

MR. CABOT. We would not know what your fundamental policy is, in the first place; and what is fundamental to you and your associates today may not be so to your successors.

MR. HEALY. Well, of course——

MR. CABOT. Second, even if you did so interpret it, had we exceeded the 150-percent limitation without first getting the permission of our shareholders, that would be illegal.

MR. HEALY. That would not be so, Mr. Cabot, if we had already established a rule or if this statute were written to say that an emergency action, in the face of unusual conditions, would not be a departure from fundamental policy.

SENATOR TAFT. In effect, the fundamental conception of this proposed law is that it shall be a law unless the Securities and Exchange Commission decides it shall not be?

MR. HEALY. No.

SENATOR TAFT. No; there is hardly a provision in this proposed statute that the Securities and Exchange Commission cannot change, tomorrow, as a matter of law.

MR. HEALY. I do not agree with that.

SENATOR WAGNER. I do not agree with it, either. In almost any law where there is any flexibility at all there is the provision that in certain circumstances the industry affected may receive permission to have an exception made, based on certain conditions and standards.

This is not a novel idea, whether or not there are certain exceptions that the Commission may have to take up with the industry.

However, Mr. Cabot, would you have any distinction between the ordinary trading company and a diversified company?

MR. CABOT. I believe I would have some sort of distinction; and I will say that had the S. E. C. seen fit to allow the industry to go over the wording of this bill prior to its introduction to Congress, we could have straightened out a great many of these difficulties.

SENATOR WAGNER. However, Mr. Cabot, our committee is here for that purpose, you understand.

MR. CABOT. Certainly.

SENATOR WAGNER. So we welcome your suggestions in that regard.

MR. CABOT. Senator, if you now look at section 13 (a) of the bill, you will see what I am talking about. It there states, if I may quote:

SEC. 13 (a). No registered diversified investment company shall become a securities trading company or securities finance company, unless such change is authorized by the vote of a majority of its outstanding voting securities.

That is the provision that would have prevented us in 1933 from going from, say, 40 percent of stocks that are very conservative to 40 percent of stocks that would be more beneficial in a business recovery.

We could not have had that action, because of this section.

SENATOR WAGNER. Yet, I am sure you will agree that as a general proposition you ought not, without the approval of your stockholders, change the fundamental policy of your operation.

Do you think you should?

MR. CABOT. No; I do not. I think you have got very carefully to define what "fundamental" is; and I shall cover that in a few minutes.

SENATOR WAGNER. Oh, do you cover that later on?

MR. CABOT. I do, sir.

Senator WAGNER. Very well.

Mr. CABOT. It ought to be recognized, Senators, that in the last few years economic conditions have changed rapidly and dramatically. It is the duty of investment management to try to change their portfolio, as relates to their cash position and also as to the types of securities held, in order to conform with those changing conditions. The Federal Government should not assume the managerial function of restricting portfolio activity, and thereby take from shareholders a necessary safeguard. I assume that one possible objection in the mind of the Commission has been the result of the study of a few cases where excessive portfolio activity was more or less motivated by a desire on the part of somebody to obtain brokerage commissions. I submit that safeguards, such as any and all of the responsible people in the industry will agree with, are sufficient for this purpose.

Fourth, I am opposed to the arbitrary elimination of the right to borrow or create and maintain a reasonable amount of senior capital. Investment companies are in their essence nothing more than a group of individuals banded together for the purpose of diversification and expert management, and as such it does not seem fair that their borrowing power should by law be restricted to any greater degree than is the borrowing power of the individual. It must be remembered that the United States was in a large measure built on borrowed money, and had there been in other industries and activities of other times a restriction on borrowing, it would have been impossible to open the West and to develop the great natural resources that have made this country what it is today. If in the late 1920's this industry, like most others, over-indulged in the power to borrow, it should not mean that it alone should be singled out and prohibited from using credit in the future. An excess today in the direction of a prohibition on borrowing can well prove to be as unfortunate as excesses in the opposite direction a decade ago. The Federal Government wants to put to work the vast resources of unused capital and credit that lie idle today, with the thought in mind that with this capital at work people will be employed at useful production. It does not seem consistent with this thought to prohibit the legitimate use of credit by these investment vehicles. At times, a reasonable and legitimate use of credit can be of great benefit to the borrower, to the lender, and to the public at large, through the results of greater employment and industrial activity. Although we now have no present desire to borrow money or sell senior securities, for several years we did use our company's credit and borrowed money, to the distinct advantage of our shareholders.

Our fifth objection is that section 17, subsection (f) (1), makes it unlawful for any investment company in any of its contracts, bylaws, articles of association, charter, or "for any other instrument pursuant to which such a company is organized or administered," to have anything that "authorizes or purports to authorize the violation" of any rule, regulation, or order of the Commission. In other words, the Commission by this power can force any investment company to change or rewrite any bylaws, charters, certificates of incorporation, or any other instruments in any way that it may see fit, regardless of how long these have been in successful operation and regardless of how much the security holders may want them continued. I believe that these documents should be subject in their final determination

to the vote of the security holders and not to the actions of a governmental bureau.

Our sixth objection is that section 13 (b) requires that no change of any fundamental investment or management policy can be made without a vote of the majority of the outstanding voting securities.

This is the part about which you were inquiring, Senator.

Senator WAGNER. Yes.

Mr. CABOT. I believe that there is great potential danger to the exercise of the best managerial functions, in this section—not because I disapprove of getting stockholders' consent to drastic policy changes but rather because the bill provides that the S. E. C. shall determine what is fundamental. They could say, for example—and I do not think they would—that to sell the shares of the General Electric Co. and buy the shares of the Texas Corporation represented a fundamental change and, hence, would be illegal without prior vote of shareholders. To obtain this vote for this and other transactions which might be more close to the border line of the S. E. C. interpretations of fundamentals, might well involve a time element that would preclude the possibility of making a rapid change in order to conform with the rapidly changing economy, and would therefore take away a managerial function which has often been used for the essential protection of shareholders.

Senator TAFT. However, Mr. Cabot, suppose that you do represent in your original picture that you are investing in insurance shares, for instance.

Mr. CABOT. Yes, sir.

Senator TAFT. There are trusts of that kind?

Mr. CABOT. Yes, sir.

Senator TAFT. Then it would be a fundamental change in policy, I suppose, to go out and buy industrials?

Mr. CABOT. I should think so; and I have a suggestion, later on, for constructive legislation.

If I may put it in this way, to use this expression, this is the “destructive” part of my criticism; and I have some constructive ideas which I hope may be of some use to you; and one of them is exactly along the line of what you are now saying.

Our seventh objection is that under section 8, subsection (b) (1) (C), we are apparently asked, among a great many other things, to submit to the Commission and to our shareholders the “characteristics and relative amounts of securities and other assets which the registrant has acquired and proposes to acquire in the course of its business.”

We submit that it is absurd to ask us or any intelligent manager what specific securities are going to be bought in the future. Obviously, we do not know; and if we were to make any statement as to what we were going to do in the future, and if we thereafter were forced to follow that statement, of course we could be put in a very bad situation.

The only thing we can be reasonably sure of is that conditions will in all probability change in the future as they have in the past and that any intelligent and honest management will be forced in the future, as in the past, to change its methods and types of investments to conform to changing circumstances. Hence, all any person can possibly say relative to future commitments is that they would be

made wholly with the thought in mind of best protecting and helping security holders.

My eighth objection: I believe that there is a size, depending upon general conditions and many other factors, beyond which it is inadvisable to go; but I do not believe it is wise to force by Federal legislation a definite size beyond which a company should not expand. If in the past there had been rigid limitations as to the size of other industries—although it is true that some difficulty and grief might have been avoided—it is equally true that the great growth of this country could never have taken place. For example, if years ago the automobile industry had been told that it could never expand beyond a definite size, it is probable that that great business could never have grown to its present importance. Other businesses are not regulated as to size, and I believe it is unsound to place arbitrary limitations on this industry, by law.

I believe that, as in the case of other industries, competition will take care of the situation; and when a point has been reached where the size of an investment trust is a serious adverse factor and a detriment to it, it will be impossible to increase it further.

My ninth and final objection is that I particularly object to the broad discretionary powers delegated to the Commission, which have been described to you in detail by Mr. Quinn, a previous witness.

I have now given some examples of those things in this bill that I think should be corrected. There are many others that I have not touched on, because they have already been explained by other witnesses, or will be explained by those witnesses to follow.

Senator WAGNER. Now you are going into the constructive suggestions?

Mr. CABOT. Yes, Senator.

Senator WAGNER. You did say that there was only one provision in this bill that affects your particular concern?

Mr. CABOT. Yes; other than the general rules and regulations that might be promulgated.

Senator WAGNER. Have you told us about that?

Mr. CABOT. No, sir; I have not. I will be very glad to if you are interested. That is a provision respecting one of our directors. I had better not mention his name. Mr. Blank is a director of one of our portfolio companies, and he would, under the provisions of this bill, have to resign and we would have to get somebody else. We think he is a very desirable director.

May I now outline my ideas as to the best way to achieve substantial protection of investors without hamstringing officers, directors, and managers in the exercise of their best investment judgment and in the handling of portfolio and management problems in the best interests of their security holders. I advocate a bill which will contain substantially the following provisions:

1. Registration of investment companies with the S. E. C.
2. Registration of officers, directors and other affiliated persons with the S. E. C. But this is not to be taken to mean that I am in favor of the portion of section 9 on this subject which gives the Commission unlimited power to obtain from such persons such information and documents as they may desire.
3. Complete disclosure to stockholders and to the S. E. C. of all matters affecting the investor. The amount and nature of such infor-

mation to be given does not, of course, lend itself to exact definition by statute, and the Commission should have a reasonable amount of power to issue rules and regulations for this purpose. I believe, however, that the powers vested in the Commission for this purpose in this bill are too broad.

4. The adoption of sound, and to the extent that it is desirable and feasible, uniform standards of accounting and auditing.

5. The establishment of standards, either by Commission rules or, preferably perhaps, through the National Association of Security Dealers, which are designed to reduce to a practical minimum the dilution of the equity of existing security holders in connection with the sale of securities of open-end companies.

Senator WAGNER. Would you mind stating that again?

Mr. CABOT. That has to do with—

Senator WAGNER. I know what it has to do with, but I did not quite catch your statement.

Mr. CABOT. It has to do with the establishment of standards, either by Commission rules or, preferably perhaps, through the National Association of Security Dealers, which are designed to reduce to a practical minimum the dilution of the equity of existing security holders in connection with the sale of securities of open-end companies.

Mr. Traylor will give you a great deal more on that at a later time, I believe.

6. A restriction on the issuance of senior securities and borrowing power only to the extent that it does not exceed the restrictions now applicable to individuals under existing Federal Reserve Board regulations.

Senator TAFT. What are those?

Mr. CABOT. I think, in common parlance, that the present Reserve Board regulations are about 40 percent. Is that right?

Mr. SCHENKER. That is the margin requirement. You want to make it analogous to the margin requirement?

Mr. CABOT. Yes.

7. Restrictions against improper relationships between investment companies on one hand and investment bankers and brokers on the other. In general, I believe in this connection that complete publicity and prohibitions against self-dealing will accomplish this purpose.

8. That officers, directors, and other affiliated persons should be subject to the same duties and liabilities as those imposed under section 16 of the Securities Exchange Act of 1934.

9. Reasonable diversification of portfolio securities. This is not to be interpreted to mean that certain companies should not be encouraged to engage in financing operations. Nor is this to be interpreted as an endorsement of the subclassifications now provided for in section 5 of the bill.

10. All management contracts and amendments thereto must be approved by stockholders; no assignments of such contracts to be made without similar approval.

11. Self-dealing between investment company and officers, directors, underwriters, and so forth, shall be prohibited.

12. All securities shall be held by depositaries approved by the S. E. C. Withdrawal of securities from depositaries shall be only according to rules and regulations to be laid down by S. E. C.

13. In any case where an investment manager or investment adviser as defined in the act serves more than one investment company, there should be a specific written agreement between the companies with respect to priority or prorata treatment in the execution of orders, in order to avoid any possible conflict of interest.

14. No substantial change in announced investment policy to be made without approval of stockholders.

Now, Mr. Chairman, I don't want to be too critical of the S. E. C., for I believe they have done a very fine and extensive piece of work in the investigation of this industry and their reports upon it. Although I am no legal draftsman and am therefore unqualified to speak, I cannot but feel that this bill has been drawn hastily and under pressure. It appears obscure, redundant, and certainly over-complicated. I cannot but feel that had the S. E. C. gone over the wording of this bill with the industry prior to its introduction to Congress some, if not much, of the difficulty would have been avoided.

I hope that you and your committee, who have been so patient with us, will think that it is advisable to send this bill back to the S. E. C. instructing them to redraft it in consultation with representatives of the industry chosen by you and that you will indicate prior thereto those broad principles and restrictions that you would want in the bill so that direct conflicts of opinion that would occur between the Commission and the industry would be minimized. I thank you.

Senator WAGNER. Are there any questions of Mr. Cabot? (No response.)

We are very much obliged to you, Mr. Cabot.

We will take a recess at this time until tomorrow morning at 10:30. (Whereupon, at 12 noon, a recess was taken until tomorrow, Wednesday, April 17, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

WEDNESDAY, APRIL, 17, 1940

UNITED STATES SENATE,
SUBCOMMITTEE ON SECURITIES AND EXCHANGE
OF THE BANKING AND CURRENCY COMMITTEE,
Washington, D. C.

The subcommittee met, pursuant to adjournment on yesterday, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, Downey, Townsend, and Taft.

Senator WAGNER. The subcommittee will come to order. Mr. Merrill Griswold, of the Massachusetts Investors Trust of Boston, will be the next witness.

Mr. Griswold, can you move up just one chair, if you do not mind being a little nearer?

Mr. GRISWOLD. Certainly. Is this O. K. now, Mr. Chairman?

Senator WAGNER. Yes; that is fine.

STATEMENT OF MERRILL GRISWOLD, CHAIRMAN, MASSACHUSETTS INVESTORS TRUST OF BOSTON, BOSTON, MASS.

Mr. GRISWOLD. Shall I begin?

Senator WAGNER. Yes; please.

Mr. GRISWOLD. My name is Merrill Griswold. I am chairman of Massachusetts Investors Trust of Boston, which was the first open-end management investment trust organized in the United States.

I shall describe it very briefly. It was started in 1924. This was long before the 1928-29 speculative era, when so many trusts were organized. It was before the so-called fixed trusts had their heyday. Massachusetts Investors Trust was not "styled" for sales purposes to overcome objections to other types of trusts. It was organized because its founders felt that it could serve investors soundly. We believe its 16-year record justifies that belief. This trust and two similar trusts organized in 1924 and 1925 now account for about 40 percent of all the assets in the open-end management trust business.

Senator DOWNEY. I did not quite follow that last sentence. Will you read that again, if you please?

Mr. GRISWOLD. This trust and two similar trusts organized in 1924 and 1925 now account for about 40 percent of all the assets in the open-end management trust business.

Massachusetts Investors Trust is the largest open-end company in the business, having assets of over \$120,000,000. It is not a corporation, but a true trust. The interest of the beneficiaries is represented not by stock, but by transferable certificates of beneficial interest, all

of one class and commonly known as shares. Its shares are redeemable on demand at net asset value. At the end of each quarter, it divides among the certificate owners the entire net income it has received from its securities, exclusive of capital gains and losses. Net taxable gains, if any, from the sale of securities are distributed only at the end of the year. The securities it owns are held by a bank, as custodian, under such strict custodianship that not even we ourselves, to use Mr. Schenker's picturesque phrase, could "back up a truck and take them away."

The trust is run by a board of five trustees assisted by an advisory board of five members. Because the testimony of the S. E. C. witnesses may have given you the impression that the investment trust business is populated almost entirely by scalawags and looters, I should like to file in the record a list of the names of our trustees and advisers, with a description of their affiliations. I think you will find them all to be men of character, ability, and high reputation. This, incidentally, is equally true of most investment trusts.

We welcome this opportunity to explain our point of view as to this proposed legislation. At the outset, I wish to say we do not oppose any legislation that may be necessary to prevent the recurrence of abuses in the open-end management trust business where existing laws are not adequate. We definitely do not favor this particular bill, however, which we consider unsound legislation in many respects that we and others will explain. We believe it should be largely, if not entirely, rewritten. I wish to be as helpful as I can to this committee on matters relative to open-end trusts. I shall be glad to answer any questions from you, and, when I have finished, I am willing to be cross-examined by the S. E. C. officials, if that will help you.

Senator WAGNER. Might I ask you a question right there without interrupting you unnecessarily?

Mr. GRISWOLD. Certainly, Mr. Chairman.

Senator WAGNER. I have noticed that several of the witnesses always began by saying, "We are absolutely against this bill," or something of that kind, and then would begin to tell some of the things they thought ought to be done. But many of the things which you and others say ought to be done are in the bill. For instance, Mr. Cabot indicated yesterday something of that same view—and therefore I want to ask you: Is it strictly accurate to say, just because one is against one phrase, or a phrase or two here and there, that he is against this bill? Or do you not mean to say there are many provisions in the bill which you are opposed to, but that there are other provisions in the bill that you favor, at least as to their objectives?

Mr. GRISWOLD. I favor some of the objectives of the bill but not all of them, and as I go along I am going to try to distinguish them.

Senator WAGNER. For instance, you may start out by saying, "This bill is terrible," or something of that kind, and I just wondered whether that was a general characterization of it.

Mr. GRISWOLD. No, sir. I think this bill is terrible.

Senator WAGNER. All of its provisions?

Mr. GRISWOLD. No. Two-thirds of its provisions.

Senator WAGNER. Very well. You may proceed with your statement.

Mr. GRISWOLD. I might say right here, to anticipate for a moment, a committee of Parliament, that had to consider this thing over there, made a study similar to that made by the Securities and Exchange Commission, and they recommended changes by Parliament, but the provisions covering the basis of open-end trusts were contained in a schedule of about one and one-half pages.

Senator WAGNER. Again yesterday evening I read the statement of Mr. Cabot, which I thought was a very clear presentation of his views, and then I read carefully also his constructive suggestions. It would require many pages to incorporate them in legislation if you wanted to do it carefully. But I am sure his suggestions impressed every member of this subcommittee, as they did me, because they were constructive suggestions and a recognition that something should be done.

Mr. GRISWOLD. Yes, sir; and we have some specific suggestions which I will come to very shortly, and while they might take more than a page and a half they would not require 104 pages of a bill.

Senator WAGNER. You may be right about that. You may proceed with your statement.

Mr. GRISWOLD. Diversified management companies, as we compute them from Moody's classifications, comprise \$554,000,000 for open-end companies, \$517,000,000 for diversified closed trusts with senior capital, and \$180,000,000 for closed trusts without senior capital. The balance of the industry represents various other kinds of investment companies which are not classified by Moody's as diversified companies. From these classifications, you will observe that the management of open-end companies comprises the largest division of the diversified management industry. Moreover, the open-end management trusts represent the only section of the industry that is growing substantially at the present time. We have available a list of the companies included in Moody's classifications. I think that has already been filed, Mr. Chairman. The statement was made by S. E. C. witnesses that the assets of investment trusts had shrunk by \$3,000,000,000. To give you some idea of the experience of open-end trusts, I have compiled the figures for 15 open-end companies in Boston. Boston companies are accountable for about 60 percent of the assets of all open-end management companies. These figures show that these 15 companies received from the sale of all their shares up to December 31, 1939, the sum of \$436,595,278; that they paid back in redemptions \$122,389,796, leaving \$314,205,482. There has also been paid back to the shareholders by these trusts since 1936, in dividends which were in the nature of capital distributions, the sum of \$30,110,033, the source of which was clearly identified. That, Senator, was because of certain provisions in the 1936 tax law. This leaves \$284,095,449, which represents the most for which the managers of these trusts should be considered accountable.

Now, let us see what the value of these trusts was on December 31, 1939. We find it was \$262,800,631, a shrinkage of only \$21,294,818, or less than 8 percent. This represents the aggregate result for all investors in these 15 trusts. Individual experience, of course, varied widely, because some holders who paid high prices for their shares in these companies show substantial losses, while others who bought their shares when market prices were low, show sub-