

Mr. CURTIS. Now, Senator, opinions differ as to whether a provision requiring the election of the officers—the trustees, so-called—would in itself turn our trusts into partnerships.

Judge Magruder, recently appointed to our First Circuit Court of Appeals, wrote an article in the Columbia Law Review (vol. 23, p. 423), in which he expressed the opinion that the mere power of election would not make shareholders partners.

Judge Brewster, of our district court, expressed a similar opinion.

It may be that that alone would not make them partners. On the other hand, opinions differ.

The California Supreme Court has said:

It is generally held that the power to elect trustees and to fill any vacancies in the board gives the certificate holders such ultimate control over the trustees that the organization will be treated as a partnership and not a true trust. That rule appeals to us—

the California Supreme Court says—

as the correct one to apply.

That is in the case of *Goldwater v. Oltman* (210 Cal. 408).

This bill, however, requires the manager of an investment company to have a written contract—proper enough; that written contract must be approved by the vote of a majority of the outstanding shares.

Now the bill begins to give them direct control. But not only must that written contract be approved by a majority of the shares, but section 15 (b) gives those shareholders power to terminate that contract at any time, and power to hire and fire the manager of the trust. That seems to me to deprive the trustees of that exclusive control and management of the trust estate on which the courts relied, and which the courts undoubtedly require before it can be held that such an organization is a trust. That is the necessary requirement, in order to make it a trust—without which the shareholders become individually liable.

There is also the requirement of section 13 (b) that any change in any fundamental investment or management policy must be authorized by vote of a majority of the outstanding shares. The Securities Commission is given authority to designate what policies are fundamental; in other words, they are given the authority to say where the ultimate power of control of the trustees over their policy ends and where the ultimate powers of the shareholders begin.

Even if the power of election, alone, may not turn the business trusts in the investment field into partnerships—the hiring and firing of the manager by the shareholders—and this power over the policy will, I submit to the committee, turn every investment company which now operates in the form of a trust into a partnership.

Senator HUGHES. And you would not issue much stock?

Mr. CURTIS. I think it would surprise the shareholders of a trust to be told that they were liable for the debts. Of course, usually the assets will take care of that; but suppose they did not. It would surprise them, Senator, I think.

Moreover, section 17 (f) (2) of this bill specifies that after 1 year any provision in a trust indenture which purports to relieve “any affiliated person”—

from any duty or liability to such company or the security holders thereof to which such person * * * would otherwise be subject—

is unlawful; and an affiliated person, according to section 45 (a) (18) (D), includes a partner.

We believe that these provisions of the bill will eventually destroy us, and, with us, all other business trusts as trusts. I believe I am, speaking for all business trusts. I am speaking, of course, particularly for Century Shares Trust. I believe I am speaking for all its 4,500 shareholders, who, as I say, would be vastly surprised to find themselves partners of each other.

However, then we go on further. Why should our shareholders be forbidden, in effect, to use the trust form of business trust, which has had an honorable and respected career, for their use in making their investments? Why should they be put to the expense of the elections, of the machinery of getting their approval of these things? It is their expense, after all. Century Shares takes pride in keeping its expenses low. Our expenses are 10 percent of income—which we believe are about as low as any.

More than that, why should not a person reasonably prefer to have the men who are going to take care of his money in the future selected by those whom he has chosen to take care of it now? He knows who they are. Why should he have to have them selected by other shareholders whom he does not know and cannot know? Why require that of him?

He puts his money into the hands of certain trustees. He knows who each one of them is. If one of them dies or retires, why should not the shareholders be allowed to have that trustee's successor chosen by the rest of the people whom the shareholder knows? He knows that they will think hard about a new colleague. He knows they want the trust to go on, not only with the permanent policy but with the same sort of men, with the same sort of attitude toward investing his money that they had when he bought his shares.

Why should he be made to rely on the choice of a majority of the other shareholders, perhaps on the choice or on the nomination of some unknown individual who has purchased enough shares—if perhaps not enough, necessarily, to control—so that his suggestion and his nomination of a new officer must be given great consideration—and even, perhaps, suggesting or nominating himself?

I do not say that that choice will necessarily be bad or even worse; but what I do say is that there is no reason why he should not be allowed to think that the surviving trustees whom he has chosen might do it better than his other shareholders.

Now, Senator, if there were anything nefarious in the trust form, I could understand and we could understand why they should be practically outlawed from the investment field; but I take it no one will say there is anything nefarious in the form of a trust, as distinguished from a corporation. I think everyone will agree that it has proved its merit and gained honor in a field of business where it ought to be permitted to continue.

I hope the committee will think long, before it makes the trust form unavailable to the public, in the field of investments.

There is one other point I should like to make, and then I am through; that is the unfortunate vagueness of the bill, in its definition of an investment officer. That is section 45 (a) (15). Century Shares has been asking our counsel what these provisions mean and what is the difference between an investment officer and a manager.

The "manager" is defined, two sections later—in section 45 (a) (17); and we should also like to know whether these definitions particularly apply to one of our trustees. Our counsel, I think, is entirely—and, it seems to me, justifiably—unable to advise us with respect to this matter, as it applies to our trustees.

Now, Senator, whatever the opinions of our counsel may be and whatever the opinions of the proponents of this bill may be, and whatever they think these particular definitions mean, is one thing; but what we are concerned with, and what every trustee of any investment company is going to be concerned with, is the future interpretation of these definitions by the courts. We hope that these matters will be made clear enough so that anyone may know, when he accepts a position in an investment trust or decides whether he ought to continue in office, when some other position is offered to him, whether he is violating the provisions of section 10 (d).

As I say, one of our trustees, with the best of advice, is unable to tell. We want him, and he wants to remain with us. If he must choose, we want him to be able to choose; and I submit that the present definitions make it impossible for him to do that. He has got to play safe—too safe.

When I say "too safe," why shouldn't a man who lacks discretion and who is simply empowered to execute or order the execution of purchases or sales of securities—which is the definition of the investment officer as the bill now stands—in other words, a man who does no more than obey orders, without exercising his own discretion—why should he not be at the same time an affiliated person? Why should he not be connected with an underwriter or whomever? Does an investment officer, as defined here, include one who simply carries out the decision of the board of trustees to buy or sell a certain security? If that is the meaning of that term, then we do not see why, on our trust board, we should be prevented from having the benefit of a man who is, under the definition of the section, an affiliated person, just because he does that sort of thing.

We suggest that the definition of "investment officer" be simply dropped out or, at least, that the definition in section 45 (a) (15) be made clear so that he is someone whose function includes the exercise of judgment, and not simply a man who obeys orders.

As it stands, the provisions of section 10 (d) and the definition of "investment officer" in section 45 (a) (15) will force a great many honorable, law-abiding citizens from enjoying perfectly proper and perfectly useful affiliations and interests and connections; and we can see no reason why they should be forced to give up these connections and relationships.

However, those are minor matters compared to the point I want to emphasize: that the provisions of this bill, giving these powers to the shareholders, will drive an old and honorable method of doing business out of the investment field—to wit, the Massachusetts business trust.

I should like to submit these lines of an amendment which, as I see it, is the only way to prevent that happening. I should like to submit a new subsection, lettered (c) to be added to section 45, and to read as follows:

(c) The provisions of subsection (b) of section 13, subsection (b) of section 15, of section 16, and of subsection (a) of section 32 shall not apply to any registered

investment company organized or established as a trust pursuant to the common or statute law of the State in which it was organized or established, and the provisions of section 18 relating to voting rights shall not apply to any security issued by such company.

That is the end of the suggested clause. Those sections are the sections which require the majority of the shareholders to approve management contracts and allow them to terminate them, to elect trustees, to approve any change in fundamental policies, and to approve the selection of accountants.

Senator HUGHES. That would go at the end of what section?

Mr. CURTIS. A new subsection (c) added to section 45; that would be added to section 45; yes.

Senator HUGHES. This thought occurs to me: Would your amendment apply to trusts hereafter created, as well as trusts already in existence?

Mr. CURTIS. I think that ought to apply to all trusts hereafter; because I think it is a form of doing this sort of a business that ought to be kept open and allowed in the future, just as much as it has been allowed in the past, and to allow the present ones to have competitors in the future.

Senator HUGHES (presiding). Thank you, Mr. Curtis.

Mr. CURTIS. Thank you very much, sir.

Senator HUGHES (presiding). Mr. Eaton, please.

STATEMENT OF CHARLES F. EATON, JR., PRESIDENT, EATON & HOWARD, INC., BOSTON MASS.

Senator HUGHES. Mr. Eaton, will you proceed, please?

Mr. EATON. Senator Hughes, I am Charles F. Eaton, Jr., president of Eaton & Howard, Inc., investment managers or investment counselors. I represent perhaps the only firm of recognized investment counsel appearing under title I. We have our principal office in Boston. By the way, sir, my office as president of Eaton & Howard, Inc., is the only office I hold and the only office I have ever held. I have held it since our firm was incorporated.

I feel that I must tell you something of the business of the company which I represent, in order to make clear to you what I consider to be some of the problems which would appear to us practically insurmountable if the bill, as now proposed, should be enacted into law.

May I say that what I have to say will not take very long, and I should be happy to have interruptions, if you choose to do so.

Senator HUGHES. Very well.

Mr. EATON. I am going to be rather personal in presenting this to you because our own business is the one that I really know about, but I am convinced that it is typical of a number of others in the industry. It seems to me that is the only way—through studying the application of the bill in specific instances—that we are able to appreciate its far-reaching effects.

We have been in business since 1924. At the present time there are 36 persons in our organization, that is, officers and others. Of this number, 30 were graduated from leading universities of the country, and 13 have studied in graduate schools. I mention this merely to give you some idea of the size or perhaps I should say, lack of size of our organization, and more particularly to suggest to you the type of personnel.

Our principal business, then, is to render investment counsel or investment management to persons whose accounts are of sufficient size to be handled individually. To take care of persons of moderate means desiring our service, we have established certain management funds—that is, we call them management funds—which are known to you as investment trusts.

As an organization, our personnel is, I believe, not only qualified to serve as investment counselors but also is well qualified to serve the investor of moderate means honestly, adequately, and economically through these trusts.

My firm would appear to be affected by the proposed law, both in regard to these management funds and also our general management and counsel business. For the present, I propose to discuss our problem from the trust angle alone, namely, title I, and with emphasis on a few of the difficulties which we would be forced to meet.

Different people naturally have different investment requirements. For example, the investment problem of a business man may be quite different from that of a person without earning power. To meet to some extent these different objectives, we now sponsor and manage two investment trusts.

The form of a trust with transferable shares has long been used in Massachusetts as a medium for investment. Its general characteristics have been described to you, just now, by the previous witness, Mr. Curtis. One of the principal points of difference between such a trust and a corporation is that in the trust the control is in the management, as distinguished from the shareholders. It is also my understanding that the duties of the trustees of such a trust and the rights of the shareholders are generally spelled out through the trust instrument in greater detail than in the case of a corporation.

As Eaton & Howard, Inc., is not a trust company, it cannot in Massachusetts act as the trustee of the trusts which we have created. Therefore, certain of the officers of the corporation, as individuals, are the trustees. We do not want and we should not have any so-called outside directors or trustees. The management of the trusts is Eaton & Howard's responsibility, and the officers of Eaton & Howard seem to us the proper persons to serve as trustees. This is a point on which we feel very strongly and about which I shall speak later.

Let me tell you a few of the restrictions which our trust indenture places on the management:

The trustees, as such, may receive no compensation.

Senator HUGHES. You are a corporation?

Mr. EATON. Yes, sir; we are a corporation.

Senator HUGHES. You are now a corporation?

Mr. EATON. Yes, sir.

The compensation of our company, which sells the shares and manages the trusts, is limited to 6 percent on sales—one-half of 1 percent a year for management, and 1 percent on redemption. That is when a person withdraws his shares.

A shareholder may redeem his shares at any time. There can be only one class of shares outstanding. These restrictions are in our trust indenture.

The managers may not resign or withdraw except after 60 days' notice to each shareholder, thus giving him 60 days within which to redeem, if he objects to the proposed change of management.

The trustees and managers are prohibited from dealing with themselves as principals or from making any personal profit on transactions for the trusts—thereby eliminating, we believe, loans to officers and also eliminating other possible conflicts of interest.

Not more than 5 percent of the assets can be invested in the securities of any one company, and not more than 10 percent of the securities of any one company may be owned by the trust—thereby preventing pyramiding or control.

There is an absolute prohibition against borrowing; in other words, we do not borrow at all; and there is also an absolute prohibition against pledging or mortgaging the assets of the trust—thereby preventing buying on margin.

These are restrictions which we have imposed upon ourselves. They cannot be changed except with the written consent of a majority in interest of our shareholders.

In our opinion, these restrictions go beyond the requirements of the proposed law in preventing the abuses which have occurred in certain parts of the investment company field.

Senator HUGHES. Excuse me just a minute, please.

Mr. EATON. Yes, sir.

Senator HUGHES. You imposed those restrictions on yourself, by means of a contract?

Mr. EATON. They are a part of the trust indenture.

Senator HUGHES. They are a part of the trust indenture?

Mr. EATON. Yes, sir; they cannot be changed except by vote of the majority of the shareholders.

I have said that we believe these restrictions go beyond the requirements of the proposed law in preventing the abuses which have occurred in certain parts of the investment company field. Yet, what happens? In spite of this, in spite of the fact that we have eliminated the possibility of most, if not all, of the abuses at which the law is directed, the proposed law would put our trusts out of business and would greatly restrict our operation along lines which we believe to be sound and in the interest of our clients. I can assure you, gentlemen, there are other trusts and corporations doing a comparable job, and which would be similarly injured.

I shall try now to show you a few of the ways in which this bill vitally affects us, and in this connection shall confine myself to the provisions relating to open-end management companies and, in fact, to those affecting diversified management companies within this group.

First, I should like to point out what I consider is a fundamental feature in the philosophy behind a so-called open-end company.

The open-end or mutual company is one in which a shareholder may at any time on short notice take his shares to the company and demand that they be redeemed at substantially their liquidating value. I have described how our investment funds or trusts were created to serve the investor with insufficient funds for us to handle as a separate account. The shareholder has, in effect, a diversified investment account under our management; he is the beneficiary of a commingled fund. In all our individual accounts, a client may terminate his management contract with us at any time. He may at any time decide to manage his own securities or take them somewhere else for management. To provide as nearly as possible the same

opportunity for a shareholder in our funds, we adopted this redemption feature which, in effect, says to a shareholder:

For any reason, at any time, you may terminate the arrangement and have the liquidating value of your shares at the time, less a fee of 1 percent which represents an approximation of the cost of redemption.

There has been some talk in these hearings about control and there are many references in the bill to control by the stockholders. In my opinion, there has been in the past much loose talk and even sloppy thinking about the subject of control.

There is more than one consideration to this question of control. When an investor comes to us and buys shares in our fund—and right here I might mention that the average investment in our largest fund is over \$5,000 per shareholder. I think those figures hold for the smaller fund, but I know these are correct figures in the case of our largest fund.

When an investor buys a share in the fund, whom does he want to control his money? Does he want it to be subject to the control of a majority in interest of those persons who happen to be at any one time the shareholders of the trust; or does he want us, whom he has selected to manage his property, to have control—subject, of course, to the restrictions placed on that control through our trust indenture, which includes his right of redemption? Does he want to have it possible for a group, alien to our management, by buying some shares to start a proxy fight and try to get control of his money, or does he want the assurance of continuity of management in those persons he has selected?

Bear in mind, please, that this investor, himself, has the right to change the management, by redeeming his shares at any time at their approximate liquidating value. It is our opinion that when he buys our shares he wishes the control to be in us, subject to his right of redemption; and the bill's provisions regarding limiting a management contract to 2 years, making it subject to annual approval, and making the directors or trustees subject to annual election, are entirely out of place and are uncalled for, when applied to an open-end diversified investment trust, and are based on a misconception of the underlying philosophy of such a trust.

I believe the commission recognizes that true control by scattered stockholders is difficult, if not impossible of accomplishment. Yet the control which a shareholder in an open-end trust has over his own funds, through the redemption feature, is a very real and valuable control. Since scattered stockholders usually vote the way the management requests, the provisions for voting by shareholders may not be regarded as objectionable to most of the investment companies appearing before you, and may not be strongly criticized. I do not mean that is the only reason; but they just may not criticize. We do.

However, gentlemen, please remember that it is easy for a person not affected by a proposed regulation to acquiesce.

I should like to put special emphasis on that point, because I may be doing it myself.

This subject of voting by shareholders is vital to us and to a number of others. Our attorneys advise us, as you have already heard—but I should like to mention it again—that if our trust permitted the annual election of trustees, as required by section 16, our shareholders would be regarded under Massachusetts law as partners and, as such, would

be personally liable for any debts or obligations of the trust—obviously preventing the salability of the shares. The shareholders not only would be surprised, but I would be surprised if we got any more shareholders. Of course, Senator, it was Mr. Curtis who spoke of the shareholders' being surprised.

Thus, sections 15 and 16 of the proposed bill would necessitate a complete reorganization of our trusts, and these sections probably would mean the dissolution of our trusts. The difficulties, expense, and confusion involved would be an unfair burden to our shareholders and to us.

To summarize briefly, continuity of management is something for which an investor naturally looks when seeking to invest his money. He derives a feeling of assurance from the realization that the persons from whom he purchases shares in a trust are responsible for the continued management of the trust and cannot get out of this responsibility without notice to him. The testimony before the Commission has disclosed the importance of not permitting a change to other management, which may be irresponsible, without adequate notice to the investor. The proposed bill, in this same paragraph 15, recognizes this danger and requires the termination of a management contract upon its assignment. We have no fault to find with this provision; but to require annual approval of, or permit the change of, management by a percentage of stockholders may, in our opinion, be bringing about a contrary result, in leaving management the football of a proxy fight to be thrown out by some unscrupulous group having no responsibility to the shareholders in the original sales of the shares.

I believe that the provisions requiring election of trustees and approval of the management contract are both unnecessary and unsound in principle; and in the case of an open-end investment company with redeemable shares, I believe that a provision requiring adequate notice before any change could be made in a majority of the trustees or in the management contract, would accomplish all that is being sought by these sections.

As I have outlined, our corporation organized our trusts, sells the shares—receiving a commission of 6 percent on such sales, and manages the trusts for a fee of one-half of 1 percent a year. This bill would prevent us from both selling the shares and managing the trusts. Thus, it would appear that selling the shares of a trust which you intend to manage is a vice. This idea, to my way of thinking, is ridiculous.

Here, again, I believe that some of the abuses indulged in by persons who were improperly representing the shares they were selling, and who were improperly managing the trusts whose shares they sold, have clouded the issue. We take a stand diametrically opposed to that premise which would separate sales from management. Unity of sales and management in one organization is, in our opinion, a virtue and a protection to the investor, rather than a vice. Our obligation to manage assures to the investor a continuing responsibility for the article which he has purchased. As sellers, we are vitally interested that the management is good and that the management costs are kept at a minimum. As managers, we are interested that the selling policy is sound and that the selling costs are low.

Thus, we avoid any risk of a temporary selling organization which may go out of business as soon as the profits from sales disappear.

Having given the trusts our name, we feel ourselves responsible, and we would refuse to permit anyone else to manage them. Conversely, as investment managers we have in more than one instance declined to manage a trust sponsored by others, because we would not have the power of control over the sales policy, which we consider so important.

Under an exception in the proposed bill, if we were merely advisers to the trusts and did not actually manage them, we could also sell the shares, provided our selling charge did not exceed 1 percent.

This exception for an investment adviser does not make sense to us, where it is provided that the sales load may not exceed 1 percent. If our principle is sound—and we believe it is—that the selling of the shares by the same organization which manages the trust is a protection to the investor, then why should the selling commission be limited so that such an organization is virtually put out of business by being limited to a commission at which one cannot afford to sell, and being in competition with other trusts whose selling commissions are unlimited, under the bill?

High-grade, honest salesmanship is one of the greatest assets in our national economy. I personally believe in it. Why penalize the type of organization which, from its very set-up in having to manage the funds whose shares it sells, is likely to use the most conservative sales methods? Yet, that is exactly what this separation does. If there had been more sales of shares of the type of companies for which I speak, the losses to investors, through the abuses about which you have heard, would have been greatly reduced.

May I record here a conviction that I have held for at least 15 years—that is, most of the time I have been in business; namely, that if an adequate selling commission had been placed on good securities, rather than on the poorer securities, the average investor would never have had such grief as he has had in recent years.

I, as an investment counselor, and individually in connection with such organizations, have seen many lists where the proverbial Susie Jones has owned five bonds of an issue where the seller has obviously obtained \$50 to \$100 commission, and one bond where the seller has obtained \$10 commission. I am thinking of lists that go back over a period of years; and had that been reversed and had the selling commission been equalized, then I do not think that would have happened.

I believe the provision requiring the separation of the selling of open-end investment trusts from management should be eliminated. I believe that if there is to be a provision exempting trusts which are run by investment advisers, it should be extended to include investment managers as well; and I further believe if there is to be such an exemption, there should be no discrimination against such trusts, in the form of a limitation on the selling commission.

The next point I want to touch upon is the matter of conflicts of interest. The title of section 10 of the bill reads: "Affiliations involving conflicts of interest." It apparently is aimed to eliminate those abuses which are referred to in paragraph 2 of the declaration of policy of the bill—namely, cases where investment companies are organized or managed in the interest of others than the shareholders of the company.