hollands, who has assisted us in the drafting of the recommendations of the Commission, will take up some of the subsequent sections.

But before we do that I would like to introduce into the record the chart of J. & W. Seligman & Co. group, which we discussed yesterday. I understand they are examining it for any inaccuracies, but I would like to introduce it subject to correction by them.

Senator WAGNER (chairman of the subcommittee.) It may be made a part of the record.

(The chart headed "J. & W. Seligman & Co. group, December 31, 1939," is here made a part of the record.

Mr. SCHENKER. There is one other thing I would appreciate being done, and that is, for the record to indicate that in my discussion of the Harrison Williams' group of investment companies and the Central States Electric group set-up, that my discussion as to the extent of Mr. Williams' ownership of Northern States Power through his control of Central States was as of December, 1935. There have been some changes since because of the Utility Holding Company Act. I think he has redistributed, or may have liquidated, some stock so that he would not be considered a holding company under the 1935 act.

Now, if Mr. Hollands might be heard.

Senator WAGNER (chairman of the subcommittee). Give your full name, Mr. Hollands.

STATEMENT OF JOHN H. HOLLANDS, ATTORNEY ON THE STAFF OF THE SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Senator WAGNER. What page of the bill are you looking at?

Mr. HOLLANDS. Mr. Chairman, I will start with section 20, on page 45.

Senator WAGNER. All right, Mr. Hollands, you may proceed.

Mr. HOLLANDS. Subsection (a) of section 20 contains the proxy provision that is customary in legislation administered by the Commission. Those companies that have securities listed on stock exchanges are already subject to a similar provision in the Securities and Exchange Act of 1934. This provision would make all investment companies registered under this act, subject to the same requirements.

The section has been changed slightly from the earlier sections in point of language to make the provisions a little more definite in the light of the experience in administering other proxy sections. It has gone about as far in that direction——

Senator TOWNSEND (interposing). Do you mean that you have changed it since the writing of this bill?

Mr. HOLLANDS. No. I say that this section of this bill is modeled on other proxy sections in other statutes. In the earlier acts it is slightly different in language. The effect of the changes in this bill is to narrow rather than to enlarge the power of the Commission, I should say.

Subsection (b) prohibits a public offering of voting trust securities if the underlying securities in the voting trust are those of a registered investment company. It permits a private offering of voting trust certificates, which means that if a family, for example, wanted to turn

over the voting power of the family holdings to one member of the family, it would be quite possible to do that because that would simply involve a private offering of voting trust certificates. It was felt that the use of the voting trust as a control device in these companies has no justification.

Subsection (c) prohibits what is known as cross-ownership or circular ownership. That exists when you have two or more companies. Let us take the case of company A and company B: If company A owns some voting securities in company B, and company B owns in turn some voting securities in company A, the result is to greatly dilute the voting power of other shareholders, and also to create a very complicated situation so far as ever seeing a clear picture of the companies is concerned.

Yesterday one of the charts handed up was that of the American Capital Corporation, where, if I remember correctly, there were three companies, and a ring-around-a-rosy arrangement.

This prohibition extends not only to cases where both companies are investment companies, but to cases where any one of the companies involved is a registered investment company. For example, in the Petroleum Corporation case the Petroleum Corporation owned a sizable block of securities of an industrial corporation which in turn owned securities of the Petroleum Corporation. Will you give the figures on that, Mr. Schenker?

Mr. SCHENKER. In the Petroleum Corporation situation, the Consolidated Oil Co. owns approximately 40 percent of the total outstanding of the Petroleum Corporation, which is an investment trust. The investment trust in turn owns about $1,200,000 of the total outstanding shares of the Consolidated Oil Co., which is approximately 9 percent of the total outstanding of the Consolidated Oil Co. So you have got the Petroleum Corporation owning a substantial or almost controlling block in the Consolidated Oil Co., and the Consolidated Oil Co. owning 40 percent of the Petroleum Corporation, and the remaining 60 percent being in the public's hands.

At one time the portfolio of the Petroleum Corporation had such a substantial block of Consolidated Oil stock in it that 80 cents of every dollar of that company was in Consolidated Oil stock. Even at the present time the Consolidated Oil stock held by the Petroleum Corporation is about 42 percent of the total value of the portfolio of the Petroleum Corporation—the investment trust.

I examined Mr. Elisha Walker, who was on both the boards of directors, and I examined Mr. Earl Sinclair on this situation; and it seemed to me at the time I examined them that the block of stock constituted about 70 or 80 percent of the total assets of the investment company.

I said to Mr. Walker and Mr. Sinclair, "Why don't you liquidate your Petroleum Corporation and declare a dividend with your Consolidated stock, which is virtually all you have, and therefore not subject to stockholders to a charge for an operating expense which last year was $80,000?"

They said, "We do not know."

I said, "Let me see if this is not the reason."

What would happen, Senator, if they declared the dividend in kind and liquidated the Petroleum Corporation? That means that the Consolidated Oil Co. would get back a very, very substantial

block of stock of its own company; they would get a block of stock which constitutes 5 percent of the total outstanding. Once that becomes treasury stock, the management cannot vote it; but by taking that block of stock and insulating it in an investment which the management controls, they can vote that 10 percent block of stock in favor of the management. We say, for that reason, that that sort of tie-up where an investment company has a big block of stock in an industrial corporation and the industrial corporation has a big block of stock in the investment company is a device for perpetuating the incumbent management, regardless of whether or not they are doing a good job, you see. So we have that situation, and in addition thereto you get this accentuated picture of earnings. If the Consolidated Oil Co. makes money, then the holdings of the investment company go up; and if the value of the investment company's stock goes up, then since the industrial corporation owns a big block of that investment company's stock, its earnings go up; and if its earnings go up, then the investment company's stock goes up. You get that vicious cycle there, and we say that as far as an investment company is concerned that situation should not be permitted to exist. At least you cannot create it knowingly in the future; and as far as the present situation is concerned, there is a time element that applies, specifying a time within which they can sever that relationship.

Senator WAGNER. Right at that point I was going to ask you a question. What is the public purpose served under the circumstances you just mentioned in having an investment trust at all?

Mr. SCHENKER. In our opinion there is absolutely no economic public service in that relationship. In fact we consider it a detriment to the public stockholders.

You see, the Consolidated Oil Co. may not wish to have the investment company reduce its block of stock in the Consolidated Oil Co., because the incumbent management would then be losing a controlling block of stock with which it could perpetuate itself. That may be to the advantage of the incumbent management of the Consolidated Oil Co. but it may not be to the interest or to the advantage of the large group of public stockholders who own 60 percent of the outstanding stock of the investment trust. It may be to the public stockholders' interest that they get out of the Consolidated Oil stock; yet because the Consolidated Oil Co.'s management has control of 40 percent of the investment company's stock, the probabilities are that they will not do it. They may reduce their position slightly, but not in a very substantial amount in the aggregate. You have this picture where at least half of the assets of the investment trust consists of the securities of another company. They are paying $80,000 a year for officers, to research and operating expenses, although the company is just sitting there with this one big block of stock. That is the story.

Senator WAGNER. Is Mr. Hollands going to explain just how, by these provisions, you are preventing that situation?

Mr. SCHENKER. He will explain the mechanics that we have recommended to the committee.

Senator WAGNER. All right.

Mr. HOLLANDS. Subsection (c) on page 46 prohibits acquisitions by a registered investment company of securities if as a result of the acquisition cross-ownership or circular ownership exists. The line is drawn at 1 percent of the outstanding voting securities of the other company.

In other words, even though the securities of the investment company are held by the other company, the investment company can acquire voting securities of the other company up to 1 percent of the outstanding voting securities of the other company—the purpose being to eliminate rather trivial cross-holdings.

The circular ownership problem is the same. The description here is somewhat complicated; but the result, I think, is to define the case of circular ownership as distinguished from cross-ownership. That is, where you have two companies, you have cross-ownership; where you have more than two—three, four, or five—it may run right around in a circle. For example, A owns voting securities of B; B of C; C of D; and D of A.

Subsection (c), as I have said, applies only to acquisitions. It prevents cross-ownership in the future, where it does not now exist, and it prevents the aggravation of any existing cross-ownerships.

Subsection (d) goes further and provides for the elimination of such cross-ownerships. It states that it shall be the duty of the investment company, where cross-ownership or circular ownership exists, up to this 1 percent figure, to eliminate the cross-ownership or circular ownership within 3 years after the effective date of this title.

Then it goes on to say, in the second sentence, that when cross-ownership or circular ownership accidentally comes into existence in the future—which is possible—the investment company shall be given a year's time within which to get out of that situation.

Now, Senator, both the 3-year figure and the 1-year figure are somewhat arbitrary. Perhaps there should be some flexibility there; perhaps the period is not right. I do not know. It is a very difficult problem to set a definite period and to say that that is absolutely fair.

Senator TOWNSEND. What would be necessary after the passage of this bill, for instance, in the case of the Consolidated Oil Co., which you just mentioned as an illustration? What would it be necessary for them to do with their stock?

Mr. SCHENKER. All they would have to do is—instead of declaring a cash dividend—declare a dividend in kind and to give the stockholder of the investment trust his proportionate share of the stock in the Consolidated Oil Co. That is all, and that ends it.

Senator TOWNSEND. It would not be necessary for them to sell their stock?

Mr. SCHENKER. No; they can declare it as a dividend.

Mr. HOLLANDS. They have a choice of any method of doing it.

Senator WAGNER. Then it will become a stockholder?

Mr. SCHENKER. They are now, Senator.

Senator WAGNER. They are in effect; yes.

Mr. SCHENKER. We have other examples of this. For instance, an important case is a big chemical company in this country. We have not been able to ascertain who are really the individuals in Germany who have the controlling block of stock of this chemical company in this country. We examined the managers of the Domestic Chemical Company and they said, "Well, the stock of this Domestic Company is in the name of Swiss companies"—who are nominees; and we can never find out who are the German interests who own the Swiss nominees, who in turn control all the common stock of the domestic company, which is the only voting stock in that picture.

What do we find? Not only do the Swiss nominee corporations own all the stock of this American chemical company—and you can

see the significance of that in case of war or in connection with the matter of national preparedness—but this American chemical company owns the securities of some of these Swiss nominee companies and Swiss companies; and you have got that circular ownership in a situation where a substantial chemical company in this country is owned by foreign interests, and we cannot find out who the foreign interests are; and the State Department has been unable to find out who owns that chemical company.

I had Walter Teagle, the president of the Standard Oil Co., who is on the board of directors of the chemical company, make a statement; and he was quite cute about it.

I said, "Do you know who your boss is?"

He said, "No; I am on the board of directors."

I said, "Who owns your company?"

He said, "I don't know. It is in the name of some Swiss corporations."

That is the situation, and we think it is unhealthy.

Senator WAGNER. Is there not a list of stockholders?

Mr. SCHENKER. No; we tried to ascertain in Europe who were the beneficial owners of the nominee corporations. This is the farthest we could get: We could get to a lawyer and his stenographer, who held the stock. Then we tried to follow it beyond that, but there was no provision in the European laws which would make available a list of the stockholders. So that today one of the biggest chemical companies in this country is controlled by foreign interests; and nobody, as far as I know, in this country knows who owns that block of stock. We examined the president, the secretary, and so forth. The fact is, however—and I am not saying that that is the situation at the present time—that originally the company's debentures were in effect underwritten by the German Dye Trust. Whether or not they are still in that picure, we do not know.

Senator WAGNER. Mr. Schenker, just as a matter of information, I did not know that a foreign company could do business in this country unless the character of the business and those engaged in the business are disclosed.

Mr. SCHENKER. Yes. Well, you see, the American chemical company is a domestic corporation. In their registration statement with us they gave the names of the nominee companies who owned the stock; and we could not get beyond the nominee companies. That is the point.

Senator WAGNER. The company operating here is an American company?

Mr. SCHENKER. Oh, yes; certainly.

Senator WAGNER. But it is a company whose stock is owned——

Mr. SCHENKER. Held in the name of European nominees.

Senator WAGNER. I see. However, it seems to me that even that ought to be disclosed, before they should be permitted to do business in this country; but that is another question.

Mr. HOLLANDS. If I may, Mr. Chairman, I shall go on to section 21.

Senator WAGNER. Yes.

Mr. HOLLANDS. Section 21 deals with the subject of loans. Subsections (a) and (b) deal with loans by the investment company. Subsection (c) deals with loans to the investment company. Perhaps they could better be called borrowings. The problem with which

subsection (a) tries to deal is the problem of loans made for ulterior motives—not bona fide business loans. The obvious loans to "insiders" are prohibited by section 17, which was discussed yesterday. The company is not permitted to make a loan to an officer or a director.

However, there can be cases of loans to personal friends and other loans which do not have any reasonable business basis. Subsection (a) states a very rough rule of thumb for dealing with that. It says that no loan shall be made to a natural person, as distinguished from a corporation or other organization.

It is difficult to imagine a case in which an investment company, which is in no sense a small-loan company or a bank, need make a loan to an unincorporated person; and that will cut down to a degree the type of loans to which there is objection.

Senator WAGNER. If they are permitted to make loans at all, is it not less of a risk to loan to an individual, on whose liability there is no limitation and who may be responsible, rather than to a corporation which may have very little in the way of assets and, therefore, be irresponsible?

Mr. HOLLANDS. That is perfectly true, Senator.

Senator WAGNER. I do not know that distinction.

Mr. HOLLANDS. That is perfectly true; but there is this consideration: An investment company, if it makes loans, should make loans only to industry, only to industrial organizations of some consequence. Otherwise, it is not engaged in an investment business but is engaged in more of a personal loan business.

Senator WAGNER. Suppose I am an industrialist; I may not be a corporation. I am wondering about that distinction; frankly, it does not make sense to me; but you may be right about it.

Mr. SCHENKER. On that aspect, Senator, by and large we had the feeling that the making of loans is a function of commercial banking, and not of investment companies.

Senator WAGNER. I agree with you there.

Mr. SCHENKER. But we figured that in view of the capital market at the present time, if an investment company wanted, bona fide, to make a loan to a small industry or to take a participation in a promotional venture, then we felt that we should not prohibit them from doing that. What we have said is that if you tell your stockholders that you are going to go into the business of making loans to industry, then of course it is all right for you to do it.

With respect to the natural person, the individual, the person who is a big industrialist, I do not know of any such type of situation. However, if you wanted to get——

Senator HUGHES. What about a partnership?

Mr. SCHENKER. He could not make it to a partnership.

There is nothing to prevent the investment company from getting the accommodation endorsement or the guarantee of the individual; but what we wanted to stop is the type of case that we found—where personal loans were made to individuals who were close to the sponsors, or where loans may have been made for some ulterior motives.

Senator WAGNER. All right; suppose that individual, if he could not get it himself, were to undertake to organize a corporation, so as to be able to get it? As you said yesterday, it takes only about $100 or less to form a corporation. Under those circumstances, then, would they loan it to the corporation?

Mr. SCHENKER. That is why this section says "directly or indirectly" to a—— ·

Senator WAGNER. Well, Mr. Schenker, I do not want to spend a great deal of time on that ; but it really did not make sense to me.

Mr. HEALY. It seems to me that in an effort to meet and obviate the evil here the pronoun has perhaps gone a little far.

Senator WAGNER. Yes.

Mr. HEALY. I think we ought to consider perhaps some loosening of that provision.

Senator WAGNER. But right there if I may make an observation, Mr. Schenker said a moment ago that the investment trust may want to go into a venture or some promotion. Well, I have always understood—and if I am wrong, I have been going along with the wrong understanding from the very beginning, with respect to these investment trusts—I thought investment trusts were absolutely distinguishable from an enterprise which seeks venture money or risk money, where those who are investing are willing to take the chance of building a new airplane or a new something else, and recognize that it is a great risk.

I understood that an investment trust's primary purpose is to accommodate this investor—usually a small investor—who has not enough money to invest in a number of securities, and yet who would like to get the benefit of that. He wants to take his money and put it into the hands of an investment trust which diversifies its investments and picks only investments in securities which have a recognized value upon the market or which are generally recognized as safe investments, as the result of some experience.

Of course, as your testimony has shown, because there is no control over some of these sponsors, the trusts have been used for these new ventures, without the knowledge of those who invested or, really, contrary to the purposes of the trust, as represented to these investors.

Am I mistaken about that?

Mr. SCHENKER. Senator, your idea of an investment trust conforms to the layman's concept of what it is. But the fact of the matter is that our study shows that you have this great diversity of types of investment companies. Perhaps they should not be called investment trusts. So the situation is that although they may have raised their money initially on the basis that the public believed it was the type of institution you believed it was, the fact of the matter is that the history of these institutions in this country shows that they went into the other type of activity.

Senator WAGNER. Well, I do not object to that.

Mr. SCHENKER. This bill takes jurisdiction of all types; and the only thing it says is substantially as follows: "Now you will have to tell the person that you are type A and you will have to stay in activities in which type A may indulge; and before you may indulge in the promotional venture type, you must tell your stockholders that and get their permission."

Senator WAGNER. Of course, I believe in this risk money; but I ought to be told that that is what I am undertaking.

Mr. SCHENKER. That is right.

Senator WAGNER. Under those circumstances I ought to be told that I am not undertaking a substantial, sound investment enterprise

but I am taking a chance on something which may turn out to be a 100-percent loss.

At the present time I think there is need for that kind of money; there is no doubt about that; but I ought to be told just what I am investing my money in.

Mr. SCHENKER. The fact of the matter is that the Commission had the definite feeling that if this legislation were passed, it might encourage people, who felt that this type of institution was under some kind of supervisional regulation, to invest in a venture investment company, you see. We felt that it would serve a salutary economic purpose, in having people taking their savings deposits and putting them in this type of company with the full consciousness that they are taking that type of risk, if all the shenanigans of the past are out and the company has this type of supervision by a Government agency.

That was one of the things that was a great factor with the Commission; that this would encourage the opening up of the capital markets, by making provision for the small person who had some surplus funds—after he had made provision for a bank account and insurance—to take a little speculation in industry and put a little money in that type of organization.

Senator WAGNER. In all of the cases of which you have spoken thus far the representations made to the investor were just to the contrary?

Mr. SCHENKER. In most cases.

Senator WAGNER. I do not know of any case where the investor was told he was putting his money into a venture of some kind. In all these pamphlets you presented here the investor was told he was investing in a diversified investment trust which was a sound investment and which was secure in the future; isn't that true?

Mr. SCHENKER. That is substantially correct, Senator.

Senator WAGNER. Yes. All right.

Mr. HOLLANDS. Mr. Chairman, in connection with the point you were just discussing with Mr. Schenker, I should like to call your attention particularly to paragraph (2) of subsection (b) of this section 21, which reads as follows:

> It shall be unlawful for any registered management investment company to lend money or property to any company, directly or indirectly, if—
>
> (2) The investment and management policies of such registered company, as recited in its registration statements and reports filed under this title, do not specifically authorize such a loan.

The purpose of that, of course, is to make sure that if this company is going to make loans of a venturesome character, it has indicated that it is going to go into that business.

Senator WAGNER. I do not want to be too critical about these things, of course; but do you not simply say that, "If you do something which is contrary to the powers conferred on you, you are doing something contrary to the powers conferred on you?" Is not that about what you say in this provision we are now discussing? It seems to me that it declares unlawful something which is unlawful; is not that the situation?

Mr. HOLLANDS. That is substantially true, sir. It states that unless you have represented and made it clear that you are going to go into this loaning, you cannot do so. You might have power under your charter but have failed to make it clear in your registration statement